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BUILDING INVESTOR TRUST AND CONFIDENCE: THE SEC CHAIRMAN'S TOP PRIORITY

By Jeffrey Diermeier, CFA

Investor trust and confidence in U.S. capital markets is returning as equity indices reach four-year highs, the accounting reforms further enhance financial transparency to shareholders' benefit, and corporate governance practices strengthen boards' independent oversight of a company's management.

The challenge before Rep. Christopher Cox, as he assumes the chair of the U.S. Securities and Exchange Commission, is to sustain this momentum. Doing so means he must ensure fair, transparent reporting from the investor's viewpoint, deal aggressively with professionals who misuse the trust given them, advance good governance principles, and achieve truly global capital markets. All without imposing unwanted burdens through the heavy hand of regulation. A delicate balance to be sure.

As was clear from his testimony before the Senate Banking Committee, Chairman Cox strongly believes in free and open markets and sees the value of both regulation and industry standards as important means of protecting investors' interests. As the Congressman for Silicon Valley, he saw first-hand how capital markets finance entrepreneurs' ideas to become realities.

First, he and his staff must continue to deal aggressively with securities industry professionals who abuse their clients' trust. Cases of wrongdoing are few and far between, but one front-page example does great harm to the reputation of all who are entrusted with the hard-earned life savings of clients. Tough, swift enforcement of existing regulations tells investors that they have an effective cop on the beat.

Second, effective dialogue with the industry on key points of debate is crucial. For instance, the so-called Merrill Lynch rule raises the issue of whether certain investment brokers are fairly representing their role to an often uninformed investing public. There may be space in our market for a transaction-focused broker, but then that broker should not don the cloak of the trusted advisor.

A third priority for his agenda is fair, transparent financial reporting, which is critical in evaluating whether a company is a good investment opportunity. Expensing of employee options is one example, and Chairman Cox told Senators that he respected the independence of the Financial Accounting Standards Board, which sets accounting rules, and, further, thought "the FASB rule that will force companies to treat stock options granted employees as an expense is an issue already decided." His message was a good first step to show investors he will act in their interests.

Other disclosure issues, however, must be addressed, to bring "on" the balance sheet many off-balance-sheet items that make it hard for financial analysts to assess a company's liabilities and assets. A starting point, here, is a recent report by the SEC staff, as required by the Sarbanes-Oxley Act. The recommendations included reforms to discourage companies from structuring transactions merely to obtain off-balance-sheet accounting.

Fourth, continued strong support is needed by the Commission for good corporate governance principles. Accountability, effective oversight through a rigorous auditing committee, independent board members, and other measures that are already in place or will soon take effect – these are critical to public trust.

Achieving the benefits of global capital markets must also be part of the SEC's ongoing efforts. Inconsistent, conflicting regulations in different countries have led to confusion, error, and inefficiencies, which are harming issuers and investors alike. Regulatory arbitrage is played, as investment managers operate from jurisdictions with less rigorous laws than those in the European Union or the United States. The Commission has a tremendous role here, building upon the harmonization underway through the EU directives and the cooperative work with the Financial Services Authority, among other initiatives.

For its part, the CFA Institute has developed Global Investment Performance Standards (GIPS®). Officially introduced in 1999, these are voluntary standards used by investment managers worldwide for quantifying and presenting investment performance that ensure fair representation, full disclosure, and apples-to-apples comparisons. The SEC in its prior wisdom chose to let the industry come forth with performance standards rather than promulgate formal regulation. Today, more than 25 countries in North America, Europe, Africa and the Asia Pacific region have adopted the GIPS standards. This example, too, shows how the industry's own standard-setting processes can be effective to the benefit of investors.

Finally, one of the biggest opportunities and challenges revolves around the issue of investor education. It will take strong leadership to address the important educational needs of an increasingly short-sighted investment public. With half of all Americans owning equities, and with a need for them to be able to take some control of their retirement, the issue of investor education must be addressed head on. An educated investor benefits capital markets and helps to regulate against wrongdoing and fraud. We and our 76,000 global members offer our expertise and counsel to bolster the education efforts of the SEC and other regulatory agencies worldwide.

The foundation of capital markets is public trust and confidence. That priority must guide Chairman Cox's initiatives. His initial statements tell us his stewardship is already headed in the right direction.

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