



Speech by SEC Chairman: Remarks at the University of Rochester's Presidential Symposium on the Future of Financial Regulation

by

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It's a pleasure to be here at the University of Rochester — participating on such a distinguished panel — as part of this whirlwind alumni weekend.

The financial events of the last two years have had an impact on every American, and the repercussions have been felt throughout our society and the world. Importantly for regulators and for our discussion today, the crisis has laid bare significant limitations in our financial regulatory structure and exposed gaps in the regulation of products and market participants that truly must be filled.

I believe in the coming months this Congress will enact new legislation regarding the way we regulate our financial markets. And, I believe this because there is such a tremendous need to reform the system.

The shape of that legislation is still subject to the rough and tumble of Washington, but I believe that many of the legislative proposals working their way through Congress — though perhaps not perfect — represent a significant step forward. And, I am personally committed to helping to turn the hope of regulatory reform into a reality.

I thought I'd take a few moments to lay out briefly:

- First, the gaps that need to be addressed.
- Second, the most constructive way to approach systemic risk.
- Third, the steps we are taking at the SEC apart from the legislative process to achieve reform.

Gaps:

OTC derivatives

Of all the various gaps that need to be addressed, I believe a top priority

must be the lack of regulation around over the counter derivatives.

While there are many culprits of the near collapse of our financial system, products like derivatives played a significant role in facilitating unregulated shadow markets. Derivative also caused hidden counter-party exposures that led to significant market risk and ultimately unprecedented government intervention.

Notwithstanding all of this, these products have been largely excluded from regulation due to a law passed earlier this decade — The Commodity Futures Modernization Act of 2000 — which prohibited the regulation by the SEC or the CFTC of credit default swaps and other OTC derivatives.

I believe, therefore, it is critical that we bring greater transparency and oversight to the OTC derivatives market by regulating these products and the professionals who deal in them.

Right now the gap in the over the counter derivatives market creates opportunities for regulatory arbitrage. This arbitrage facilitates the flow of capital from regulated markets to unregulated markets. And, once in this dark, unregulated arena, there are far fewer checks available to market participants and regulators.

That is why the Administration, Congress, CFTC Chairman Gensler and I have sought to regulate this area. Not only will such regulation improve transparency, but through rigorous regulation of swaps dealers and by facilitating central clearing of these products we can significantly reduce counter-party risk that has threatened many institutions. Next week, the House Financial Services Committee will begin marking up legislation that goes right to the heart of this very issue.

Hedge Funds

Another area where we can fill a gap is hedge funds. These funds have flown under the regulatory radar for far too long.

Today, we don't have a comprehensive database of even basic census information as to who these hedge funds and their managers are. As such, it is virtually impossible to monitor their activities for systemic risk and investor protection purposes.

That is why I strongly support the administration's proposal to require investment advisers to hedge funds and other private pools of capital to come under the regulatory umbrella by registering with the SEC, as investment advisers.

IA / BD

Finally in the area of gap-filling, I support the administration's efforts to harmonize the standard of conduct that applies to broker-dealers and investment advisers.

Today, an investor who visits a financial consultant for advice does not think about whether that professional is a broker or an investment adviser. And, yet the duty of care that customer is owed and the rules that apply

differ depending on the shingle that hangs outside the door.

That is why I believe there should be a single standard — namely a strong, fiduciary standard of conduct. That way all investors who seek investment advice will know that the professional across the desk is someone who will put the investor's interest before their own.

That being said, however, it is essential to recognize that a fiduciary standard of conduct, by itself, does not eliminate fraudsters who prey upon unsuspecting investors. To be effective for the protection of investors, a fiduciary standard of conduct must be coupled with an effective and, I believe, harmonized, regulatory program for broker-dealers and investment advisers. Again, I appreciate the administration's inclusion of the need for greater harmonization in its white paper on financial regulatory reform.

Systemic Risk:

I believe by filling these gaps, among others — and of course using existing authorities — we will help to minimize systemic risks, which is the next area I want to touch upon.

In today's world, markets are so fast and interconnected, and traditional regulation so "siloed" with particular regulated entities, that we need a regulator looking across those markets to identify and minimize systemic risks.

There's been much discussion about a systemic risk regulator which I favor. But, I believe that in addition to vesting in an individual agency responsibility for systemic risk regulation, we need a strong and diverse oversight council.

Under this hybrid system I envision, the Oversight Council would be responsible for identifying risks across the system, setting standards for key elements such as liquidity and capital, and helping to ensure that future regulatory gaps — and arbitrage opportunities — are minimized or avoided. On the other hand, the individual systemic risk regulator, say the Federal Reserve, working with the primary regulators, would then be responsible for ensuring these standards are implemented.

This approach would provide the best structure to ensure clear accountability, to enable a strong, nimble response if needed, and to maintain the broad and differing perspectives needed to identify developing risks and minimize unintended consequences.

To be effective, the "systemic risk regulator" should among other things:

- Have access to information across the financial markets.
- Serve as a "second set of eyes" upon those institutions whose failure might put the system at risk.
- Have ready access to information about institutions that might pose a risk to the system, including holding company liquidity and risk exposures.

- Monitor whether institutions are maintaining capital levels required by the Council.
- Have clear delegated authority to respond quickly in extraordinary circumstances.

I favor this hybrid approach because it would help minimize systemic risk in a number of ways:

First, the Council would ensure different perspectives to help identify risks that an individual regulator might miss or consider too small to warrant attention.

Second, the financial regulators on the Council would have experience regulating different types of institutions (including smaller institutions) so that the Council would be more likely to ensure that risk-based capital and leverage requirements do not unintentionally foster systemic risk — for example: by giving large, systemically important institutions a competitive advantage over smaller institutions that would permit them to grow even larger and take on more risk.

And, third, the Council would include multiple agencies, thereby significantly reducing potential conflicts of interest.

Of course, the most potent weapon against systemic risk is tough regulation by the primary or prudential regulators — but a single systemic risk regulator together with a Council will help to serve as a protective backstop that can identify significant risk and hopefully address it before it leads to another near meltdown.

Madoff/Internal Reforms:

Finally, I believe that every regulator should take steps to look at what they can do short of legislation within their current areas of responsibility, to restore resiliency to the regulatory system.

At the SEC, we were particularly motivated to reform our procedures due to the revelation of the Madoff fraud. When I got to the agency earlier this year, that fraud had just come to light and our Inspector General had already begun an investigation. But, rather than waiting for his report, we identified a number of areas that I believed could be improved and we began making reforms immediately.

- We have been revitalizing our enforcement division, which under its new director — a highly accomplished former federal prosecutor and Rochester graduate — is creating specialized units that can target particular types of fraud and misconduct — and have the specific know-how to bring complex cases quickly. The Commission has removed procedural barriers to the staff's investigative and litigation practices and eliminated a layer of management to put more investigators and attorneys on the front lines.
- We have been working to revamp the way we handle the million-plus tips and complaints we receive each year, through changes in business processes and new technology.

- We have been bringing on new skill sets and improving on our risk-based techniques so that we are focusing our resources on the proper targets. We have created the first new division in 15 years — the Division of Risk, Strategy and Financial Innovation and we are populating it with experts in derivatives, hedge funds, financial analysis and new products.
- We have proposed new rules that will better protect and ensure the safe custody of investment adviser client assets.
- We have been bolstering our examinations unit that, like enforcement, will undergo a thorough assessment.
- And, we have brought in new leadership across the agency.

Other Changes Using Existing Authority

In addition to all the internal reforms, we have also been engaged in a very active agenda to change the rules that govern the markets. For instance:

- We have proposed rules that we hope will address abusive short selling and finalized rules to minimize failures to deliver securities in the clearance and settlement process.
- We have adopted rules that would require credit rating agencies to reveal their performance track records — and have proposed other rules that would likely inhibit entities from shopping around for the best rating.
- We have proposed rules that would put a greater onus on brokers who trade municipal securities to ensure information about those securities is more transparent.
- In a critical response to the financial crisis and the corrupting influence of excessive compensation packages, we have proposed to facilitate shareholders ability to nominate directors to the boards of the companies they own.
- We have proposed rules that would provide assurance to clients that their accounts contain the funds that their investment adviser and account statements say they contain.
- We have proposed rules to significantly strengthen the standards governing money market funds to prevent against another “breaking of the buck” as occurred last fall.
- And, we have proposed rules to ban flash orders — that is, where selected market participants are given a chance to see buy and sell orders before the rest of the market.

Conclusion

These are really just the tip of the iceberg, but these initiatives should give

you a flavor of what's keeping us busy at the SEC as we set out to reform our regulatory process in the hopes of restoring investor confidence, while engaging in the legislative process to build a more enduring financial regulatory system.

Thank you.

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