

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

On
Enhanced Investor Protection After the Financial Crisis

Dirksen Senate Office Building

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Thank you Chairman Johnson and Ranking Member Shelby for holding this hearing and it is an honor to be invited to testify before you. Our capital markets in the U.S. have been the crown jewel of our economy for over two centuries. But in the last decade, they have been the source of great scandal, resulting in investors questioning whether they are on a level playing field or sitting across the table at a casino where the odds are greatly stacked against them. This along with a declining U.S. economy has led investors to invest increasing amounts of capital overseas, with less available here for jobs, investment in plant, and research and development. If that trend is to be reversed, investors must know they will be afforded reasonable protections and have regulators who serve as their advocates.

Background

Before I start, it might be worthwhile to provide some background on my experience. I have held various positions in the accounting profession for some 35 years. I started my career with one of the world's largest international accounting and auditing firms where I rose to become an audit and SEC consulting partner. I served as a CFO and vice president of an international semiconductor company as well as a business executive in a venture backed newly formed start-up company. I have had the good fortune to be the Chief Accountant of the Securities and Exchange Commission ("SEC"). In addition, I have been; a member of and chaired audit committees of corporate boards of both large and small public companies; a trustee of a mutual fund and a public pension fund; and a professor of accounting. In 2007, Treasury Secretary Paulson appointed me to the U.S. Treasury Advisory Committee on the Auditing

Profession (“ACAP”). I have also served on the Standing Advisory Group (“SAG”) and Investor Advisory Group (“IAG”) of the Public Company Accounting Oversight Board (“PCAOB”).

The Financial Crisis

It has now been over 4 years since the worst post Great Depression financial crisis imploded in this country and around the globe, resulting in the Great Recession. The financial damage to civilization was tremendous as Exhibit A illustrates; investors in the global markets lost over \$28 trillion in the value of their holdings. In the U.S. investors saw approximately \$10-11 trillion in value disappear, not including the value of their homes which continue to depreciate. And consider the numbers: in 1930, 1.2 percent of the population owned stock; in 2008, the number invested in the markets through stock, mutual funds or retirement accounts approximated 110 million.

To put the damage to investors and the capital markets in greater perspective, the Dow Jones Industrial Average closed on October 9, 2007 at 14,164.53 but then proceeded to plunge as fear grasped investors to close at 6547.05 on March 9, 2009. That represents a fall during the financial crisis of 7839.88 points or 54.9%. The S&P 500 closed on October 9, 2007 at 1565.15. On March 9, 2009, it would close at 676.53, representing a fall of 898.36 points or 57.4%. By this point in time, investors and the American public had lost confidence in the capital markets, no longer trusted business executives, and believed Wall Street had become a casino where the house odds were overwhelming in favor of Wall Street, not Main Street. Congress had to act.

Sound Financial Markets and Capitalism

My 35 years of experience as a businessman, regulator, and investor have taught me that sound financial markets and efficient capitalism, can only exist if built upon five fundamental bedrock pillars. These pillars are:

1. Transparency – Investors must receive unambiguous financial information that allows them to make fully informed decisions as to which companies they should invest in.
2. Accountability – Those entrusted with the money millions of Americans invest must be held accountable for how they use that money. Business executives should be rewarded for sound business decisions and long term performance. Their compensation should be cut or they should be replaced when underperforming. And investors must have redress when they have been recklessly or worse yet, fraudulently wronged, such as when credit rating agencies or public companies issue misleading reports.
3. Independence – A lack of conflicts and where conflicts do exist, clear and timely disclosure of those conflicts prior to solicitation of investor's money.
4. Effective Regulators – Independent, strategic and balanced regulators who understand their mission is necessary to protect investors, create confidence in the markets and attract capital. Effective regulation also requires that regulators be held accountable by Congress in a timely manner.
5. Enforcement of the Laws – In the past, the U.S. has prided itself as being a nation of laws. Those who break the laws, should be held accountable so that the markets and all market participants operate in a fair market place, and the playing field is not tilted to any one party's advantage.

Yet when we look back of the mayhem of the past decade, we see that:

- There was a dearth of transparency as investors and regulators alike could not decipher the financial statements and financial condition of institutions such as AIG, Lehman Brothers and many of the largest banks in the country. Assets and capital were inflated, liabilities understated and profits upon which huge compensation packages granted, a mirage.
- Regulation was most ineffective under the onslaught of those who mistakenly thought the markets and market participants could police themselves. These disciples of *laissez faire* failed to understand the culture of markets and power of greed and megalomania. At the same time, most of the regulators were captured by industry, lacked adequate funding and resources in the case of the SEC and CFTC, and lacked authority to regulate such markets as derivatives which had become increasingly toxic as they grew close to 10 times the GDP of the entire world.
- As the Senate's own investigations have illustrated, conflicts abounded as institutions collected fees for originating loans aptly named "Liars", "No Doc", or "NINJA", packaged them up for another fee, and then collected even greater fees when they sold them off to an unsuspecting, and poorly informed investing public. Conflicts were rampant among credit rating agencies, the lawyers who drafted and reviewed all these agreements, and auditors.
- Things falsely done in the name of capitalism or entrepreneurship, had nothing to do with them. As Charlie Munger, Vice Chairman of Berkshire Hathaway recently said;

“None of us should fall for the idea that this was constructive capitalism. In the 1920s they called it bucket shops -- just the name tells you it's bad -- and they eventually made it illegal, and rightly so. They should do the same this time.”

- And the public now questions whether the law enforcement agencies have created a two tier justice system; one for Wall Street and business executives and one for Main Street.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“The Act”)

With that as a backdrop, Congress chose to act passing the Dodd-Frank Wall Street Reform and Consumer Protection Act. I believe doing nothing was not an option even though some have suggested that, or something akin to fringe changes, more intent on maintaining the status quo then protecting investors and consumers. And while I would have preferred a Pecora style investigation as Senator Shelby had urged, it is abundantly clear that was not going to happen in this city. Accordingly, I applaud Congress for acting.

Within the Act, are Title IV, *Private Fund Advisors* and Title XI, *Investor Protection and Securities Regulation*. I shall confine my remarks to Title XI and certain of the strong investor protections afforded within that section.

Whistle Blower Protection - Sections 922, 923, and 924.

It is important the SEC become aware of securities law violations at the earliest possible date, so that it can act to stop the violation before further harm to investors and the markets occur,

and it can hold people accountable . Obtaining credible information is vital to early action and successful prosecution by law enforcement agencies.

In its 2010 Global Fraud Study, The Association of Certified Fraud Examiners stated that on average, it took 27 months for companies to detect financial statement fraud. That's over two years investors would be unknowingly investing based on false and misleading financial information. The report also notes that the number one way in which frauds are detected is not a management review, internal audit or external auditors. Rather it is through tips.

Consistent with these findings, Dodd Frank allows the SEC to reward those who provide it with a wide range of information of securities laws violations resulting in successful prosecutions. The SEC had very limited authority to do so before passage of the Act. In fact, since 1989 and prior to Dodd Frank, the SEC had only made seven payouts to five whistleblowers for a total of \$159,537.

The SEC adopted rules implementing the whistle blower sections of Dodd Frank in May of this year, after soliciting and receiving public comments on the issue. While some from the business community feel the rules as proposed will encourage people to report to the SEC without going through the normal hot lines and compliance program a company sets up, others felt they would cause some to avoid providing useful tips to the SEC and result in tips showing up on the internet at sites such as Wiki Leaks.

Having served on audit committees of public companies, I believe the SEC took a reasonable and balanced approach to the final rules it adopted. Hot lines will not work unless employees have confidence their identity will remain anonymous and protected, and the complaint will be

addressed in an unbiased thorough manner. This is especially important as the business groups forming the Committee of Sponsoring Organizations of the Treadway Commission (COSO), noted in a May 2010 report that in the 347 cases of fraudulent reporting brought by the SEC from 1998 through 2007, the CEO and/or CFO were named in 89% of the cases, up from 83% in the prior decade. I believe Dodd Frank and the new SEC rules will result in companies reexamining their hot lines and compliance programs, ensuring employees can put their faith in them.

The SEC provided reasonable protections for public companies. The SEC encouraged those who provide tips, to go through the normal company compliance channels. It did so stating that reporting internally will be considered when the size of an award is determined by the SEC. The Commission also provided individuals the opportunity to first report to the company, and then if they chose, reporting to the SEC. This is very beneficial from my perspective as it allows the company to act on the information and where appropriate, self report to the SEC. In addition, the SEC excluded payments to certain employees such as in house counsel, compliance personnel, internal auditors, certain executives and external auditors.

Enhanced Law Enforcement – Sections 925, 926, 929E, and 929KLMNOP

Dodd Frank includes a number of beneficial provisions that will enhance law enforcement giving investors greater protections and ensuring fair markets. For example, under prior law, a securities professional who had been barred by the SEC as a result of serious misconduct as an investment advisor, could simply participate as a broker dealer, offering similar services. Dodd Frank appropriately addressed this issue by giving the SEC the authority it sought to impose

collateral bars against regulated persons. Likewise, Dodd Frank prohibits someone already convicted of a felony in connection with a securities offering, from offering securities under Rule 506 of Regulation D. While the Act allows critical financing for start ups, it keeps felons from gaining a foothold in the process, reducing the likelihood of fraud being perpetrated by repeat offenders.

Previously the SEC did not have the authority to bring claims and seek penalties against those who recklessly and knowingly aided or abetted others in a violation of the Securities Act of Investment Company Act. In essence, certain individuals could “drive the getaway car” when it came to a securities law violation and know they were beyond the reach of the regulator and law. Dodd Frank addressed that problem. It also called for a study by the SEC on whether investors should be given redress against these individuals. Today, professionals including gatekeepers and investment bankers critical to a fair and orderly market, can assist an individual in the commission of a securities law violation. Such actions have contributed to great damage being inflicted on shareholders, but the person aiding or abetting the crime here in the U.S. knows the shareholder has no right to sue them, unless the person aiding and abetting the crime tells the public they are doing so. Such a ridiculous standard, which fails any test of common sense, needs to be corrected. And as is discussed later on, regulators often have not had the resources or the will to pursue such cases.

The Act further enhances investor protections by giving the SEC enforcement authority in key areas, and giving the SEC greater ability to hold market participants accountable for violations of the law. Under the Act, civil money penalties may now be imposed by the SEC in cease and

desist proceedings. This should serve as a further deterrence to fraud. The SEC enforcement director has stated this will also enhance the effectiveness and efficiency of the Division's enforcement efforts, a view I agree with.

With the growing number of global markets, the legislation amends the 1933 Securities Act and 1934 Exchange Act to give U.S. district courts' jurisdiction over violations of the antifraud provisions when there is conduct in the United States that furthers the fraud, even if the securities transaction occurs outside the United States. Being able to have redress in these situations is critical to investor confidence and ability to invest safely. It is also important to ensure accountability on the part of those who engage in such unlawful behavior.

Dodd Frank also requires the SEC to study the extraterritorial application of the securities laws to actions that would be brought by investors. This is in response to the U.S. Supreme court ill advised opinion in the case of Morrison v. National Australia Bank, Ltd. In November, 2010, a number of public pensions, including one for which I serve as a trustee, wrote this Committee urging them to reverse this opinion. Investors must have an opportunity to obtain redress in the US courts for fraud committed in the U.S. by foreign entities which seek capital from U.S. investors, and U.S. federal securities laws should deter fraudulent statements by foreign entities to investors.

Improvements to the Management of the Securities and Exchange Commission – Sections 961, 962 963, 964, 966, 967, and 968

Leading up to and during the subprime financial crisis, the SEC has been the subject of much public criticism of its management. Most notably have been complaints for its failure to

investigate whistleblower complaints on Madoff and the Stanford Group, a failure to adequately supervise market participants such as Bear Stearns, Lehman and Merrill Lynch, questionable investigations such as in the Aguirre matter, the leasing matter that has now been referred to the Department of Justice by the Inspector General, poor internal controls and lax enforcement actions such as the one against Bank of America which the judge was extremely critical of. I can't help but believe some of these criticisms are the result of very poor leadership and management of the agency during the later half of the past decade. Leadership that, in my opinion, failed to foster the right tone at the top, culture and investor advocate mission that had long been the mantra of a proud agency and its staff.

In the past, the SEC has had a reputation as the gold standard among regulators. But that image has been tarnished by the criticisms noted. Yet a well managed and run, independent SEC is vitally important to the capital markets. Investors over the years have had confidence in the markets, firmly believing the SEC ensured confidence could be placed in financial disclosures, that the markets were fair and the playing field level. I can tell you from personal experience, many an employee of the SEC has taken great pride in providing outstanding public service and their efforts to ensure the agency was indeed the public watchdog, the one true investors advocate.

There are a number of provisions in Dodd Frank that I believe, as a former business executive, will contribute in a positive manner to the SEC restoring public confidence in the agency. I have found one manages what one measures, and does not manage what one does not measure. While the SEC has required public companies to increase their transparency,

controls, monitoring and accountability, it has fallen short of adopting some of its own recommendations in a timely manner that could have been beneficial, such as reporting on internal controls. Accordingly, enhancements to the SEC's management and structure that will in the long run benefit it, include:

- An assessment of its overall structure and personnel.
- Enhanced monitoring, assessment and transparency of supervisory controls;
- Greater accountability for supervision through certification of the effectiveness of controls;
- Increased evaluation, monitoring and transparency of personnel management including actions taken with respect to those who have failed to perform their duties; and
- A suggestion program and hotline for the employees of the agency.
- Taking a long hard look at its "revolving door." Unfortunately, the study mandated by Dodd Frank only requires a study of employees leaving the SEC for financial institutions and not the largest and fastest spinning revolving door – employees who leave the SEC bound for legal firms that represent individuals and public companies before the SEC.

Securities and Exchange Commission Funding – Section 991

The SEC has sought now for over two decades, the same types of self funding mechanisms that banking regulators have. Unfortunately, Senate conferees rejected such a provision, which in June, 2010, the Federal Bar Associations securities law committee stated was "critical" to the "chronic underfunding" of the SEC.

Current and former SEC Chairmen such as Arthur Levitt and Richard Breeden have urged Congress to increase the SEC's funding so that it can do the job Congress and investors expect of it. Those who represent investors such as the Council of Institutional Investors have also called for increased funding of the SEC. Investors have always voiced support for adequate funding of the SEC and ultimately, the money comes out of their pockets.

As the GAO has noted in prior reports, the SEC was essentially starved by Congress of necessary resources during much of the 1990's. During this time period the markets experienced fast growth as millions of Americans invested through their retirement accounts. After this underfunding contributed to and played a role in the corporate scandals of a decade ago, Congress increased the funding of the agency. But during the period from 2005 to 2007, as the subprime market bubble was growing toward an implosion, the SEC staff was again reduced by over 10% and its spending reduced by some \$75 million as a result of actions by Congress and management of the agency.

Despite the fact no taxpayer dollars are used to fund the SEC, but rather it is funded through user based fees, it seems as if Congress has been bent and determined to somehow shrink the SEC to greatness. The fact of the matter is that congressional approach at times over the past two decades has been an absolute miserable failure.

Congress through Dodd Frank, as well as the public has upped the bar for performance by the SEC and rightly so. The SEC is being asked to increase its inspections, its enforcement, the number of entities and the types of transactions it regulates. Dodd Frank also requires the SEC to establish several new offices such as the office of the Investor Advocate and

Ombudsman, the Office of Credit Ratings and the Whistle Blower office. I believe investors in general are strong proponents of these new functions at the SEC. At the same time, the SEC is being asked to do a much better job of market surveillance and take proactive steps to identify and address in a timely manner future market problems, before they become a crisis. To accomplish all of these tasks takes top notch people with the requisite experience, and very significant investment in technology, training and support services. And that takes money.

Dodd Frank specified acceptable levels of funding, which have been applauded by many investors. Those levels are as follows:

- 2011 - \$1.3 billion
- 2012 - \$1.5 billion
- 2013 - \$1.75 billion
- 2014 - \$2 billion
- 2015 - \$2.25 billion

Unfortunately, Congress is already breaking its promise to investors and the SEC for the year 2011 as its funding is below the \$1.3 billion level. If such funding is not forthcoming, and there are further crisis in the capital markets, such as has been seen with the flash crash, a good deal of the blame will rest squarely on the shoulders of members of Congress.

Expansion of Audit Information to Be Produced and Sharing Privileged Information with Other Agencies - Section 929, and 929 K

The Act expands the power of the Public Company Accounting Oversight Board (“PCAOB”) by:

1. Broadening the PCAOB’s authority to include independent audits of broker dealers;
2. Enhancing the PCAOB’s access to work papers of foreign auditors; and
3. Share information with foreign regulators.

The Madoff ponzi scheme brought to light a gaping hole in the regulation of independent audits investors rely upon. The PCAOB did not have the authority to inspect the audit of the Madoff fund, and the auditor was not subject to inspection by the accounting professions peer review program. To this day, the Madoff auditor would not be subject to inspection by the state regulator as he was a sole practitioner. Dodd Frank rightly remedies this shortcoming by giving the PCAOB the right to inspect such audits and ensure the firms providing such audits have effective systems of quality controls.

More recently, scandals resulting from flawed audits of Chinese companies have also come to light, resulting in large losses for investors. Much of the audit work has been performed by Chinese auditors, although a U.S. audit firm may issue the audit report read and relied upon by investors. At the same time, with U.S. companies increasing their global operations, a growing portion of their audits are performed by foreign audit firms, many of which are affiliated with U.S. audit firms. If the PCAOB is to carry out its mandate of providing investor protections, it must be able to inspect the auditor work, and documentation of that work, regardless of where it is performed.

For example, frauds at such companies such as Satyam, Enron, Xerox, and the now infamous Lehman Repo 103 transactions involved transactions and related audit work executed in foreign

countries. Without the access to audit work papers for this audit work, the PCAOB cannot ensure that the work supports the overall opinion the auditors are providing on the consolidated financial statements of the company. Nor can they inspect audit quality for a significant portion of the audit, leaving investors exposed to a portion of an audit where quality may be substandard at best.

Ensuring international audit quality, especially with respect to large international conglomerates that can attract hundreds of billions in capital from investors, is critical to confidence in financial disclosures that are the life blood of any capital market. It is important the PCAOB be able to share information, work and cooperate with its counterparts in carrying out this mandate. But I have talked to foreign regulators who expressed criticisms of the PCAOB, and a reluctance to work with it. That was because while they could share information with the PCAOB, it was a one way street because the prior law prevented the PCAOB from sharing information with them. The prior law had been adopted when the PCAOB was new and its counterparts in foreign jurisdictions did not exist. But that has changed and once again, to its credit, Dodd Frank has updated the law and corrected this deficiency. It did so by giving the PCAOB the ability to share information with foreign regulators on a confidential basis. This was a badly needed reform to ensure regulatory cooperation on an international basis.

At the same time, the PCAOB has also called upon Congress to allow it to enhance the transparency of its enforcement program. It would do so by making its enforcement actions public, at an appropriate time, consistent with the way the SEC handles its 102(e) enforcement actions. Having been involved with the development of the current SEC 102(e) rule, I applaud

the PCOAB for working to enhance its transparency. Without such a rule change, as evidence is now starting to show, audit firms will take every action available to them to seriously delay enforcement actions, during which time they continue to issue audit reports while their quality controls and audit work may suffer from serious deficiencies. This exposes investors and the capital markets to great risks which lack any transparency whatsoever.

Other Sections

There are many other important sections of Title IX of the Act which I also strongly support. The governance provisions granting investors the same access to the proxy for nominating directors as management has, is a great tool for establishing accountability over entrenched and underperforming boards. Creating independent compensation committees, enhancing the transparency of compensation and incentives, and giving shareholders an advisory vote on pay should all prove to be beneficial to ensure destructive risks taking is not rewarded, and executives compensation is based on performance. Already investors have shown they can use such rights in a wise and reasoned manner. And while investors did not get all that they wanted in this section of the bill, it was a very positive step forward.

The enhanced regulations of credit rating agencies should also improve the quality of credit ratings. Especially important is the private right of action granted investors, a useful mechanism to hold credit rating agencies accountable.

Closing

I believe the sections of Dodd Frank I have discussed all help build and contribute to a stronger foundation upon which the capital markets can function more effectively. They increase transparency and accountability, they enhance independence including that of the regulator, they will improve the effectiveness of the SEC and PCAOB, and they certainly give these agencies greater authority necessary to enforce the laws and protect investors. That in turn should give a boost to investors confidence in the markets which is necessary if the capital markets are to continue to be the crown jewel of our economy.

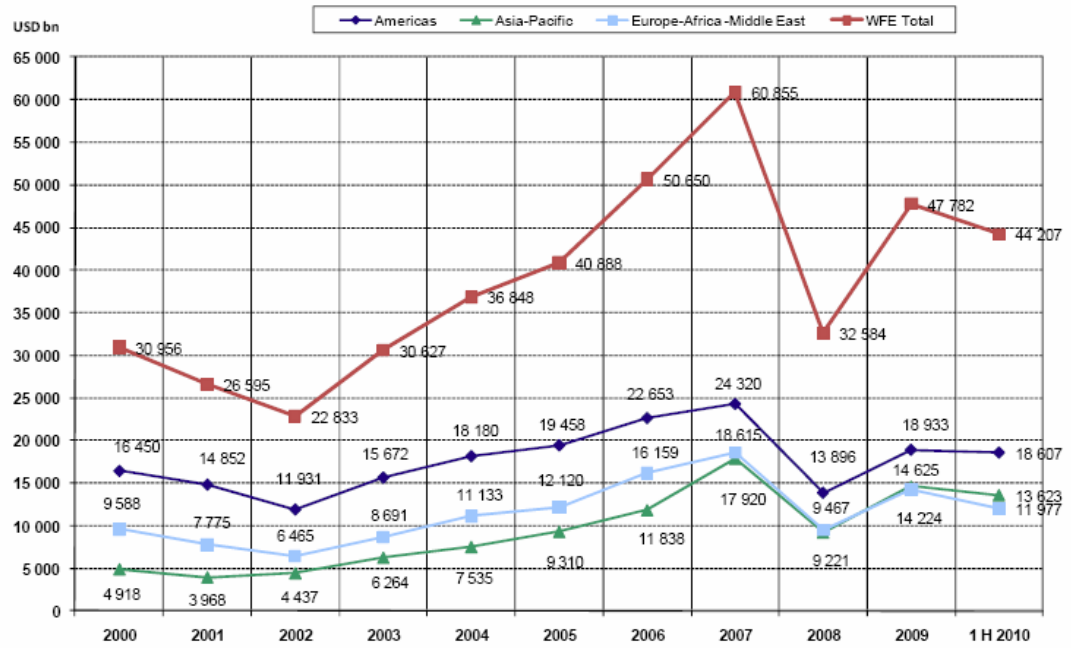
Thank you and I would be happy to take any questions.

Exhibit A

World Federation of Exchanges

Markets capitalization

◆ Recent evolution of domestic equity market capitalization by time zones in USD



WFE total (USDbn)	30 956	26 595	22 833	30 627	36 848	40 888	50 650	60 855	32 584	47 782	44 207
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