

Statement
Of
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Before the Senate Committee on Banking, Housing, and Urban
Affairs

On
Enhancing Investor Protection and the Regulation of the Securities
Markets

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Thank you Chairman Dodd and Ranking Member Shelby for holding this hearing on an issue important to not only investors in America's capital markets, but to all who are being impacted by the current economic devastation.

Before I start with my personal perspective on international accounting standards, it might be worthwhile to provide some background on my experience. I serve as a trustee of a mutual fund and a public pension fund. I have served as an executive of an international semiconductor manufacturer as well as on the board of directors of both Fortune 500 and small cap public companies. In the past, I served as chief accountant of the U.S. Securities and Exchange Commission (SEC) and as a partner in one of the major international auditing firms. I also was the managing director of research at a financial and proxy advisory firm. In addition, I have also been a professor of accounting at a major U.S. public university and an investor representative on the Public Companies Accounting Oversight Board Standards Advisory Group and the Financial Accounting Standards Board's (FASB) Investor Technical Advisory Committee.

The Crisis – Bad Loans, Bad Gatekeepers and Bad Regulation

The economic crisis of 2007-2009 has three root causes; the making of bad loans with other peoples money, gatekeepers who sold out and a lack of regulation. In order to prevent a repeat of this debacle it is of paramount importance that policy makers understand what will cure the "disease" before they remedy the cause. To that end, I would urge the committee to take the same approach it did some seven decades ago when the Senate Banking Committee, with experienced investigators using its subpoena powers, investigated the banking and security markets, stock exchanges and conduct of their participants. A similar approach in the midst of the current crisis would give Americans and investors hope and confidence that their interests will be served, and adequate protections restored. Unfortunately, if the public perceives the remedy is off target, as it has with other recent legislation, I fear the markets will continue their downward spiral resulting in a lengthening of the recession, or potentially worse outcome.

From my perspective, those most responsible for the current crisis are the banks, mortgage bankers, and finance companies who took money from depositors and investors and loaned it out to people who simply could not, or did not repay it. In some instances predatory practices occurred. In other instances, people borrowed more than they should have as Americans in general "leveraged" their personal and corporate balance sheets to the max. Speculators also took out loans expecting that real estate values would continue to rise, allowing them to profit from flipping their investments. But who can dispute that when "liar," "no doc" and "Ninja loans" are being made while banking regulators are watching, there is something seriously wrong.

In addition to the financiers, a second problem was the gatekeepers – the credit rating agencies and underwriters – who are suppose to protect investors. They did anything but

that. Instead they became the facilitators of this fraud on the American public, rather than holding up a stop sign and putting the breaks on what was occurring. They became blinded by the dollars they were billing rather than providing insight to the public into the perfect storm that was forming. Recent testimony before the House of Representatives that the rating agencies knew their models did not work, but did not fix them was stunning. But perhaps not as stunning as the report of the SEC in which employees of an agency stated they would rate a product even if it had been created by a cow.

And while lenders were making bad loans in exchange for up front fees, and gatekeepers were falling down on the job, federal government agencies were failing to supervise or regulate those under their oversight, as well as failing to enforce laws. It is a huge public concern that a systemic failure of financial and securities market regulation in this country occurred. Some of this was due to the lack of regulation of new products and institutions, such as credit default swaps and hedge funds, but more importantly, the fundamental problem was the lack of Federal government regulators doing their jobs, or lacking the resources to do so.

For example, for thirteen years, as abuses of sub prime lending occurred, the Federal Reserve refused to issue regulations as mandated by the Homeownership Equity Protection Act of 1994 (HOPEA). That legislation specifically stated:

“PROHIBITIONS- The Board, by regulation or order, shall prohibit acts or practices in connection with--

 ` (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and

 ` (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.'.

...Not less than once during the 3-year period beginning on the date of enactment of this Act, and regularly thereafter, the Board of Governors of the Federal Reserve System, in consultation with the Consumer Advisory Council of the Board, shall conduct a public hearing to examine the home equity loan market and the adequacy of existing regulatory and legislative provisions and the provisions of this subtitle in protecting the interests of consumers, and low-income consumers in particular...”

Yet the Federal Reserve, which had examiners in the very banks who were making mortgage loans did nothing. Had the Federal Reserve acted, much of the subprime disaster might have been averted. Instead, ignoring the clarion calls of one of its own Governors for action, the late Edward Gramlich, it was not until 2007 that the Federal Reserve acted. But by then, much of the damage to the American economy and capital markets had been done.

Indeed, even the Comptroller of the Currency spoke in 2006 of three years of lowering of lending standards. In a press release in 2006, the Comptroller stated:

““What the Underwriting Survey says this year should give us pause,” Mr. Dugan said. “*Loan standards have now eased for three consecutive years.*” The Comptroller reported “slippage” in commercial lending involving leverage lending and large corporate loans as well as in retail lending *with significant easing in residential mortgage lending standards including home equity loans.*” [Emphasis supplied]

Unfortunately, armed with this information and legislative authority to fix the problem, the OCC failed to act in earlier years. Rather than reining in these abusive practices, the OCC permitted them to continue, with the most toxic of the sub prime loans being originated in 2006 or 2007. And today, we have Inspector General reports that have cited the lack of action by the OCC and OTS, leaving taxpayers and investors exposed to losses totaling trillions of dollars.

What is equally troubling about this lack of action by the banking regulators, is that it comes after similar problems occurred with the crisis in the savings and loan and banking industries in the 1980’s and early 1990’s. I was at the SEC at that time and watched as the Federal Reserve who had oversight over an undercapitalized Citi Bank, worked to keep it afloat. It seems that we are seeing a repeat performance of this situation and rather than having learned from history, we are again repeating it. After having two swings at the bat, I wonder why some want to make the same regulators the risk regulator for the entire financial system in the United States. These are regulators who all too often have been captured by the regulated.

Once again, as with Enron, a lack of transparency has also been a contributing factor to the current crisis. Investors have time and time again – from Bear Stearns to Lehman to Wachovia to Citigroup and Bank of America – questioned the validity of the financial numbers they are being provided. The prices of their stocks have reflected this lack of credibility driven by transactions hidden off the balance sheets and values of investments and loans that fail to reflect their real values.

Unfortunately, millions of bad loans were made that are not going to be repaid. While financial institutions argue they will hold the loans to maturity and be repaid, that just isn’t true for loans subject to foreclosures or short sales. And for many mortgages, they prepay and once again are not held to maturity. At the same time, collateral values of the underlying assets securing the loans have taken a tremendous tumble in values. Almost 5 million Americans have lost their jobs since this recession began impacting their ability to make their mortgage payments. There is a years worth of inventory of unsold homes on the market even further depressing home prices. Asset backed securities are being sold in actual transactions at pennies on the dollar. Yet the financial institutions continue to act like an ostrich with their head in the sand and ignore these facts when valuing their assets. At the same time however, the markets are looking through these numbers and revaluing the stocks in what is an inefficient approach, driving stocks of some of the

largest financial institutions in this country to a price that is lower than what you can buy a Happy Meal for at McDonalds.

In 1991 the General Accounting Office published a report titled “Failed Banks – Accounting and Auditing Reforms Urgently Needed.” In that report, the GAO noted how during the savings and loan crisis, the failure of banks and savings and loans to promptly reflect their loans and assets at their market values drove up the cost to the taxpayer. I hope Congress will not allow this mistake to be repeated by allowing banks to avoid marking their assets to market.

Managing the assets held by a financial institution and the positions taken has also been lacking. One large institution that was failing and required a bailout through a buyer did not even have a chief risk officer in place as the risks that caused their demise were entered into. This could have been avoided in if the recommendations of the Shipley Working Group on Public Disclosure had been adopted by the banking and securities regulators that had convened the group. Instead, consistent with a deregulatory approach, the type of risk disclosures the group called remained nonexistent, hiding the build up of risks in the financial system.

There has also been a lack of regulation of new products and institutions. Credit rating agencies were not subject to regulation by the SEC until after many of the sub prime loans had been made. Credit default swaps and derivatives were specifically exempted by Congress from regulation, despite a plea for regulation from the CFTC chairman, creating grave systemic risks for the financial system. These markets grew to over \$60 trillion, a multiple of many times the actual debt subject to these swaps. In essence, a betting system had been established whereby people were wagering on whether others would pay their debt. But while we regulate betting in Las Vegas, congress chose to specifically not regulate such weapons of mass destruction in the capital markets. This has directly led to the bailout of the bets AIG placed, and those to whom it owes on those on those bets, now aggregating more than \$160 billion.

Likewise, there has been a rise in a shadow banking system that includes hedge funds and private equity firms. These funds have under management money from many public sources, such as public pension funds and their members and the endowments of colleges and universities. Yet they remain largely opaque and these unregulated entities have been allowed to co-exist along side the regulated firms as a push was made for less regulation. That push was advanced by an argument that the markets can regulate themselves, a perspective that has been proven to totally lack any credibility during this decade of one scandal after another. Others said that without regulation, these unregulated entities could innovate and create great wealth. Unfortunately, their innovation has not always created wealth and in other instances has been quite destructive.

The sub prime crisis, and our economic free fall, is the showcase for what can happen without adequate regulation and enforcement. Those who made the loans including mortgage bankers, the credit rating agencies who put their stamp of approval on the

Ninja, no doc and liar loans, and the investment bankers who packaged them up and sold them to an unsuspecting public were all unregulated or regulated only in a token fashion.

Unfortunately, the deregulation of the U.S. capital markets that many not so long ago called for, has not resulted in increased competitiveness of the markets. Rather it has left the preeminence and credibility of our capital markets shattered. Instead of making the allocation of capital more efficient, it has resulted in a lack of transparency and mispricing and misallocation of capital. Investors have watched as over ten trillion in wealth has disappeared. And instead of fueling a growth in our economy, we have seen it fall into a decline the likes that haven't been seen since the great depression. Indeed, some have now called our situation the "Not So Great Depression" and one commentator, Stephen Roach of Morgan Stanley has warned of a Japanese style economy that continues to this day to sputter along.

Reforms - The Long Road Back

On a bipartisan basis, we have dug the hole we find ourselves in over an extended period of time. During much of that time we have enjoyed economic prosperity that in recent years contributed to the "suspended disbelief" that the good times would never end. All too often people spoke of the "New Economy" and those who doubted it or warned of dangers were treated as outcasts. But as with many a bubble in the past, this one too has burst.

The capital markets have always been the crown jewel of our economy – the engine that powered it. And it can once again achieve that status, firing on all cylinders, but only if care is taken in structuring reforms.

Basic Principles

In creating regulator reform, I believe there are some critical fundamental principles that should be established. They include:

1. Independence.
2. Transparency.
3. Accountability.
4. Enforcement of the law.
5. Adequate Resources

Independence

Those responsible for oversight, including regulators and gatekeepers, must be independent and free of conflicts and bias when doing their jobs. And it is not just

enough that they are independent on paper, they must be perceived by investors to be free of conflicts avoiding arrangements that cause investors to question their independence. They need to be free of political pressures that unduly influence their ability to carry out their mandates to protect the American consumer and investor. They must avoid capture by the regulated. And their ability to get resources should not be contingent on whether they reach a favorable decision for one group or another.

This is especially true of regulators such as the SEC and CFTC. These agencies must avoid becoming political footballs thrown between opposing benches. Unfortunately, that has not always been the case as we saw recently at the SEC or with the CFTC when it asked for regulation of credit derivatives.

Similarly, the credit rating agencies have suffered from some of the same lack of independence the auditors did before Enron, WorldCom and the enactment of the Sarbanes-Oxley Act of 2002. They became captured by the desire to increase revenues at just about any cost, while ignoring their gatekeeper role.

Independence also means there is a lack of conflicts that can impact one's independent thinking. For example, when a bank originates a sub prime loan it may will ask its investment banking arm to securitize it. But if it is a no doc, liar loan or Ninja loan, will the investment banker perform sufficient due diligence and ensure full and fair disclosure is made to the investors clearly delineating in plain English what they are being sold? I doubt that has really occurred.

Unfortunately, when the Gramm Leach Bliley act was passed, allowing the creation of giant financial supermarkets, it failed to legislate and adequately address such conflicts. In fact, it did not address them at all leaving us with huge conflicts that have now given rise to investments that are not suitable for the vast majority of investors. Given this act gave an implicit blessing to the creation of institutions that are "Too Big To Fail" and knowing that after the failure of Long Term Capital management the creation of such institutions brings with it the backing of taxpayers money, this serious deficiency in the laws governing regulation of conflicts of interests in these institutions needs to be addressed in a robust fashion.

Transparency

Transparency is the life blood of the markets. Investors allocate their capital to those markets where they get higher returns. Investors need the best possible financial information on which to base their decisions as to which capital markets they will invest in, and which companies, in order to generate the maximum possible returns. Maximizing those returns is critical to investors, and institutions who manage their investments, as it determines how much they will have for retirement, or spending.

Investors will allocate their capital to those markets where returns are maximized. While economic growth in a particular country has a significant impact on returns for a capital market, the quality of the information provided to those who allocate capital also

significant impacts it. In general, the better the information, the better the decisions made, and the more efficiently capital is allocated and returns maximized.

The U.S. capital markets have maintained their lead in transparency, albeit our pride in that respect has been tarnished by off balance sheeting financings, a lack of disclosures regarding the quality of securities being sold, and credit ratings that were at best poorly done, if not outright misleading. Nonetheless, even in today's markets, the US markets have continued to outperform foreign markets.

Accountability

Accountability clearly places the responsibility for decisions made and actions taken. People act differently when they know they will be held accountable. When people know there is a state trooper ahead on the highway, they typically drive accordingly. When there is no trooper, a portion of the population will hit the accelerator and speed ahead.

There needs to be greater accountability built into the system. The executives and boards of directors of the financial institutions that have made the bad loans bringing our economy to its knees, and causing Americans to lose their jobs, students to have to forgo their education, all at a great cost to the taxpayer should be held accountable. The American public will demand nothing less.

The banking, insurance, commodities and securities regulators all need to have greater accountability. We need to know that we have a real cop on the beat, not just one in uniform standing on a corner.

Likewise, gatekeepers must be held accountable for the product they provide the capital markets. Their product is critical to ensuring the credibility of financial information needed for capital allocation.

Enforcement

We are a nation of laws. The laws governing the capital markets and banking in this country have been developed to provide protections for investors and consumers alike. They provide confidence that the money they have worked hard for, when invested, is safe from abusive, misleading and fraudulent practices. Without such laws, people would be much more reluctant to provide capital to banks and public companies that can be put to work creating new plants and products and jobs.

But laws aren't worth the paper they are written on if they are not properly enforced. An unlevelled playing field in the markets brought on by a lack of enforcement of laws providing consumer and investor protections can have the devastating effect we are now seeing. For example, the Financial Accounting Standards Board Chairman has written members of this committee citing how some institutions were not properly following the

standards improperly hiding transactions off balance sheet. Yet to date, enforcement agencies have not brought any cases in that regard.

And laws are not just enforced by the law enforcement agencies, but also through private rights of actions of investors and consumers. This is critically important as law enforcement agencies have lacked the adequate resources to get the job done alone.

Unfortunately, in recent years we have seen an erosion of investor and consumer rights to enforce the laws. Court cases setting up huge hurdles to these attempts to enforce the laws have made it much more costly taking significant time and resources to get justice. For example, one such court decision has now made it in essence legal for someone to knowingly aid another party in the commission of a fraud on investors, yet be protected by the courts from legal liability. It is akin to saying that if one drives a get away car for a bank robber, they can go to jail. But if one wears a white collar and provides assistance to such a fraud in the securities market, they get a pass. Something is just simply wrong when that is allowed to occur in this nation of laws. Congress needs to remedy this promptly with legislation Senator Shelby introduced seven years ago in 2002.

Likewise we have seen passage of laws such as the Commodities Modernization Act of 2000 which also put handcuffs on our enforcement and regulatory agencies. This act passed in the waning moments of that Congress at the requests of special interests and supported by government officials, specifically prevented the SEC and CFTC from regulating the hundreds of trillions derivatives market. These handcuffs need to be promptly removed. The Securities and Commodities laws need to be clarified to give the CFTC the authority to regulate commodities and any derivative thereof such as carbon trading, and the SEC the authority to regulate securities and any derivative thereof such as credit derivatives.

Adequate Resources

No one can do their job if they are not provided the proper tools, sufficient staffing and other resources necessary for the job. This includes being provided the necessary authority through legislation to do the job. It means congress has to provide a budget to these agencies to hire sufficient number of staff. But it is not just the numbers that count, the agencies must also be given enough money to hire staff with sufficient experience. For example, while I was at the SEC, the budget you provided to the agency did not give the Office of Compliance and Inspections and Examination a sufficient number of staff. And it certainly did not provide the office with enough money to hire senior experienced examiners who had the type of depth and breadth of expertise in the industry that was necessary to do the job right. Whose fault is it then when that agency fails to detects frauds through their examinations? I would say a good part of the blame lies at the feet of Congress.

I would urge you to take a look at how these agencies that are so critical to the proper functioning of our markets are funded. In the case of the SEC, it collects sufficient fees to pay for an adequate budget yet each year it must go hat in hand to ask for a portion of

those fees that has not met its, or the investing publics, needs. Instead, the SEC should be removed from the annual budget process and established as an independently funded agency; free to keep the fees it collects to fund its budgets.

Necessary Reforms

Once again, before legislating reforms, I would urge this committee to undertake “Pecora” hearings to ensure it gets the job done right. Some of the reforms that I believe are necessary, and which could be examined in such hearings include the following;

Regulatory Structure: Arbitrage among banking regulators should be eliminated, and accountability for examination and regulation of banks centralized in one agency. To accomplish that, Congress should once again consider the legislation offered in 1994 by the former Chairman of this Committee, Donald Reigle. That legislation would combine the examination function into one new agency, while having the FDIC remain in its role as an insurer and the Federal Reserve as the central banker. Careful consideration needs to be given to the conflicts that arise when the central banker both sets monetary policy, such as when it created low interest rates earlier this decade, and then regulates the very banks such as Citigroup and Country Wide that exploit that policy, and at the same time fails to put in place safeguards as the Fed had been asked to do by Congress in 1994. And the mission of the new agency, the FDIC and Fed with respect to consumer and investor protection needs to be made much more explicit. All too often these regulators have been captured by industry, much to the detriment of consumers and investors and in the name of safety and soundness. Yet we have learned that what is good for consumers and investors alike, is also good for safety and soundness, but not necessarily the opposite.

I believe the roles of the CFTC and SEC should be clarified. I do not support the merger of the two agencies as I don’t believe the synergies some believe exist will be achieved. I also believe commodities and securities are fundamentally two different markets, with significantly differing risks, and the regulator needs significantly differing skill sets to regulate them. Accordingly, as I have previously mentioned, I would clarify the roles of these two agencies by giving all commodities and derivatives thereof to the CFTC to regulate, and all securities and derivatives thereof to the SEC.

Some have argued for the creation of new agencies. Too date; I have yet to see the need for that. For example, some have argued that a separate investor and consumer protection agency should be created. However, when it comes to the securities markets, I believe the SEC should continue in that role, and given the resources to do so.

Over the years, the SEC has shown it can be a strong investor protection agency. It has only been in recent years, when quite frankly people who did not believe in regulation were appointed to the Commission, that it fell down on the job. By appointing investor minded individuals to the Commission, who have a demonstrated track record of serving and protecting the public, this problem can be fixed. Likewise however, if a separate

agency is created, but the wrong people put in place to run it, we will see a repeat performance of what has occurred at the SEC.

Gaps in Regulation: There are certain gaps in regulation that are in need of fixing. Credit derivatives should become subject to regulation by the SEC as Chairman Cox urged this committee to do some time ago. While the establishment of a clearing house is a positive development, in and of itself it is insufficient.

I understand the securities laws generally exclude over-the-counter swaps from SEC regulation. This improperly limits the SEC's ability to provide for appropriate investor protection and market quality. The OTC derivatives market is enormous, and proper regulation is in the public interest. The SEC would be in a better position to provide that regulation if the following changes were made.

- Repeal the exclusion of security-based swap agreements from the definition of "security" under the Securities Act of 1933 and Securities Exchange Act of 1934.
- Include within the definition of "security" financial products that are economic derivatives for securities. It is important to consolidate the regulatory authority at the SEC because of its investor protection and capital markets mandate. While the SEC has a mandate to protect investors and consumers, other regulators may lose sight of that mission. Based on my business and agricultural background, I have found derivatives in agriculture and other physical commodities have a different purpose than financial derivatives as they permit risk management and secure supplies for users and producers of goods.
- Require all transactions in securities to be executed on a registered securities exchange and cleared through a registered clearing agency.

There needs to be much greater transparency for this market. The recent reluctance of the FED to disclose the counter parties receiving the bailout in connection with AIG is alarming but not surprising. Even the current Fed Chairman has stated this is an agency that has been all to opaque in the past.

There needs to be greater disclosure to the public of the trading, pricing and positions of these arrangements. There also needs to be disclosure identifying the counterparties when the impact of the contracts could have a material effect on their operations, performance or liquidity. Given the deficiencies that have existed in some contracts, there also needs to be more transparency provided around the nature, terms and amounts of such contracts when they are material.

There is also a legitimate question as to whether one party should be able to bet on whether another party will pay their debt, when the bettor has no underlying direct interest in the debt. Certainly as we have seen at AIG and elsewhere, these contracts can have devastating effect and quite frankly, do not serve a useful purpose for the capital markets. As such, I would like to see them prohibited.

There is also a gap in regulation of the municipal securities market as a result of what is known as the Tower Amendment. Recent SEC enforcement actions such as with the City of San Diego, the problems in the auction rate securities, and the lurking problems with pension obligation bonds, all cry out for greater regulation and transparency in these markets. As a result, these token regulated markets now amount to trillions of dollars and significant risks. Accordingly, as former Chairman Cox recommended, I believe Section 15B(d) – Issuance of Municipal Securities - of the Securities Act of 1934 should be deleted.

The SEC should be given authority to regulate hedge and private equity funds that directly or indirectly take public capital including from retail investors, should be subject to the same type of regulation as their counter parts in the mutual fund market. This regulation should give the SEC the (i) authority to require the funds to register with the SEC, (ii) give the SEC the authority to inspect these firms, (iii) require greater transparency through public quarterly filings of their positions and their financial statements and (iv) give the SEC appropriate enforcement capabilities when their conduct causes damage to investors or the financial markets and system.

As testimony before this committee in the past has demonstrated, the SEC has insufficient authority over the credit ratings agencies despite the roles those firms played in Enron and now the sub prime crisis. This deficiency needs to be remedied by giving the SEC the authority to inspect credit ratings, just as Congress gave the PCAOB the ability to inspect independent audits. In addition, the SEC should be given the authority to fine the agencies or their employees who fail to adequately protect investors. Greater transparency should be provided to credit ratings themselves. And disclosure should be required, similar to that for independent auditors of potential conflicts of interests.

The SEC, CFTC and Banking Regulators should also be given powers to regulate new financial products issued by those whom they regulate. This should be accomplished through disclosure. The agencies should have to make a determination that adequate disclosures have been made to consumers and investors regarding the risks, terms conditions of new products before they can be marketed. If a new product is determined by an agency to present great risk to the financial system or investors, the regulating agency should be empowered to prevent it from coming to market, just as is done with new drugs.

In addition, there needs to be greater regulation of mortgage brokers. Some states have already made progress in this regards. However, the federal banking regulators should be given power to provide consumers necessary protections, if they find that state regulators have failed to do so.

Greater Accountability Through Improved Governance and Investor Rights:

Legislation equivalent to an investor’s Bill of Rights should be adopted. Investors own the company and should have some basic fundamental rights with respect to their ownership and investments. It is well known that investors in the U.S. lack some of the

fundamental rights they have in foreign countries such as the United Kingdom, the Netherlands and Australia. Yet while some argue for regulators such as exist in those countries, these very same people often oppose importing investor rights that exist elsewhere into this country.

The excesses of executive compensation have been well documented and need no further discussion. Some have argued that investors have an ability to directly address this by voting for or against directors on the compensation committee of corporate boards. But that is a fallacy. First of all, investors can only vote for a director in the system we have today, a system in need of some repair. Second, some institutional investors who have conflicts due to the fees they receive for managing corporate pension funds at times seems to unduly influence their votes.

To remedy these shortcomings, Congress should move to adopt legislation that would:

- Require majority voting for directors and those who can't get a majority of the votes of investors they are to represent should be required to step down.
- Require public issuers to annually submit to a vote of their investors, their compensation arrangements.
- Give investors who own the company, the same equal access to the proxy as management currently has. While some argue this will give special interests an ability to railroad corporate elections, that simply has proven not to be the case. When special interests have tried to mobilize votes based on their interests and not those of investors, they have ALWAYS failed miserably.
- Investors who own 5 percent or more of the stock of a company should be permitted, as they are in other countries, to call for a special meeting of all investors. They should also be given the right to do so to call for a vote on reincorporation when management and corporate boards unduly use state laws detrimental to shareholder interests to entrench themselves further.
- Strengthen the fiduciary requirements of institutional investors when voting on behalf of those whose money they manage. This should extend to all such institutional investors including mutual funds, hedge funds, public and corporate pension funds as well as the labor pension funds.

Since voting is an integral part of and critically important to governance, greater oversight should be put in place with respect to those entities who advise institutions on how they should vote. Recently a paper from the Milstein Center at Yale has made recommendations in this regard as well. As a former managing director of one such entity, I would support legislation that would:

- Require these entities to register with the SEC as investment advisors, subject to inspection by the SEC. While some have registered, others have chosen not to.

- Require these entities to improve their transparency by disclosing their voting recommendations within a reasonable time period after the vote.
- Require all institutional investors, including public, corporate and labor pension funds to disclose their votes, just as mutual funds are currently required to disclose their votes.
- Require that only the legal owner of a share of stock can vote it, prohibiting those who borrow stock to unduly influence an election by voting borrowed stock they don't even own, and eliminating broker votes.

It should also be made explicit that the SEC has authority to set governance standards for the mutual funds. For example, the SEC should have the authority, and act on that authority, to require a majority of independent directors for mutual funds, as well as an independent chair.

Investor's rights of private actions have also been seriously eroded in the past decade. Certainly we should not return to the abuses of the court system that existed before the Private Securities Law Reform Act was passed. But at the same time, investors should not have to suffer the type of conduct that contributed to Enron and other scandals. And the SEC does not, and will not have the resources to enforce the securities laws in all instances.

The SEC should continue to be supportive of investors' private right of action. The SEC should also continue to support court rulings that permit private investors to bring suits in the event of aiding and abetting and scheme liability. In 2004, the SEC filed an amicus brief in *Simpson v Homestore.com, Inc.* upholding liability against an individual regardless of whether or not the person made false or misleading statements. In 2007, a request from SEC Commissioners to the Solicitor General to submit a brief in favor of upholding scheme liability in the case of *Stoneridge v Scientific-Atlanta* was denied by the White House, despite the urging of Senate Banking Committee Chairman Christopher Dodd (D-CT) and House Financial Services Committee Chairman Barney Frank (D-MA). The SEC needs to reclaim the SEC's role of providing strong support for the right of investors to seek a private remedy.

Investors in securities fraud cases have always had the burden of proving that defendants' fraud caused the investors' losses. Congress continued this policy in PSLRA. However, recent lower-court interpretations of a 2005 Supreme Court case have improperly transformed loss causation into an almost impossible barrier for investors in serious cases of fraud. Congress, with the support of the SEC, should act to fix the law in this area.

Taking advantage of the loophole in the law the courts have now created, public companies have begun gaming the system. Specifically, corporations may now simultaneously disclose other information – positive and negative – in order to make their adverse disclosures "noisy," so that attorneys representing shareholders will find it more

difficult, if not impossible, to satisfy loss causation requirements. Other corporations may leak information related to the fraud, so that the share price declines at an early date, before they formally reveal the adverse news.

In sum, narrow lower-court standards of loss causation are allowing dishonest conduct to avoid liability for fraudulent statements by disclosing that the corporation's financial results have deteriorated without specifically disclosing the truth about their prior misrepresentations that caused the disappointing results. Insisting on a "fact-for-fact" "corrective disclosure" allows fraudsters to escape liability simply by not confessing.

Transparency: The lack of credible financial information has done great damage to the capital markets. This has ranged from a lack of information on off balance sheet transactions as was the case with Enron, to a lack of information on the quality of assets on the balance sheets of financial institutions, to a lack of information on risk management at public entities, to a lack of transparency at regulators.

The lack of transparency begins with accounting standards that yet again have failed to provide the markets and investors with timely, comparable and relevant information. The off balance sheet transactions that expose great risk to the markets, have once again been permitted to be hid from view by the accounting standard setters. What is more disturbing about this is that the standard setters were aware of these risks and failed to act.

To remedy this serious shortcoming, and ensure the standard setters provide a quality product to investors and the markets, I believe that Section 108 of SOX be amended to require that before the SEC recognizes an accounting standard setter for the capital markets, either from the U.S. or internationally, that its board of trustees and voting board members must have preferable a majority of representatives from the investor community and certainly no less than 40% of their membership should be investors with adequate skills and a demonstrated ability to serve the public. In addition, any standard setter should be required to have an independent funding source before their standards are used. And finally, each standard setter should be required to periodically reevaluate the standards they have issued, and publicly report on the quality of their implementation. For too long accounting standard setters have attempted to disavow any responsibility for their standards once they have been issued, a practice that should come to an immediate halt.

The SEC also needs to closely monitor the current efforts of the FASB and IASB to ensure appropriate transactions are brought on balance sheet when a sponsoring company controls, or effectively controls the economics of the transaction. I fear based on developments to date, these efforts may yet once again fail investors.

Transparency of the regulators needs to be enhanced as well so as to establish greater transparency. For example, the regulators should be required in their annual reports to Congress to:

- Identify key risks that could affect the financial markets and participants they regulate, and discuss the actions they are taking to mitigate those risks. For example, the OCC and SEC have had risk management offices for some time, yet their reports have failed to adequately alert Congress to the impending disaster that has now occurred.
- They should have to provide greater detail as to their enforcement actions including the aggregate number and nature of the actions initiated, the number of actions in the pipeline and average age of those cases, the number and nature of the cases resolved and how those cases were resolved (e.g., litigation, settlement, case dismissed).
- Banking and securities regulators should be required to make public their examination reports. The public should be able to see in a transparent fashion what the regulator has found. Regulators who have found problems have all too often not disclosed them to the unsuspecting public or Congress, and in some instances, the problems identified have resulted in the need for taxpayer bailout. That simply should not be allowed to occur. And while some in the industry and banking regulators have indicated such disclosure could harm a financial institution, I believe any such harm is questionable and certainly of much less significance than the damage now being wrought on our economy and society.

The securities and banking regulators should also be required to adopt greater disclosures of risks that can impact the liquidity and capital of financial institutions. The Shipley Working Group encouraged such disclosures. These disclosures should include greater information regarding the internal ratings, risks and delinquencies with respect to loans held by financial institutions. In addition, greater disclosures should be required regarding how a company identifies and manages risk, and changing trends in those risks, with an eye to the future.

Improve Independence and Oversight of Self Regulatory Organizations: FINRA has been a useful participant in the capital markets. It has provided resources that otherwise would not have been available to regulate and police the markets. Yet serious questions have arisen that need to be considered when improving the effectiveness and efficiency of regulation.

Currently the Board of FINRA includes representatives from those who are being regulated. This is an inherent conflict and raises the question of whose interest the Board of FINRA serves. To address this concern, consideration should be given to establishing an independent board, much like what congress did when it established the Public Company Accounting Oversight Board.

In addition, the arbitration system at FINRA has been shown to favor the industry, much to the detriment of investors. While arbitration in some instances can be a benefit, in others it has been shown to be costly, time consuming, and biased to those who are constantly involved with it. Accordingly, FINRA's system of arbitration should be made

optional, and investors given the opportunity to pursue their case in a court of law if they so desire to do so.

Finally careful consideration should be given to whether or not FINRA should be given expanded powers over investment advisors as well as broker dealers. FINRA's drop in fines and penalties in recent years, and lack of transparency in their annual report to the public, raises questions about its effectiveness as an enforcement agency and regulator. And with broker dealers involved in providing investment advice, it is important that all who do so are governed by the same set of regulations, ensuring adequate protection for the investing public.

Enforcement: With respect to enforcement of the securities laws, there are a number of steps Congress should take. After all, if laws are not adequately enforced, then in effect there is no law.

Enforcement by the SEC would be enhanced if it were granted the power to bring civil and administrative proceedings for violations of 18 U.S.C. 1001, and seek civil money penalties therein. 18 USC 1001 is a criminal statute that provides, in pertinent part:

“in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully—

- (1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact;
- (2) makes any materially false, fictitious, or fraudulent statement or representation; or
- (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry;

shall be fined under this title, imprisoned not more than 5 years or, if the offense involves international or domestic terrorism (as defined in section 2331), imprisoned not more than 8 years, or both.”

The SEC should be authorized to prosecute criminal violations of the federal securities laws where the Department of Justice declines to bring an action. When I was at the Commission, it made a number of criminal referrals, including such cases as the Sunbeam matter, that DOJ declined to advance because of resource constraints. Finally the SEC should be provided an ability to take actions for aiding & abetting liability under the Securities Act of 1933. The Commission can bring actions for aiding and abetting violations under the Securities Exchange Act of 1934.

The SEC has been chronically under funded. A dedicated, independent financing arrangement, such as that enjoyed by the Federal Reserve, would be useful is long overdue.

Finally, we have seen serious problems arise for those who have blown the whistle on corporate fraud. Despite the provisions of SOX designed to protect such individuals, regulatory interpretations of that law have rendered it meaningless all too often.

Congress should fix these shortcomings, in part by giving jurisdiction over the law as it is applicable to the securities markets, to the SEC rather than the Department of Labor.

Conclusion:

Improvements to the securities laws and regulations that will once again ensure investors can have confidence they are playing on a level playing field are critical to recovery of our capital markets and economy. Such legislative changes are necessary if a recovery is to occur, but it is equally important that when they are made, they are ones investors perceive as being credible and worthwhile.

Thank you and I would be happy to answer any questions.