

**Testimony of Christopher Cox
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“Improving Financial Disclosure for Individual Investors”

**Before the Committee on Banking, Housing, and Urban Affairs
United States Senate**

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Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

Thank you for giving me the opportunity to be here today to testify about the initiatives and priorities underway at the Securities and Exchange Commission to improve financial disclosure for individual investors.

Several years ago, in the midst of rampant financial scandals and a crisis of investor confidence, this Committee held a series of exceptionally important hearings on corporate responsibility and investor protection. Those hearings, and the work of the Members of this Committee that followed, laid the foundation for landmark reforms that have restored investor confidence and the health of our capital markets. I commend each of you for your efforts, and am happy to report that the SEC is using the new tools that you have given us to insure that those reforms are implemented exactly as intended by the Congress.

A lot has happened in the nine months since I last sat at this table. I very much appreciate this opportunity to give you a report on the new initiatives the SEC has undertaken, as well as to hear from you about your priorities.

Introduction

The principal subject of this brief testimony is improving disclosure for the benefit of individual investors. If I may, I'd like to take a step back and put these efforts into context.

As a Member of Congress for 17 years, I was constantly reminded by my constituents of the real world impact of the decisions we make here in the Capitol. Like every one of you, I learned the importance of being a good listener, and of remembering that the common sense of ordinary Americans is the essence and the strength of our democracy.

Most of your constituents are not investment bankers, or lawyers, or accountants. But most of them are investors. It is a stunning fact of life in the 21st century that a majority of Americans now own stocks, either directly or through mutual funds.

It is chiefly to serve these people that the SEC exists. Our mission – to protect investors, promote capital formation, and maintain orderly markets – must always put ordinary Americans first.

Since making the transition from the halls of Congress to the SEC, I have set out to rededicate the agency's ongoing efforts in virtually every area to the service of the individual investor.

In a well ordered market, educated consumers can choose from a number of competitive products, and find what they want at a price they are willing to pay. But in order to educate themselves, investors need comparative facts. So while investors must bear the responsibility of learning what they can about their investment choices, the correlative duty of sellers of investment products is to provide the relevant information. What's more, in order for investors to make sound decisions, the seller's information has to be understandable, accessible, and accurate.

These are the basic ingredients of healthy competition in every corner of the financial marketplace.

To more closely match the theory of a well ordered market with today's reality, the SEC is currently pursuing four key initiatives to improve the quality and usefulness of disclosure for individual investors. These initiatives, taken together, are designed to insure that investors have access to more accurate and understandable information about the securities they own or are considering buying.

These four initiatives are:

- (1) Moving from boilerplate legalese to plain English in every document intended for retail consumption;
- (2) Moving from long, hard-to-read disclosure documents to easy-to-navigate Web pages that let investors click through to find what they want;
- (3) Reducing the complexity of accounting rules and regulations; and
- (4) Focusing our anti-fraud efforts on scams that target older Americans.

Making Disclosure Understandable for Ordinary Investors

It's the SEC's job to see to it that financial data and qualitative information about the issuers of securities are fully and fairly disclosed. But surely we can't say we've achieved that objective if the information is provided in a way that isn't clearly understandable to the men and women for whom it is intended.

Empowering investors doesn't just mean better access to information – it also means access to better information. Simply put, the question is: once that SEC-mandated information is available, is it understandable? The answer all too often is a resounding and frustrated "no".

Even though they are nominally written in English, the disclosure in some documents that are provided to investors is often so full of legal jargon and boilerplate disclosure that it can actually obscure important information.

Convoluting language and disclosure in footnotes may serve lawyers and insurance companies, but it doesn't improve an investor's ability to understand the most important facts about a particular investment.

Exhibit A when it comes to convoluted disclosure is today's regime for reporting executive compensation. Ordinary American investors have a right to know what company executives are paid, because those investors own the companies. The executives work for them.

It's a direct corollary of the fact that more than half of Americans own stock today, that executive compensation will be judged just like every other labor and material cost that a firm incurs. Gone are the days when investors were mostly privileged, high-income elites. Today's investors come from middle class households that sit around the kitchen table and make tough choices about their monthly budgets. They expect the companies they invest in to do the same.

But how can an investor judge whether he's getting the best executive talent at the best price? Too often, the most important parts of total compensation are hidden away in footnotes, scattered in different parts of the proxy statement, or – depending on the form the compensation takes – not even disclosed at all until after the fact.

Three months ago, the Commission voted unanimously to propose an overhaul of the executive compensation rules. This marks the first time in 14 years that the SEC has undertaken significant revisions of the disclosure rules in this area.

The proposal would require better disclosure on several fronts.

First, companies would report a "total" figure – one number – for all annual compensation, including perquisites.

Second, retirement benefits would be clearly outlined in new tables showing the defined-benefit and defined-contribution plans of top officers.

Third, there would also be clear descriptions of payments that could be made if an executive is terminated. No such disclosure is required under our current rules.

Fourth, for the first time, all compensation for the last year to board members would be fully disclosed.

Fifth, a new Compensation Discussion and Analysis section would replace the Compensation Committee Report and the performance graph, which is now often mere boilerplate and legalese. This new narrative section will allow the board members to have a frank discussion with their bosses, the shareholders, about how they have gone about determining the compensation for the company's top executives.

Just to be clear, the Commission does not propose getting into the business of determining what is the proper method or level of compensation. It is not the job of the SEC to substitute our judgment for that of the board. Nor would I, speaking as Chairman, subscribe to the notion that all executive pay is excessive. Surely many executives deserve every penny they're paid, and more. It should go without saying that being a CEO requires a rarefied collection of attributes and skills that are in all too short supply. And it's a fact that competition in the market for executive talent can be fierce. At the same time, I needn't cite here the several notoriously public cases of extravagant wastes of shareholder assets by gluttonous CEOs and pliant compensation committees.

By improving the total mix of information available to investors, the directors who work for them, and the marketplace, we can help shareholders and compensation committees to better inform themselves and reach their own conclusions.

Sixth, and finally: Since the purpose here is to improve communications, the proposed rules require that all of this disclosure be in plain English – the new official language of the SEC. That will be true whether the information is in a proxy statement, an information statement, or an annual report.

Plain English uses plain words – and, among other basic ingredients, the active voice. We want to promote the use of the active voice not just because it makes for punchier sentences, but because it requires a definite subject to go with the predicate. That's the only way that investors will be able to figure out who did what to whom.

It's a testament to the importance of this issue that, when the comment period on these proposed executive compensation rules closed on April 10, we had received nearly 17,000 comments. That's one of the highest totals in the SEC's 72-year history. We are now reviewing these comments and look forward to incorporating them into any final rules that the Commission may adopt for improved, plain English compensation disclosure.

And we won't stop there. Some years ago, under Chairman Arthur Levitt, the SEC began a crusade for plain English in investor documents. It was a noble first step that has been carried on by both Harvey Pitt and Bill Donaldson. During my time at the Commission, I hope to advance this cause still further, so that ultimately every communication aimed at retail investors is so free of jargon and legalese that it could pass muster with the editors of the Money section of *USA Today*.

Improving Disclosure via Interactive Data

Making the SEC's mandated disclosures more useful to investors is the idea behind another of our initiatives: interactive data.

The beauty of interactive data is that it will not only make today's 10Ks, proxies, and mutual fund prospectuses more useful to investors, but it will also reduce much of the time and expense that companies currently devote to filing SEC reports.

Today, the SEC has over 800 different forms. Each form is required to have its own cover page. The genesis of this requirement dates back to when reports were hand-filed in steel cabinets. Back then, the cover pages helped Commission staff do the filing – but today, they provide no useful information to the public, or to the SEC. Despite the fact that every individual company is required to file many different forms, these cover pages ask over and over again for the very same information in a slightly different format. In other words, more junk disclosure that no one needs, or wants.

If one goes beyond the cover pages to the entire form, to focus only on the truly unique information in each one, it's been estimated that instead of the 800 forms now required, the SEC might have need of no more than a dozen.

The key to making this happen is looking at the data on the forms independently from the forms themselves. That's what we mean by interactive data. Computer codes can tag each separate piece of information on a report, and tell us what it is: operating income, interest expense, and so forth. That way, every number in a report or financial statement is individually identified, both qualitatively and quantitatively.

For individual investors, this means they'll be able to quickly search for any information they want without slogging through an 80-page document. And it means they could search through our database not by the names of individual reports, but instead just by looking up the companies that file them. We'd no longer need what we have for domestic issuers today:

9 Securities Act registration statement forms,
3 Exchange Act registration statement forms,
2 annual report forms,
2 quarterly report forms,
1 current report form....
... and a partridge in a pear tree.

And I haven't even gotten to all the forms for proxy materials, annual reports, securities ownership, tender offers, and mergers and acquisitions. Investors, and the analysts who interpret financial information for them, shouldn't have to hunt around for each separate form – all the information should be in one place, organized by company. Today, every one of these forms has to be filed and processed separately, which adds to the SEC's workload; and then the investors have to separately hunt down every different form for a single company, making more work for all of them. Rube Goldberg would be proud.

Our initiative to let investors get information fast, easily, and all in one place, envisions this added benefit: instead of long and hard-to-read annual reports and proxy statements, investors could have easy-to-navigate Web pages that let them click through to find what they want.

I am extremely pleased that our interactive data initiative has the support of the Chairman and other members of this Committee. In hearings and briefings before this and other committees, you've heard the technology variously described as data tagging, or XBRL, or my personal favorite, interactive data. But whatever one calls it, the point is the same: to allow investors to more easily access, search, analyze, and compare data provided by public companies.

The move to interactive data represents a sorely needed upgrade in the SEC's electronic disclosure regime.

From the 1930s to the 1980s, the Commission required that disclosure documents be filed exclusively on paper. Thousands of companies mailed us hundreds of thousands of documents. Each document was date-stamped, copied, sent to various divisions for review, and made available to the public for physical inspection in a Washington, DC library that is still maintained by the agency at significant expense.

In the 1980s, the Commission pioneered the use of electronic filing on our EDGAR system. (EDGAR stands for Electronic Data Gathering, Analysis and Retrieval.) This was a significant leap forward, and it became even more so with the dawn of the Internet. Now, investors and analysts are able to download documents with the click of a mouse instead of making a trip to the SEC's library in Washington, D.C.

But while EDGAR was a great improvement for the 1980s, 20 years is a lifetime in the computer age. EDGAR may be electronic, but it isn't interactive. It doesn't begin to tap the potential of the Web. Because today's EDGAR filings are really just snapshots of paper reports that are stored in electronic form, the information they contain isn't searchable. Nor can it be used in any of the myriad ways that electronic data now speed around offices, home computers, and the Internet.

With today's SEC reports, an investor or analyst who is looking to compare, say, data on annual capital expenditures of two companies, has to search through perhaps hundreds of pages of the filings of each company page-by-page. Not surprisingly, the burden of this time-consuming, tiresome task has led to the creation of a cottage industry in re-keyboarding the information in SEC reports, so that it can be downloaded into spreadsheets and other software. Investors, or more precisely the intermediaries whose fees they pay, can then buy this information from both domestic U.S. firms and overseas providers to whom the drudge work has been outsourced. Once the information is manually input, it is often first sold to third or fourth parties for further reduction and analysis before it eventually is made available to an individual investor.

One hates even to think of the human error and data corruption that inevitably occurs in this process. We know from experience that the error rate is unacceptably high.

Interactive data is a way to eliminate these problems, and to connect investors directly to the information in a company's filings – accurately, cheaply, and quickly. It will allow anyone to easily search, extract, compile, compare, and analyze financial and qualitative data according to each individual's preferences.

What about the benefits beyond retail investors? For preparers of financial reports, interactive data could streamline and accelerate the collection and reporting of financial information to the SEC and the public. Further down the road, the potential exists for companies to use interactive data as a means of getting real-time management control information.

The SEC is strongly committed to interactive data. This is why we have taken major steps to promote it. We have offered significant incentives for companies to file their financial reports using interactive data. These include expedited review of registration statements and annual reports. A number of well known firms – the list is 17 and growing – have already begun to lead the way and are filing their reports using interactive data.

And because mutual funds and exchange-traded funds have become the investment of choice for millions of Americans, I am very encouraged that the Investment Company Institute and its member funds recently decided to throw their weight behind interactive data.

Throughout 2006, the Commission will host a series of roundtables focused on the move to interactive data. The first roundtable is in June. The discussions will focus on several topics:

- What investors and analysts really need from interactive data;
- How to encourage the development of software for companies, institutions, and retail investors that takes full advantage of the potential of interactive data; and
- How to redesign the SEC's disclosure requirements to maximize the advantage of using interactive data.

Our aim is to move from long, hard-to-read disclosure documents to easy-to-navigate Web pages that let investors click through to find what they want. We want to emancipate the data from the page, and let it find its way across the Internet and around the world in the form of RSS feeds, AJAX applications, and whatever comes next. Revolutionizing the way the world exchanges financial information is a worthy goal. We intend to achieve it.

Accounting Complexity

When it comes to giving investors the protection they need, information is the single most powerful tool we have. It's what separates investing from roulette. But if the SEC is truly to succeed in helping investors with more useful information, we'll need one more ingredient: an all-out war on complexity.

It is, of course, true that a complex world often requires complex solutions. And certainly, there are desirable states of complexity – the ones that arise from a thing's intrinsic nature: DNA. A snowflake. Encryption algorithms. There, the complexity is essential to the function. But it's the contrived, artificial complexities that cause the problems – intricacy without function. Winston Churchill said it best: "However beautiful the strategy, you should occasionally look at the results."

That, Mr. Chairman, is what we're now doing at the SEC. We're looking at results from the vantage point of the ordinary investor. And what we're finding is that, in many cases, we're not getting the right results. The complexity of the disclosure mandated by our rules too often adds nothing to function.

It is not just public companies that sometimes have difficulty using plain English. Our accounting rules and regulations also can sometimes be complex and difficult to interpret. And when the rules are difficult to interpret, they may not be followed very well. And if the rules aren't followed very well, then intentionally or not, individual investors inevitably will suffer.

When complexity needlessly adds to the costs and efforts involved in financial reporting, it's the investors who foot the bill. And when a company takes advantage of detailed standards and complex reporting to hide information from investors, rather than to disclose it, investors are doubly damaged.

Not surprisingly, users of financial statements – investors and regulators alike – are looking for more balance in making financial reporting comparable and understandable. Preparers and auditors are also looking for standards that are easier to understand and implement.

The SEC has been helping to lead a major national effort to reduce complexity in financial reporting. The laboring oar is being manned by the Financial Accounting Standards Board, which is already intently focused on improving the understandability, consistency, and overall usability of the existing accounting literature. The SEC staff are working closely with the FASB in a supportive role.

The first step is to systematically re-address specific accounting standards that do not provide the most relevant and comparable financial information. Examples of standards in need of reworking for this reason include consolidations policy, certain off-balance sheet transactions, performance reporting, and revenue recognition.

The second task is to codify Generally Accepted Accounting Principles. The codification will be a comprehensive and integrated collection of all existing accounting literature, and it will be organized by subject matter. The aim is to provide a single, easily accessible source for all of GAAP. A dividend of this project is that it will provide a useful roadmap to those areas most in need of simplification.

A third priority is to stem the proliferation of new accounting pronouncements from multiple sources. We are encouraging the FASB to consolidate U.S. accounting standard setting under its auspices, and to develop new standards more consistent with a principles-based, objectives-oriented system.

The final element of this strategy is to strengthen the existing conceptual framework for U.S. GAAP in order to provide a more solid and consistent foundation for the development of objectives-oriented standards in the future.

Making financial reporting more user-friendly goes far beyond the work of the FASB. Weeding out the counter-productive complexity that has crept into our financial reporting will require the concerted effort of the SEC, the FASB, the PCAOB, and every market participant. This cannot be a one-time effort; we will have to commit for the long term. But it will be well worth it.

Financial Education for Retirees and Elderly Investors

Finally, let me turn to our efforts to better protect older Americans against financial fraud.

Consider these statistics: An estimated 75 million Americans are due to turn 60 over the next 20 years. That's an average of more than 10,000 people retiring every day. Households led by people aged 40 or over already own 91% of America's net worth. The impending retirement of the baby boomers will mean that, very soon, the vast majority of our nation's net worth will be in the hands of the newly retired.

Following the Willie Sutton principle, scam artists will swarm like locusts over this increasingly vulnerable group – because that's where the money is.

On a daily basis, our agency receives letters and phone calls from seniors and their caregivers who have been targeted by fraudsters. Sometimes there is still time to help. But often, the victims have already been taken. These fraudulent schemes may begin with a free lunch, but we want to make sure that they end with a very high cost to the perpetrators.

That is why we are attacking the problem from all angles – from investor education, to targeted examinations, to aggressive enforcement efforts. And because state securities regulators share our concern about fraud aimed at seniors, we're cooperating in this initiative with state regulators across the country – the local cops on the beat.

A top priority is education. SEC programs are aimed not only at older Americans and their caregivers, but also at pre-retirement workers, designed to help them reach their personal savings and investing goals as they age. While we cannot tell investors which products to purchase, we can arm them with the information they need to assess various products and investment strategies.

We are expanding our efforts to reach out to community organizations, and to enlist their help in educating older Americans about investment fraud and abuse.

A portion of the SEC website is devoted specifically to senior citizens (<http://www.sec.gov/investor/seniors.shtml>). We provide links to critical information on investments that are commonly marketed to seniors – including variable annuities, equity-indexed annuities, promissory notes, and certificates of deposit.

On the SEC website, investors can also find detailed warnings against the dangers of listening to the sales pitches of cold-callers. We're alerting seniors to the very real threat of affinity fraud – scams that prey upon members of groups to

which they may belong, including their religion, their nationality or ethnic heritage, or their profession.

Seniors are often subjected to high pressure sales pitches that are simply not true, such as telling seniors that equity-indexed annuities “just can’t lose money.” There are also “free lunch” seminars that encourage seniors to buy complex products that don’t fit the risk profile of a retiree with a relatively short life expectancy. There are also outright scams, such as Ponzi schemes.

To detect abusive sales tactics that target seniors, examiners in our SEC field offices will share regulatory intelligence with their counterparts at the state level, and with other regulators. Once we identify firms that may be preying on seniors, we’ll examine those firms to make sure their sales practices are lawful.

This effort has already started in Florida, where we’ve recently initiated on-site compliance examinations, along with the State of Florida and the NASD, of firms that sponsor “free lunch” investment seminars. Our goal is to see that the sales people at these seminars are properly supervised by their firms, and that the seminars aren’t used as a vehicle to sell unsuitable investment products to seniors.

Each of our offices across the country will work closely with state and local law enforcement, and both federal and state regulatory agencies, to target scams aimed at seniors. And they’ll work together to bring both civil and criminal actions aimed at shutting them down. This effort is already well under way in California.

Finally, when we do find fraud, you can be sure that we will do something about it. Over the past two years, the SEC’s Division of Enforcement has brought at least 26 enforcement actions aimed specifically at protecting elderly investors. Many of these actions were coordinated with state authorities.

In one notable case, SEC v. D.W. Heath and Associates, the Commission coordinated with the Riverside County District Attorney’s Office to crack down on a \$144.8 million Ponzi scheme that lured elderly victims in southern California to workshops with the promise of free food. The Commission’s complaint alleged that the defendants then bilked them out of their retirement money by purporting to sell them safe, guaranteed notes.

Just last month, in SEC v. Reinhard et al., the Commission halted another possible Ponzi scheme, this time in Allentown, Pennsylvania. The Commission’s complaint alleges that the defendants raised more than \$3.9 million from at least 50 investors in several states by claiming to sell certificates of deposit that did not exist.

The complaint further alleges that the primary salesman lured investors, many of whom are elderly, with promises of above-market rates on FDIC-insured CDs

purportedly issued by a non-existent entity called the “Liberty Certificate of Deposit Trust Fund.” The complaint also alleges that the defendants distributed fictitious investment documents and account statements to attract investors and to ensure they continued to invest in the scheme.

As reflected in these recent cases, any would-be fraudsters should consider themselves on notice that the SEC’s enforcement staff will aggressively investigate and file actions against anyone who preys upon seniors.

Conclusion

Mr. Chairman, members of the Committee – thank you for your interest in these vital issues. Each of the four initiatives I have outlined is part of an overall strategy to make the individual investor – the average American – the ultimate beneficiary of all that we do at the SEC. Our agency has for many years proudly worn the badge of the “Investor’s Advocate.” In the months and years ahead, we are pledged to rededicate ourselves to that mission.

I appreciate the opportunity to be with you here today. Thank you for your continuing strong support for the work of the Commission. I am happy to answer any questions you may have.