Speech by SEC Commissioner: "Corporate Governance and the New Financial Regulation: Complements or Substitutes?"

by

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Thank you for the generous welcome. It is a pleasure to join you today at the Transatlantic Corporate Governance Dialogue. Events like this allow us to continue exploring the consequences and lessons of the recent financial crisis. It is a particular pleasure to be among a number of friends and colleagues from academia.

A key question focuses today's proceedings: "Corporate Governance and the New Financial Regulation: Complements or Substitutes?" This question asks us to engage a range of complex considerations, some of which are marked by tension — for example, the imperative that businesses must take risks for our economy to grow, but our desire that they do so prudently; the desire for executives, directors, lawyers, bankers, accountants, and others to act ethically, but not to be unduly hamstrung by fear of liability; and the need for the government to serve its regulatory mission responsibly, such as by guarding against risks that could threaten the financial system, but without regulating to such an extent that the private sector dynamism and entrepreneurism that drive economic growth are stifled.

Against this backdrop, I could have talked about almost anything. Ultimately, I decided to limit myself to three topics: the implementation of Dodd-Frank; executive compensation, which, as you know, is a key determinant of how the CEO and other senior officers behave; and the role of board directors in corporate decision making. Although my perspective is that of an SEC Commissioner, these topics are not relevant only to the U.S. discussion of financial regulatory reform, but are important dimensions of the global dialogue.

Before I say more, as is customary for members of the SEC, I want to remind you that the views I express here today are my own and do not necessarily reflect those of the Securities and Exchange Commission or my fellow Commissioners.

The Implementation of Dodd-Frank

The Dodd-Frank Wall Street Reform and Consumer Protection Act has realigned the relationship between the government and the private sector in the U.S. I will not flesh out this claim in detail, but instead will only suggest my reasoning by mentioning a few categories of rulemakings that Dodd-Frank directs the Securities and Exchange Commission to undertake. Among the scores of Dodd-Frank-related rulemakings that fall within the Commission's jurisdiction — not to mention the numerous studies that Dodd-Frank instructs the agency to conduct — are regulatory initiatives concerning swaps, securitization, the "Volcker Rule," credit rating agencies, private funds, and corporate governance. The Chairman of the Commission also is a member of the Financial Stability Oversight Council — a new systemic risk regulator that Dodd-Frank empowers with extensive authority to regulate financial companies in the name of protecting the financial system against identified threats.[1]

The Commission's regulatory responsibilities under Dodd-Frank follow in the wake of what already has been an active period for the agency. Since the financial crisis, the SEC has advanced a number of non-Dodd-Frank-related initiatives concerning matters such as short selling;[2] the election of board members;[3] public company compensation and governance disclosures;[4] money market funds;[5] credit rating agencies;[6] municipal securities;[7] the custody of advisory client assets;[8] asset-backed securities;[9] target date funds;[10] broker-dealer risk management controls;[11] mutual fund fees;[12] and dark pools.[13] Two concept releases that the Commission put forth this year — one regarding equity market structure[14] and the other regarding the U.S. shareholder voting system[15] — suggest still other topics that are receiving attention. One also could add the May 6 "flash crash" to the mix, when the markets fell precipitously before rebounding rapidly.

There is much that could be said about the particulars of the regulatory reform agenda, but for now, let me speak more generally, offering the following overarching thought: The extent to which the recent wave of federal government regulation in the U.S. already has displaced and distorted private sector decision making in our economy concerns me, and I am troubled by the potential that future regulatory initiatives — notably, the regulations implementing Dodd-Frank — will go too far, unduly burdening the financial system at the expense of economic growth.

Dodd-Frank charges the SEC with extensive rulemaking that allows the Commission a great deal of choice and discretion to shape the legislation's practical contours and thus to determine Dodd-Frank's ultimate impact. Without question, there is a fundamental role for government, including the SEC, in overseeing our financial markets and our economy more generally; and regulatory reform affords us the chance to fashion a regulatory framework that is resilient and that fits our increasingly interconnected and complex financial system.

Yet even as we share the common goal of mitigating the prospect of a future financial crisis and look to fend off the hardship that such a crisis would spawn, we have to recognize the real-life costs to society if the regulations implementing Dodd-Frank excessively constrain and hamper the U.S. financial system. As we strive to further secure the financial system and protect investors and others from misfortune, we need to be mindful that, as the regulatory regime becomes increasingly restrictive, financing may be more costly for companies and individuals to come by; the ability of businesses and investors to manage their risks appropriately may be compromised; fewer valuable investment opportunities that would create wealth and income for investors may become available; and the commercialization of new ideas may be frustrated.

Put differently, as the U.S. regulatory regime becomes more confining and rigid, all of us are impacted — non-financial companies, entrepreneurs, consumers, employees, and investors — if financial firms lose the flexibility they need to provide the full range of products, transactions, capital-raising techniques, and services that drive our economy. New regulatory strictures that end up burdening the economy in these ways come at the expense of private sector innovation, entrepreneurism, and competition — which is to say, U.S. economic growth and our long-term standard of living.

This builds to a straightforward but important point — that is, we need to use the regulatory authority Dodd-Frank has conferred upon us cautiously, carefully evaluating the intended benefits of our actions while giving due regard to the potential undesirable consequences of our regulatory steps.[16] This should include assessing the cumulative impact of the entire package of new regulatory demands to anticipate the overall effect of the regulatory regime when viewed as a combined whole.

It also should include ensuring that the U.S. regulatory regime is appropriately predictable. Private sector transacting and enterprise — including business investment and capital formation — are frustrated when regulatory frameworks become unpredictable. This is so whether the uncertainty is because a doctrine or rule is applied inconsistently or because a doctrine or rule is expected to change but in an unknown way. Parties need to know what the rules of the road are and have well-founded confidence that the rules are not shifting beneath their feet. Throughout the financial crisis itself, there was a great deal of uncertainty as to how the law would be applied and as to the nature and extent of the U.S. government's potential intervention.

To me, all of this means that we must approach our regulatory responsibilities with humility, appreciating the complexity of the challenges before us, to ensure that we succeed in striking appropriate balances when we exercise the choice and discretion Dodd-Frank entrusts to us as U.S. regulators.

What does such humility imply in practice for a regulator such as myself? I have three practical suggestions.

First, it is important to solicit — as the SEC has, especially when it comes to the implementation of Dodd-Frank — the full range of ideas and perspectives that interested parties have to offer. For we are better equipped as regulators to make informed decisions when we receive input from those on the ground who would be impacted by the regulatory change. With this input, we can evaluate more critically the practical consequences and tradeoffs of choosing one regulatory course over another. Similarly, the detailed input we receive allows us to refine our regulations, tailoring the regulatory regime to fit the different cost-benefit analyses that attach to different facts and circumstances.

Second, regulatory decision making should be supported by data, to the extent available, and rigorous economic analysis. The report prepared by the SEC and CFTC staffs on the May 6 "flash crash" exemplifies how the careful study of data can — and should — guide us as regulators.

Not only does empirical analysis allow the SEC to leverage its expertise, but data and economics often reveal insights — many of which are counterintuitive — that we might not have appreciated otherwise and that allow us to challenge, in fruitful ways, our presuppositions and inclinations. For example, new insights can inform the agency’s rulemaking agenda by highlighting unidentified areas of concern or, alternatively, assuaging suspicions that otherwise might have prompted regulation. Economic studies — whether they are empirical or theoretical — also can assist in revealing the potential impact of regulatory change over time, as parties act and react dynamically before the marketplace reaches equilibrium. In short, data and economics have a way of disciplining decision making so that we make better, more informed choices in discharging our regulatory duties.

Moreover, empirical analysis can serve as a firm foundation upon which the SEC can resist external pressures — be they pressures to regulate or deregulate — if those pressures encourage us to follow a course that is not in the best interests of investors. Indeed, the pendulum does swing between periods when regulators are urged to act more aggressively and climates that are more deregulatory, and excess is possible in both directions.

Third, in some instances, the SEC should exercise the choice and discretion we are permitted under Dodd-Frank to fashion a more incremental approach to regulatory reform, in contrast to initiating a more far-reaching set of regulations. Proceeding with such caution — namely, taking some regulatory steps now while deferring others until we can assess how the private sector has adjusted — allows for a more efficient and better calibrated regulatory regime to develop over time, having been grounded in the learning of experience and our consideration of the market’s adaptations. An appreciable measure of regulatory restraint — as manifested in a regulatory structure that is appropriately flexible in accommodating innovation and the forces of competition — can be particularly prudent when regulators are exercising new authority and the impact on private sector conduct and marketplace dynamics of extending the regulatory regime is highly contingent and indeterminate. The new regulatory framework the SEC must fashion for security-based swaps comes to mind. It is worth recognizing, in this vain, that many longstanding strands of U.S. securities regulation have taken time to mature without the Commission trying to do too much too fast.

Regulating, in essence, is about determining what conduct we are going to permit; what conduct we are going to prohibit; and what conduct we are going to mandate. Accordingly, like my colleagues around the globe, as a regulator, I am in the business of drawing lines.

As you can imagine, it can be difficult to identify the appropriate demarcations. In fact, people often disagree on where the lines should be drawn. By way of illustration, very recently, the SEC moved forward two rulemakings. The first rule proposal concerns the due diligence that issuers must perform when offering asset-backed securities; the second proposal concerns new regulations for the swaps market. If you were to take the time to consider the issues each release explores, you would readily appreciate the complexity of the issues before us and the difficulty of drawing the lines that will determine the contours of the U.S. securities laws.

Stated more generally, regulators have to make decisions under tight time pressures and with imperfect information; we are unable to predict the future with certainty. More to the point, every regulatory step we take — or decide not to take — has both costs and benefits associated with it. Even mandatory disclosure — which is the core of U.S. securities regulation — is not costless, notwithstanding the considerable benefits that flow from transparency. At each turn, the practical question, then, is this: Do the benefits of some regulatory course outweigh the costs or not?

This is all by way of underscoring that regulators need to act with humility as we attempt to strike what we think are the appropriate balances among diverse interests given our understanding of the tradeoffs. We need to guard against being overconfident that we have crafted well-calibrated regulatory regimes that will do more good than harm; we must appreciate that there are limits to what we can and should expect from government.

Executive Compensation

How executives are paid influences how they behave. Executive behavior reveals itself in how the company evaluates risk; in whether the management team is too tepid or, by contrast, overconfident in pursuing new growth opportunities; in the extent to which innovation is rewarded; in the extent to which the corporate culture emphasizes ethics and personal responsibility; and in whether the company's controls demand accountability.

Regarding the connection between executive pay and corporate conduct, suffice it simply to say that different compensation arrangements can play on both the incentives and the psychology of corporate officers. The executive compensation provisions of Dodd-Frank, therefore, are of considerable note.

Among what Dodd-Frank provides for is a mix of SEC rulemakings concerning executive compensation. I will steer clear of the details in favor of briefly observing that the subjects of new U.S. securities regulation will include so-called shareholder "say-on-pay," including the frequency of the shareholder advisory vote on executive pay;[17] shareholder approval of certain golden parachutes;[18] compensation committee independence;[19] consultants and other advisers to compensation committees;[20] the clawback of incentive compensation that was awarded to executives based on "erroneous data," as evidenced by a company's financial restatement;[21] and new issuer disclosure requirements regarding (1) executive pay compared to the firm's financial performance,[22] (2) the ratio of the median annual total compensation of the issuer's employees (excluding the CEO) to the CEO's annual total compensation,[23] and (3) employee and director hedging of the value of the issuer's stock.[24]

In one way or another, each of these regulatory initiatives is expected to impact how executives at U.S. companies behave by bringing new dimensions of accountability to executive pay — although I should note that the impact of this additional accountability is indeterminate, in large part because human decision making is difficult to predict, especially when decisions are made by groups, as they tend to be in companies. Indeed, one can imagine circumstances where the adverse impact of unintended consequences could swamp the intended benefits of the new regulatory requirements, doing more harm than good.

Now is not the time or place for me to weigh in with specific thoughts on these executive compensation initiatives, but I do want to offer three sets of observations that suggest my take on executive pay and the types of considerations that I expect will inform my analysis, to one degree or another, as the SEC discharges our regulatory responsibilities in this space. Of course, the input of commenters throughout the regulatory process will prove to be valuable, as always.

First, to anticipate the consequences of any new regulation, one has to consider how the regulatory developments might affect the incentives of issuers, boards, senior executives, and shareholders. As I previously mentioned, some of the effects may be undesirable. For example, what steps might a U.S. company take so that it can report a median employee compensation-to-CEO compensation ratio that signals that the company's pay practices are more equitable? How, if at all, might an issuer's efforts to manage the ratio impact how the business is structured and operated? Might a CEO come to believe that he is underpaid because the multiple of his compensation to that of the median employee is lower for him than for his peers at other companies?

One also might consider how executive compensation arrangements may be restructured in light of the clawback, recognizing that many companies already have a clawback policy in place. To what extent should we expect executives to press for higher base pay to compensate them upfront for the risk that incentive compensation they receive may have to be forfeited in the future? An executive may press particularly hard for more salary or a larger signing bonus when being recruited if she is concerned that her incentive compensation may be at risk, even when she has not engaged in any personal misconduct. How might a shift from incentive-based pay toward more guaranteed pay impact an executive's motives? To what extent might such a shift influence a CEO to think more like a creditor and less like a shareholder?

Second, it is important to be mindful that the optimal compensation structure depends on a host of facts and circumstances that are unique to each executive at each company. Executive compensation does not lend itself to one-size-fits-all approaches, but instead demands a textured, firm-specific analysis.

In my view, for U.S. companies, corporate governance generally does not lend itself to one-size-fits-all approaches. The countless characteristics that differentiate thousands of public companies from each other underscore the value of tailoring the internal affairs of each corporation — including the structure of executive compensation — to each enterprise's own attributes and qualities, including its personnel, culture, maturity as a business, and business strategy.

Indeed, the essence of the disclosure philosophy of securities regulation in the U.S. is that, by ensuring that shareholders have the information they need to make informed decisions, mandatory disclosure leverages market discipline as a means of corporate accountability and promotes private ordering. As a regulatory technique, disclosure thus contemplates that the government will not engage in more direct substantive regulation of corporate affairs but instead will defer to shareholders to evaluate the substance of how companies are organized and run.

Third, a chief purpose behind the Dodd-Frank executive compensation provisions is to dissuade companies from taking excessive risks. While lawmakers should acknowledge the prospect of excessive risk taking, we also must recognize that companies can take too few risks. Undue emphasis on reducing the likelihood of bad outcomes can be costly if it leads to excessive conservatism. A dynamic and innovative economy that offers an ever-expanding mix of entrepreneurial and investment opportunities depends on the willingness and ability of enterprises to take risks.

Without question, the shifting regulatory landscape introduces new considerations for boards of directors when it comes to recruiting, retaining, and motivating the CEO and other senior executives. I hope that boards of U.S. companies do not see this as an unwelcome burden, but rather engage the process as a fresh opportunity to reassess how best to compensate the management team.

The Role of Board Directors

Across jurisdictions, boards of directors are central to good corporate governance. Not only do directors help ensure regulatory compliance, but they shape corporate strategy and help chart its execution.

Let me, therefore, turn to what I think is the bottom-line question that directors and their advisers have to ask. The question is this: What makes for an effective board of directors?[25]

In the U.S. and elsewhere, the evaluation of boards routinely focuses on board composition and structure and the frequency of meetings. How many independent directors does a board have? What constitutes “independence”? Is the chairman of the board independent? If the chairman is not independent, is there an independent lead director? Are board elections competitive? What committees has the board constituted? How often does the board meet? What is the board’s practice regarding independent directors meeting separately? How do the skills, experiences, and qualifications of the directors blend?

These are all appropriate inquiries. But what matters most is not how a board is composed or structured or how many meetings are held each year. What matters most is how directors act.

As I view U.S. corporations, boards of directors are expected to improve corporate decision making by spurring deliberation. In acting as a body, the promise is that boards will draw on the distinct perspectives, experiences, sensibilities, and expertise that different directors offer. The expectation is that as the group works through a range of ideas and arguments, the decision that is made will be better as a result of the directors’ collective efforts. As decision making improves, so should the company’s competitiveness and its ultimate performance.

The active engagement of directors is the lynchpin of meaningful deliberation. Decision making should improve when directors — whether interacting with each other or with management — engage in open and frank discussions, even if it means being critical. When assessing some course of action, directors should ask probing questions and follow-ups of each other and of management; should challenge key assumptions; should offer competing analyses; and should develop competing options to ensure that alternatives are considered and not cast aside too readily.

Put differently, insofar as my view of U.S. companies is concerned, directors should be willing to dissent, and disagreement from others should not be discouraged or suppressed. When it leads people to engage rigorously, disagreement helps ensure that the unknown is identified, that potential conflicts are spotted, that information is uncovered, that biases are managed, and that challenges and opportunities are assessed in a more balanced way. Indeed, a board may want to consider designating one or two directors, perhaps on a rotating basis, whose express charge is to be skeptical and to press when needed.

Peter Drucker, the influential management consultant and professor, expressed a similar sentiment this way:

> Decisions of the kind the executive has to make are not made well by acclamation. They are made well only if based on the clash of conflicting views, the dialogue between different points of view, the choice between different judgments. The first rule in decision-making is that one does not make a decision unless there is disagreement.[26]

There is a word of caution, however. Disagreement and spirited deliberation should not give way to hostility. Distrust and disharmony can threaten an enterprise; boards need collegiality and cooperation and a well-functioning relationship with management. Dissent will be most constructive, then, when conflicting viewpoints and pointed resistance do not trigger defensiveness, but instead are encouraged as catalyzing better decisions that benefit the corporation and its stakeholders.

One can easily look at the SEC through a similar lens. In the U.S., administrative agencies, including the SEC, are built on their political independence and expertise.[27] The expectation is that independence permits an administrative agency to be walled off from electoral politics — at least to a meaningful degree, if not completely so — so that the agency has room to exercise its expert judgment.

The practice of the Commission as an "expert agency" is bolstered by its very structure. Section 4(a) of the 1934 Securities Exchange Act provides: "There is hereby established a Securities and Exchange Commission . . . to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate." I would add that each Commissioner, including the Chairman, has one vote. The wisdom in this feature of the agency's structure is the promise that as five unique perspectives contribute to the Commission's decisions, the dynamic will produce a better regulatory regime — one that incorporates a wider range of informed viewpoints, insights, and judgments.

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Since I joined the SEC in the summer of 2008, the SEC has had to confront serious difficulties. We have not been alone. Many countries have faced the strains of financial crisis, and regulators throughout the international community have been forced to make hard decisions in trying to arrest the crisis and restore economic growth. Accordingly, I want to conclude by recognizing the cooperative spirit with which policymakers around the globe have committed themselves to addressing the causes and consequences of the turmoil.

Of the many lessons to learn from the financial crisis, one is particular apt for this gathering: Simply put, the world is extremely interconnected, perhaps to a degree and in ways that were not fully appreciated. Global capital markets with global consequences recommend enhanced global regulatory cooperation. I trust that we can and will build on the new relationships that have been established and the longstanding friendships that have been strengthened as we continue shaping the new financial regulatory regime.

For me, a corollary to cooperation is to recognize that we in the United States do not have a monopoly on good ideas. As the SEC continues wrestling with complex matters, we must give due attention to the views of our fellow securities regulators abroad who may have grappled with similar issues and adopted approaches from which we can learn. There is value in looking to other jurisdictions to assess their responses to common regulatory challenges and opportunities.

Of course, as regulators cooperate and learn from each other, it must be stressed that even if something works for one country it may not work for another. Given the complexities of crafting a financial regulatory regime, no two countries’ regulatory systems will be mirror images. In fact, one would expect diverse countries with unique economies, political structures, cultures, and histories to approach financial regulation differently, even as we share the common ends of ensuring the integrity of our financial markets, protecting investors, mitigating systemic risk, and facilitating access to capital.

There is much more to say. For now, though, I’ll end simply by saying what an honor it is to serve at the SEC, especially during such a historic period. I continue to be humbled by the chance I’ve been given to contribute what I can to advancing the public interest.

Thank you.

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[1] *See* Troy A. Paredes, Commissioner, U.S. Securities & Exchange Commission, Remarks at Midwest SIFMA & St. Louis Regional Chamber and Growth Association Luncheon (Mar. 24, 2010), *available at* http://sec.gov/news/speech/2010/spch032410tap.htm (critiquing the concept of a Financial Stability Oversight Council).

[2] *See* http://www.sec.gov/rules/final/2010/34-61595.pdf.

[3] *See* http://www.sec.gov/rules/final/2010/33-9136.pdf. *But see* http://www.sec.gov/rules/other/2010/33-9149.pdf (Commission order granting stay of final rules pending resolution of judicial challenge).

[4] *See* http://www.sec.gov/rules/final/2009/33-9089.pdf.

[5] *See* http://www.sec.gov/rules/final/2010/ic-29132.pdf.

[6] *See* http://sec.gov/rules/final/2009/34-59342.pdf; http://sec.gov/rules/final/2009/34-61050.pdf; http://sec.gov/rules/proposed/2009/34-61051.pdf.

[7] *See* http://sec.gov/rules/final/2010/34-62184a.pdf.

[8] *See* http://sec.gov/rules/final/2009/ia-2968.pdf.

[9] *See* http://sec.gov/rules/proposed/2010/33-9117.pdf.

[10] *See* http://sec.gov/rules/proposed/2010/33-9126.pdf.

[11] *See* http://sec.gov/rules/proposed/2010/34-61379.pdf.

[12] *See* http://sec.gov/rules/proposed/2010/33-9128.pdf.

[13] *See* http://sec.gov/rules/proposed/2009/34-60997.pdf.

[14] *See* http://sec.gov/rules/concept/2010/34-61358.pdf.

[15] *See* http://sec.gov/rules/concept/2010/34-62495.pdf.

[16] *See also* Troy A. Paredes, Commissioner, U.S. Securities & Exchange Commission, Remarks at "The SEC Speaks in 2009" (Feb. 6, 2009), *available at* http://sec.gov/news/speech/2009/spch020609tap.htm (discussing the role of cost-benefit analysis in regulatory decision making).

[17] *Id*. § 951.

[18] *Id*.

[19] *Id*. § 952.

[20] *Id*.

[21] *Id*. § 954.

[22] *Id*. § 953.

[23] *Id*.

[24] *Id*. § 955.

[25] *Cf*. Peter F. Drucker, The Effective Executive (1966).

[26] *Id*. at 148. *See generally* Cass R. Sunstein, Why Societies Need Dissent (2003).

[27] *See generally* Stephen Breyer, Breaking the Vicious Circle: Toward Effective Risk Regulation (1993); James M. Landis, The Administrative Process (1938).

http://www.sec.gov/news/speech/2010/spch102510tap.htm