

Testimony Concerning
Enhancing Investor Protection and Regulation of the Securities Markets

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I. Introduction

Chairman Dodd, Ranking Member Shelby, and members of the Committee:

Thank you very much for inviting me to testify as we face a critical juncture in the history of our nation's financial markets. I am here today testifying on behalf of the Commission as a whole. The Commission agrees that our goal is to improve the financial regulatory system, that we will work constructively to that end, and that we all are strongly dedicated to the mission of the SEC. In light of the economic events of the past year and their impact on the American people, I believe this Committee's focus on investor protection and securities regulation as part of a reconsideration of the financial regulatory regime is timely and critically important.

Thank you also for giving me an opportunity to talk about the historic mission of the Securities and Exchange Commission, what we do for the nation's investors and capital markets, and how our critical mission is a necessary foundation for a modernized financial regulatory structure. These are matters that have been the central focus of my entire professional career.

I strongly support the view that there is a need for system-wide consideration of risks to the financial system and for the creation of mechanisms to reduce and avert

systemic risks. I am convinced that regulatory reform must be accomplished without compromising the quality of our capital markets or the protection of investors. I am also convinced that getting it right will require hard work, attention to detail, and an overriding commitment - not to engage in bureaucratic turf wars - but to further the public interest. All of that is well within our grasp.

In my testimony this morning, I will explain some general principles that I believe should guide this effort. These principles are: first, an integrated capital markets regulator that focuses on investor protection is indispensable; second, that regulator must be independent; and third, a strong and investor-focused capital markets regulator complements the role of a systemic risk regulator, resulting in a more effective financial oversight regime. Included as an Appendix to my testimony is an overview of the major functions of the SEC, a summary of recent activity, and the resources allocated to each function.

II. A Capital Markets Regulator Devoted To Investor Protection Is Indispensable

All economic activity starts with capital. Small businesses need money to start up, and all companies need capital to innovate, compete, create jobs, and thrive. This capital comes from a variety of sources. Ultimately, capital comes from investors – people who invest directly in companies; people who invest in financial institutions that lend capital; people who invest in mutual funds and other pooled vehicles that in turn invest in America’s businesses; people who buy municipal securities to help fund the operations of state and local governments; and people who look to the capital markets to save, put away money for their kids’ education, and prepare for retirement. Markets that attract this capital are critical to America’s economic future. And a strong, focused,

vibrant, and nimble market regulator is critical to getting investors back into the market and to maintaining their trust and confidence in the future. Such a regulator is fundamental to the future growth of our economy.

That's where the SEC comes in. Let me review some of the core functions of the SEC. These functions are interdependent: remove one function and the agency's capacity to do the others is diminished.

A. Regulation of the Integrity of Markets

Investor protection starts with fair and efficient capital markets. In these tumultuous economic times, despite record volumes and enormous volatility, the markets that the SEC oversees have priced, processed, and cleared trillions of dollars in customer orders in an orderly and fair way. The dollar value of average daily trading volume was approximately \$251 billion a day in February 2009 in stocks, exchange-traded options and security futures. By comparison, the average daily trading volume for such securities was approximately \$87 billion a day in February 1999, and \$10 billion a day in February 1989.

The securities laws and our rules, and the rules of the exchanges and the national securities association we supervise, prohibit fraudulent trading practices, manipulation of securities prices, insider trading and other abuses. These laws and rules require trades to be executed at fair prices, require market participants to keep records of their activities, and require prompt dissemination of pricing information. We regulate transfer agents and clearing agencies, so that transactions are effected seamlessly and without interruption. In overseeing the markets, the Commission is guided by its professional

staff, which has extensive knowledge and expertise developed over decades of overseeing our nation's dynamic capital markets.

Innovation has completely transformed our securities markets over the last decade. The shouts on the trading floors of the nation's securities exchanges have largely given way to the whirl of computers. Transactions that took minutes to execute now take well under a second. In an instant, traders can search within markets and across markets to locate counterparties willing to pay the very best price. Spreads – that is the price differences in transactions captured by intermediaries rather than investors – have narrowed dramatically over the past decade. This has been due in part to the SEC's rules requiring intermediaries acting for customers to trade at the very best prices as well as rules permitting securities prices to be quoted in pennies. In many instances, spreads in stocks have shrunk from twelve cents to less than a penny. According to a 2005 GAO study, decimalization of stock quotes alone cut trading costs by 30-50 percent. We've achieved similar results in the options markets.

These pro-investor changes have been possible because of a regulatory regime that focuses on competition – one that does not pick winners and losers but instead, one that removes barriers to new entrants. It is a regime that requires a focus on the needs of investors and their welfare, allowing market participants to innovate and compete for their customers' business. While it is a regime that works well, it is one that requires a regulator to keep up with the breakneck pace of change in our ever-evolving markets.

This is not to say that our markets always function perfectly. There are practices that are contrary to fair and orderly markets; abusive short selling, for example, would fall into that category. To target potentially abusive “naked” short selling in certain

equity securities, the Commission has tightened up the close-out requirements and adopted a new antifraud rule specifically aimed at abusive short selling when it is part of a scheme to manipulate the price of a stock. And, early next month, the Commission will consider proposals to re-institute the uptick rule, or something much like it.

B. Regulation of the Integrity of Market Information

However well structured, markets fail without timely and reliable information. Accurate information is the lifeblood of the securities market. A big part of the SEC's mission is to safeguard the markets' blood supply. We operate from the premise that our markets work best when investors are fully informed. Our job is to make sure investors get full and complete information. It involves setting meaningful disclosure standards, monitoring compliance with them, and, when appropriate, enforcing the law against those who fail to comply. It also involves programs to equip investors with tools to understand and analyze the market information they receive.

SEC rules require complete and accurate disclosure of information that investors need to make informed investment and voting decisions. Companies cannot raise capital from the public without first filing with us comprehensive disclosures about their business, their performance, and their prospects. One of our major accomplishments over the last few years has been to streamline this process so that potential issuers of securities can raise money more quickly, while providing investors with more, and more current, information.

Registrants file extensive disclosures about their business performance annually and update them quarterly, and – because today's markets demand immediate information – whenever certain specified events occur. We review these filings on a

selective basis, and work closely with reviewed companies to improve the quality of their disclosure. In fiscal year 2008, our staff reviewed the filings of nearly 5000 reporting companies in addition to more than 600 new issuers.

Accurate information, of course, encompasses both words and numbers, and we work to protect the integrity of both. We play a special role in the formation of accounting standards for public companies and other entities that file financial statements with the Commission. We oversee the process by which they are set to ensure that professional, independent standard-setters include those whose primary concern is the welfare of investors, that the deck is not stacked against investors, and that the outputs of the process are fair and appropriate.

There is a delicate balance here. We have authority to set standards, and we use this authority prudently. Sometimes we prod the standard-setters to act more quickly, and we often give them the benefit of our views. But we are convinced that accounting standard-setting should be the product of an independent, expert body that is organized to act in the public interest and with appropriate due process.

While the Commission rarely sets accounting standards, we deal with accounting matters every day. We and our staff provide guidance about how accounting standards should be applied in particular situations; our staff reviews corporate filings to determine whether companies are applying standards properly; and where the accounting is wrong, we ask companies to fix it. Our rules, given new vigor by the landmark Sarbanes Oxley Act that emerged from this Committee in 2002, promote the independence of those who audit the financial statements of public companies.

Investors need accurate and comprehensive information not only when they trade but also when they vote, whether it is to elect directors, adopt compensation plans, approve transactions, or consider shareholder proposals. And so we have a variety of means to promote fair corporate voting.

Speaking for myself, I believe the SEC has not gone far enough in this latter area. And so I intend to make proxy access – meaningful opportunities for a company’s owners to nominate its directors – a critical part of the Commission’s agenda in the coming months

C. Regulation and Oversight of Financial Intermediaries and Market Professionals

For our markets to be fair and efficient and to operate in the best interests of investors, those who control access to our capital markets must be competent, financially capable, and honest. That brings me to a third core function of the SEC: regulation and oversight of financial intermediaries and other market professionals, including approximately 5,500 broker-dealers, over 11,000 investment advisers, stock and option exchanges, clearing agencies, credit rating agencies and others. Exchanges and clearing agencies are an essential part of the plumbing of our financial system. Their smooth operation is something that many Americans take for granted, but that the Commission takes very seriously and works to ensure. Brokers, advisers and credit rating agencies are the entities that Americans turn to for guidance and technical assistance when accessing our nation’s financial markets. It is essential that these firms – and the people who work in them – be held to the high standards expected of professionals.

The SEC’s regulatory role, along with its oversight of the various self-regulatory organizations with respect to financial intermediaries and market professionals, focuses

on helping to ensure that investors are treated fairly and that the institutions managing and processing their investments are subject to meaningful controls to protect investor assets. Our statutes and rules require that brokers and advisers tell investors the truth, that brokers recommend to their customers only those products that are suitable for them to buy, and that advisers act in accordance with their fiduciary duties. In the same way, we require that investment advisers manage any potential conflicts of interests and fully disclose them to investors.

Our capital requirements go a long way to ensuring that customer funds entrusted with a broker-dealer are safe in the event the broker-dealer gets in financial trouble. Again, our focus is not to insulate broker-dealers from competition and the risks of failure, but to protect investors in the event that failures do occur. We conduct examinations of these firms to assess their compliance with laws and regulations. And when we find violations or deficiencies, we direct that corrective action be taken.

Since 2006, with the authority provided by the Congress, we have adopted significant reforms related to credit rating agencies. Given the critical role of ratings in our capital markets, it is essential that we stay active in this area. We have rule proposals outstanding and are convening a public roundtable on possible further reforms to be held next month.

Some of our rules regulating financial intermediaries need to be modernized, and the Commission is considering what, if any, legislation to ask for from the Committee. Among other things, we are considering asking for legislation that would require registration of investment advisers who advise hedge funds, and possibly the hedge funds themselves. We are studying whether to recommend legislation to break down the

statutory barriers that require a different regulatory regime for investment advisers and broker-dealers, even though the services they provide often are virtually identical from the investor's perspective. We also are carefully considering whether legislation is needed to fill other gaps in regulatory oversight, including those related to credit default swaps and municipal securities. It is time for those who buy the municipal securities that are critical to state and local funding initiatives to have access to the same quality and quantity of information as those who buy corporate securities. I will lead the Commission to continue to focus efforts in this area in 2009.

In addition, I have asked the staff to develop a series of reforms designed to better protect investors when they place their money with a broker-dealer or an investment adviser. I have asked the staff to prepare a proposal for Commission consideration that would require investment advisers with custody of client assets to undergo an annual third-party audit, on an unannounced basis, to confirm the safekeeping of those assets. I also expect the staff to recommend proposing a rule that would require certain advisers to have third-party compliance audits to review their compliance with the law. And to ensure that all broker-dealers and investment advisers with custody of investor funds carefully review controls for the safekeeping of those assets, I expect the staff to recommend that the Commission consider requiring a senior officer from each firm to attest to the sufficiency of the controls they have in place to protect client assets. The list of certifying firms would be publicly available on the SEC's website so that investors can check on their own financial intermediary. In addition, the name of any auditor of the firm would be listed, which would provide both investors and regulators with information to then evaluate the auditors.

D. Regulation of Mutual Funds and Other Pools of Investor Money

Most retail investors participate in the capital markets through pooled investment vehicles, the most common of which are mutual funds. The size of these investments is astonishing: mutual funds hold over \$9 trillion in assets -- representing the investments of approximately 92 million Americans. As part of its oversight functions, the SEC focuses on ensuring that funds are run to benefit investors and not insiders. SEC rules also seek to ensure that fund investors are provided accurate, timely and complete information about their funds in a form that is investor-friendly. The SEC requires that funds comply with investor-oriented prohibitions against complex capital structures, excessive leverage and preferential treatment for certain shareholders. In addition, the SEC examines the actions of independent fund directors and chief compliance officers to evaluate whether they are fulfilling their critical responsibilities on behalf of fund investors.

A particular focus of the Commission in coming weeks will be proposals to enhance the standards applicable to money market mutual funds, which are widely used by both retail and institutional investors as a cash management vehicle. The SEC has been closely monitoring money market funds and their investments, since we permitted the first money market fund in the early 1970s. Over that time, we have built up significant money market fund expertise. We will bring that expertise to bear as we act quickly this spring to strengthen the regulation of money market funds by considering ways to improve the credit quality, maturity, and liquidity standards applicable to these funds. These efforts will be aimed at shoring up money market fund investments and

mitigating the risk of a fund experiencing a decline in its normally constant \$1.00 net asset value, a situation known colloquially as “breaking the buck.”

E. Enforcement of the Securities Laws

Finally, there’s enforcement. We are an integrated regulator of the country’s capital markets with an important focus on law enforcement. We enforce the securities laws aggressively and intelligently, without fear or favor. Enforcement is one of our core competencies and a central part of our heritage as an agency.

In the past year alone, the SEC has brought enforcement actions related to sub-prime abuses, market manipulation through the circulation of false rumors, insider trading by hedge funds and other institutional investors, Ponzi schemes, false corporate disclosures, and penny stock frauds. This past year we brought the biggest foreign bribery case ever. We also required securities violators to disgorge illegal profits of approximately \$774 million and to pay penalties of approximately \$256 million, and we distributed over \$1 billion to injured investors.

Enforcement is integrated with our regulation of the capital markets for the benefit of investors. We enforce the securities laws and the rules we promulgate. We understand markets because we regulate them. We understand disclosure because we regulate it. Our regulatory functions add nuance and sophistication to our enforcement efforts, and enforcement adds backbone to our rules. It is all one piece.

We have work to do to stay one step ahead of the predators and sharp practices that prey on investors. It is a never-ending struggle, and it requires never-ending energy and ingenuity. As part of this effort, I expect to come to you in the near term with a request for authority to compensate whistleblowers who bring us well-documented

evidence of fraudulent activity. Currently, we have the authority to compensate sources in insider trading cases. I would like to see this authority extended so that the SEC can further encourage individuals to come forward with helpful information.

III. A Capital Markets Regulator Devoted To Investor Protection Should Be Independent

As we look to the future of securities regulation, we believe that *independence* is an essential attribute of a capital markets regulator that protects investors. There are other agencies of government that touch on what we do, just as what we do touches on other agencies of government. But Congress created only one agency with the mandate to be the investors' advocate. Other agencies have had, as part of their responsibilities, the protection of important financial institutions and, as part of those responsibilities, customer protection. But, as Justice Douglas pointed out long ago, only the SEC has the mission, and the privilege, of serving as "the investors' advocate."

We are a creature of the Congress. The vision of the Congress when it created an independent SEC was to make sure that there was one agency of government focused single-mindedly and without dilution on the well-being of America's investors. That independence has allowed us to build expertise and a culture of investor protection, which benefits the public and the economy. And it has been a tremendous success as U.S. capital markets lead the world.

If there were ever a time when investors need and deserve a strong voice and a forceful advocate in the federal government, that time is now. Individual investors may not be the strongest political force; they are disparate in their backgrounds and not always well-organized or funded. They are typical Americans – our families, friends, and fellow citizens. These investors expect and deserve a strong and independent regulator

dedicated to providing for fair financial dealings, timely and meaningful disclosure of information, and protection from unscrupulous actors.

Congress made us independent precisely so we can champion those who otherwise would not have a champion, and when necessary take on the most powerful interests in the land. Regulatory reform must guarantee that independence in the future.

IV. A Strong and Independent Capital Markets Regulator is Important to Systemic Risk Oversight

An independent, investor-first capital markets regulator is vital to a revamped regulatory structure that pays due attention to overarching systemic risk. Investor protection enhances the mission of controlling systemic risk. More than that, financial services exist to serve investors and our markets, and a focus on investors is absolutely essential to any credible regulatory restructuring. The SEC, as the independent capital markets regulator with unique experience and competencies, must continue to be the primary regulator of important market functions, and would be a critical party in contributing to any systemic risk regulator's evaluation of risks. Appropriate regulation must safeguard both investor protections and important market functions.

The SEC, as a strong independent regulator with market expertise, can perform its critical capital markets and investor protection functions without compromising the oversight of systemic risk. Even as attention focuses on reconsidering the management of systemic risk, investor protection and capital formation – both of which are fundamental to economic growth – cannot be compromised as a product of any reform effort. The SEC stands alone as the government agency responsible for both protecting investors and promoting capital formation for the past 75 years.

To the extent the activities of the SEC touch systemically significant institutions, there is rarely a risk of inconsistency between the SEC and other regulators focused on systemic risk. No one, for example, argues that major financial institutions should be permitted to lie, cheat, or steal as a means of avoiding systemic risk. To the extent those issues do arise, and have arisen in the past, any tensions have been creative, and well-meaning regulators can and have been able to resolve them.

There are questions that need to be answered in the months ahead. Among others, there is a need to identify or create the appropriate systemic regulatory regime; determine how such a regime can identify systemic risks without creating additional ones; and determine how much and how heavily any systemic risk regulator should touch the other participants in the system of financial regulation. We will need to figure out what should be consolidated, what should be split off, what should be added, and what should be subtracted. As it has since it was formed, the Commission stands ready to assist.

We view regulatory reform as vital. We will give Congress, our fellow regulators, and other parts of the government the benefit of our insights. It is critical that the reform is done right, and the Commission will actively engage with all stakeholders throughout the process.

V. Conclusion

When I returned to the SEC as Chairman in January, I appreciated the need to act swiftly to help restore investor confidence in our capital markets. In less than two months, we have instituted important reforms to reinvigorate our enforcement program, better train our examination staff and improve our handling of tips and complaints. In the near term, I will ask the Commission to consider taking action related to short selling,

money market fund standards, investor access to public company proxies, credit rating agencies, and controls over the safekeeping of investor assets. But, speaking personally, much more needs to be done. Everyday when I go to work, I am committed to putting the SEC on track to serve as a forceful capital markets regulator for the benefit of America's investors. Today, more than ever, the SEC's core mission of capital markets oversight and investor protection is as sound and fundamentally important as it ever was, and I am fully committed to ensuring that the SEC carries out that job in the most effective way it can.

Thank you again for the opportunity to share the SEC's views. We look forward to working with the Committee on any financial reform efforts in the months ahead, and I would be pleased to answer any questions.