U.S. Securities and Exchange Commission

Speech by SEC Commissioner: SEC in Transition: What We've Done and What's Ahead

by

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Thank you. It is a pleasure to be back among so many old friends. Before I begin, let me say that the views I express today are my own, and not necessarily those of the Commission or its staff.

As you know, there have been some big developments at the Commission in the last few weeks. Not only are we in the process of moving to Station Place, our new building next to Union Station, but we are getting new leadership as well. The White House has announced its intent to nominate Rep. Christopher Cox as our new chairman. With these significant transitions underway, this is an opportune time to bring you up to date on our work at the Commission. It's too soon to know the views and priorities of our potential new chairman, but I'd like to use this opportunity to clarify my views on actions we've taken and highlight some of our upcoming issues.

Commissioners of the SEC are sworn to protect investors and maintain the efficient functioning of the capital markets. I assure you that we commissioners recognize the importance of our responsibilities and carry them out to the best of our abilities, regardless of political affiliation or philosophical bent. But commitment to a common mission does not necessarily translate into unanimity on how best to protect investors or ensure the efficient functioning of the markets. The split votes on three recent rulemakings - independent chair for mutual fund boards, registration of hedge funds and Regulation NMS - illustrate philosophical differences among the commissioners regarding how much to permit the markets to work freely and how much to regulate them. I am not opposed to regulation per se, but I have voted against intrusive regulation that puts the Commission in the position of micromanaging how markets or regulated entities operate. I do not believe it appropriate - or an effective use of our authority -- for the Commission to tell mutual fund boards how they should be structured, as the majority did with the independent chair rule, or to

eliminate investor choice on how and where to trade, which is the result under Regulation NMS. In addition to being overly intrusive, regulation of this type increases the possibility of unintended consequences, which often then requires additional regulation to remedy.

As an economist, I believe strongly in letting markets work. Nevertheless, there is a role for regulatory oversight to ensure that competition is fair and that information provided to customers is clear and accurate. Regulations should create the right incentives to accomplish their goals, be based on a good understanding of how the business works, and should not result in unintended consequences to investors or regulated entities. Moreover, regulators must be ready to step in when the standards are abused.

So let me start there - with enforcement. We continue to have a steady diet of financial fraud cases, and we continue to deal with the fallout from the mutual fund scandals. I have been and will continue to be tough on wrongdoers. Supporting free markets requires punishing those that abuse the system. In fact, in several cases, I have pushed for higher penalties and other sanctions on individuals. Sanctions in our financial fraud can include an injunction or cease and desist order, disgorgement to recoup a fraudster's ill-gotten gains, a civil penalty to deter future misconduct and, as appropriate, officer and director bars. Since 1990, we have had the power to impose civil penalties on corporations. Congress gave us this authority in the belief that increasing the financial consequences of violations would deter unlawful conduct, but cautioned against imposing corporate penalties on shareholders already victimized in the aftermath of the underlying fraud.

My sense is that all of us on the Commission agree that identifying and punishing individual wrongdoers is essential to deterring fraud. Where there has been disagreement among us is on the appropriateness of imposing corporate penalties, which, at the end of the day, are paid by the shareholders. If the shareholders have benefited from the fraud, then I would not normally oppose a penalty. But I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud. Our use of so-called Fair Funds, provided by Sarbanes-Oxley, as a vehicle to return civil penalties to defrauded investors (previously, penalty amounts went to the Treasury) leads to the anomalous result that we have shareholders paying corporate penalties that end up being returned to them through a Fair Fund - minus distribution expenses. This gets a headline, but it makes no sense to me - it is form over substance.

Moving from enforcement to our inspection and examination activities, I continue to push for more focus on encouraging good outcomes proactively rather than looking for violations after the fact. By setting clear standards, we can make it easier for regulated entities to comply with our rules and easier for our examination staff to inspect for compliance. The Commission is developing a risk-based approach to inspections, which I support, but we need better coordination among the exam staff, the operating divisions and the Commission to determine priorities and the cost/benefit balance of risk assessment as well as to minimize inconsistent interpretations and eliminate the impression that we are using our inspection process to make rules.

Speaking of rules, last week the Commission published the final version of Regulation NMS, along with Paul Atkins' and my dissent. We have been dealing with market structure issues for years. From the beginning, the problem that generated the most comment was the inefficiency caused by the Intermarket Trading System ("ITS") trade-through rule in the listed market. The rule was designed to prevent a market from trading through a better price in another market. With the development of electronic markets, the rule produced inefficiencies by slowing the electronic markets to the speed of the manual markets if a manual market was displaying the best price. Under the ITS rule, a manual market has 30 seconds to decide whether to execute an order. If the specialist decided not to execute an order, and prices moved during the interim, the order likely couldn't be executed anywhere else.

Instead of coming up with a solution to this discrete problem, however, the end result of our lengthy review of market structure was the imposition of even more complex trade-through restrictions on both the listed market and the Nasdaq market. This occurred notwithstanding the lack of compelling empirical evidence that trade-throughs were a significant problem or that intermarket price protection was the solution. A study by the Commission's Office of Economic Analysis showed that trade-through rates market-wide for 2003 based on the number of trades were only 2.5%, even on Nasdaq, which had no trade-through rule. Additional evidence showed rates declining in 2004. Considering that the rule's cost-benefit analysis claimed benefits of only $321 million, representing only 1/100th of one percent of total trading on the New York Stock Exchange ("NYSE") and Nasdaq in 2003, I did not believe that a trade-through rule was justified, especially in the Nasdaq market, where competition has been robust without a trade-through rule.

Instead of relying on competition, technology and innovation to drive execution quality, Reg NMS gives that job to the government. It may seem counterintuitive to argue against a trade-through intended to deliver best price, but for many investors, size, speed and all-in price are just as important, especially when the order is for 10,000 shares and the best quote is for only 100 shares. By mandating price as the sole criterion of execution quality, the trade-through rule eliminates investor choice regarding how and where to execute their orders, and competition and innovation may be reduced as a result. Furthermore, the trade-through rule, renamed the order protection rule, does not guarantee "best price" nor does it fully protect orders. Orders at the best price may not even get executed since the best price can be matched by another market or ignored under a number of exceptions to the rule. I have many more concerns about Reg NMS, but it took 45 pages to lay them out in our dissent, so please read it if you are interested.[1]

On the heels of the adoption of the new rule in early April, proposed mergers were announced between the NYSE and Archipelago and between Nasdaq and Instinet. Contrary to the views of some, I do not believe that it was the substance of Reg NMS and the trade-through rule that spurred the mergers,

which apparently were in the works for months. I think it would be more accurate to say that the markets just needed resolution one way or another of the Commission's market structure review. If approved, the mergers will represent a substantial consolidation of the markets, which raises additional concerns about another outstanding issue, the appropriate oversight model.

In late 2004, we proposed a rule designed to enhance the governance and transparency of self-regulatory organizations ("SROs") - i.e., the exchanges and the NASD -- and to minimize conflicts between the business interests and regulatory responsibilities of the SROs. The proposed rule retains the SRO concept, but prescribes a higher degree of independence for SRO boards and key committees and requires the SROs to report more information to the Commission about their governance, regulatory programs and financial condition. One impetus for the rule proposal was a governance structure at the NYSE that permitted headline-grabbing CEO compensation. As we reviewed the governance structures and compensation practices of other SROs, it became obvious that an SRO should be subject to no less rigorous governance practices than the issuers listed in its market, especially in the aftermath of the corporate scandals that led to Sarbanes-Oxley.

At the same time, SRO conflicts became an increasingly significant focus of our enforcement program. We entered into settlements with the seven specialist firms on the NYSE based on allegations that they stepped ahead of their customers' orders, and with the Exchange itself based on its alleged failure to monitor the specialists' misconduct. We entered into a settlement with the National Stock Exchange and its CEO based on allegations that they permitted member firms to put their proprietary interests before their customers' interests. In addition, we issued a Section 21(a) report about the failure of the NASD and Nasdaq to address abusive practices by a broker-dealer that was important to NASDAQ's business interests.

Given these conflicts, we realized that we needed to re-assess the current self-regulatory concept, and we published a concept release to seek comment on the advantages and disadvantages of various alternatives to the current SRO model. The alternatives included the then current NYSE model of combining regulatory and market interests within the SRO; the current NASD model, where market and regulatory interests are housed in affiliates within a holding company structure; a single self-regulator; the Commission as sole regulator; or an independently-funded third-party regulator, somewhat akin to the Public Company Accounting Oversight Board ("PCAOB"). We are in the process of reviewing comments on both releases.

A critical theme running throughout much of our enforcement and rulemaking activities is the necessity for clear and accurate disclosure. To operate freely, markets require transparent, timely and useful information. The longer I am here, the more convinced I become that we need to rethink our disclosure program. We will be taking a major step forward with the expected consideration of the Securities Act reform package in the very near future. The proposed rules would liberalize the registration, communications and offering processes under the Securities Act of 1933 and do away with outdated restrictions on communications about registered offerings and how

such communications are delivered to investors. I also want to encourage you to take a look at our soon to be released study on the disclosure of off-balance sheet arrangements, prepared by the Division of Corporation Finance, the Office of Chief Accountant and the Office of Economic Analysis. It contains some excellent recommendations for improving the disclosure and the transparency of these arrangements.

Much work remains to be done, however, on our mutual fund disclosure regime. First, we need to look at the substantive disclosures made in the prospectus. Many investors are overwhelmed by mutual fund prospectuses, finding it difficult to separate the wheat from the chaff. If we could streamline the most important information and make it more timely, clear and useful, we would be doing investors a great service.

Second, we need better disclosures to alert investors to what they are paying and what they getting. This is an issue we are dealing with in many contexts, and it presents many challenges. To help resolve them, we are testing some of our proposals on real investors, which has been enormously helpful in informing my decisions. For example, broker-dealers and investment advisers operate under different regulatory regimes. One important distinction is that investment advisers owe a fiduciary obligation to their clients. Brokers have a suitability requirement, and may have a fiduciary duty, depending on the customer relationship. In 1940, Congress created an exception from investment adviser regulation for brokers that give investment advice that is "solely incidental to" their brokerage business and for which they receive no "special compensation." Needless to say, these terms are not crystal clear. Fee-based, rather than commission-based, brokerage accounts and advertising that raises expectations that the broker is the customer's trusted confidant have increased customer confusion about the duties and obligations they are owed by investment professionals.

So, in January, when we proposed a rule to allow broker-dealers to offer fee-based brokerage accounts without treating them as advisory accounts, it contained several conditions, including making certain disclosures to investors. The disclosure language we originally proposed was intended to convey that fee-based brokerage accounts are brokerage accounts, not advisory accounts, and that there are differences between brokerage and advisory accounts, including the extent to which the broker has a fiduciary obligation. To see whether the disclosure would be useful to investors, our Office of Investor Education and Assistance arranged for the language to be tested on actual investors. The result was a good news/bad news story. While our proposed disclosure was successful in alerting investors to the need to ask questions about the differences between brokerage and advisory accounts, it was clearly not successful in answering these questions. Focus group participants did not appreciate the distinctions among various financial professionals. Many thought that anyone with a title other than a broker-a "financial adviser" or "financial consultant"-was something more than a broker. In addition, many assumed that investment advisers, financial advisers and financial consultants all provided financial planning. So instead of resolving investors' issues, we simply raised their anxiety level. As a result, the rule that we adopted included what we hope is improved

disclosure.

But we realized that we have more work to do. As a result of the negative feedback we received from the focus group participants, we questioned whether disclosure alone was sufficient to address the broader investor protection concerns raised during the rulemaking. We concluded that those issues extended beyond fee-based accounts, and are now considering additional rulemaking that we could undertake to reduce investor confusion. We are also considering options for a longer-term study on the need to rationalize broker-dealer and investment adviser regulation.

Another initiative we are working on to highlight the information mutual fund investors need - and to provide it in a format they find effective - is to provide additional disclosure on the confirmation and, importantly, a proposed "point of sale" disclosure form for mutual funds sold by broker-dealers. This would be a brand new form that, unlike the confirmation, which you only get after your trade is executed, would be delivered to investors at the time they are making their investment decision. The proposed form includes information regarding fees and conflicts of interest that may affect an investor's decision to buy mutual fund shares. Here again, the Commission tested the proposed form with investors to obtain a better sense of the information that would be most helpful to them, and we are taking into consideration input from broker-dealers and mutual funds about accomplishing this objective cost effectively. As is often the case, balancing costs and benefits is turning out to be a challenge.

No speech is complete these days without mentioning Section 404, the Sarbanes-Oxley requirement for public reporting on internal controls. There is no question in my mind that the implementation has been misdirected. What was meant to be a top-down, risk-focused management exercise became a bottom-up, "check the box" auditor-driven exercise.

We held a roundtable in April to get feedback on implementation from a wide range of interested parties. Participants acknowledged that Section 404 had produced some benefits, including:

- management's increased focus on, and companies' increased funding for, improving internal controls,
- heightened awareness of the importance of the internal audit function, and
- audit committees' becoming more engaged and focused.

Most of the day was spent, however, discussing the costs associated with 404. Many participants spoke of the need for a more risk-based assessment of internal controls, which was actually one of my early concerns. One of the most worrisome statements I heard was that while many companies initially set the scope of the internal controls review through a risk-based approach,

their framework was "scrapped" for the coverage-based, all-inclusive approach of the auditors. We heard reports of up to 60,000 "key" controls. How can 60,000 controls all be "key" with a "material" impact on financial statements?

It was apparent from the roundtable that, despite the explicit language in our rules and the PCAOB's Audit Standard #2 regarding the use of judgment and "reasonable assurance" in the reliability of financial reporting, the first year 404 process often aimed for something approaching "absolute assurance." The Commission and the PCAOB recently issued guidance for companies and their auditors to re-focus the responsibility for the assessment of, and reporting on, internal controls back to management, and to adopt a risk-based approach to 404 compliance. We need to make sure that our message is being heard. If not, I will strongly urge that we consider taking additional steps, including working with the PCAOB to reconsider elements of Auditing Standard#2, if necessary.

I cannot give a forward-looking speech without addressing at least one international issue. We are but one player in the global economy, and we do not operate in a vacuum. As many of you may be aware, beginning January 1, 2005, all listed European Union companies must prepare their consolidated financial statements in accordance with International Financial Reporting Standards ("IFRS"). As a result of this change, there has been increased focus on the desired elimination of our current reconciliation requirement and on the ultimate convergence of IFRS and U.S. GAAP. Since October 2002, the Financial Accounting Standards Board and the International Accounting Standards Board have been jointly pursuing a convergence project, and we have been very supportive of this effort. Don Nicolaisen, our Chief Accountant, has proposed a "roadmap" to convergence that lays out the staff's thinking about conditions and actions that would need to take place prior to ending our reconciliation requirement.[2] Our staff has already begun this analysis, and the Commission is intent on considering the eventual elimination of the reconciliation requirement and the ultimate convergence of IFRS and U.S. GAAP. The consistent application and interpretation of the standards and the pace towards convergence will depend on companies and accounting firms as well as standard-setters and regulators.

There are many more items on our agenda, but I want to touch briefly on just two more. The first is soft dollars. I hope that we will take some action on soft dollars in the next few months to address the definition and disclosure issues. Whatever we do, I want to make sure that proprietary and third party research receive equivalent treatment. Second, I don't think an SEC Commissioner can address the Exchequer Club without addressing Reg B. All I can say is that we are continuing to make progress on a rule that is less burdensome than previous iterations, but is still within our investor protection mandate under GLBA. Whether or not we extend the date past September depends both on the timing of our new chairman's arrival and how much progress we make toward an acceptable solution.

We have accomplished a lot since I have been on the Commission, and I fully support almost everything we have done. That said, going forward, I hope

that we will do a better job of tailoring our regulations to the precise problems we are trying to solve. As I said at the outset, I am not against regulation, but I do not support regulation that is overly broad, misdirected or imposes costs and burdens that far exceed the intended benefits. I also hope that we will be more sensitive to the anti-competitive impact of our rules on the marketplace and on market participants.

Which brings me back to another of my goals. When I was appointed to the Commission in early 2002, Chairman Pitt asked me to undertake a review of our rules and regulations to make sure that they are accomplishing their objectives in an efficient and effective manner. The project never really got off the ground, due to intervening circumstances, but I hope the Commission can now return to it.

Let me conclude by saying that I hope the transition to our new leadership will be quick and smooth. I have every confidence that our incoming chairman will find his new job as interesting, challenging and fulfilling as I have found mine. Thank you, and I'm happy to take some questions.

Endnotes

[1] Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS (June 9, 2005) (available at http://www.sec.gov/rules/final/34-51808-dissent.pdf).

[2] *See* Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, 25 Nw. J. Int'l L. & Bus. 661 (Spring 2005).

http://www.sec.gov/news/speech/spch061505cag.htm

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