Speech by SEC Chairman: Address to Transatlantic Corporate Governance Dialogue — 2009 Conference

by

Chairman Mary L. Schapiro

U.S. Securities and Exchange Commission

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Thank you, Professor [Ron] Gilson *[conference chair]*. It's a pleasure to have the opportunity to speak to all of you today. I hope that you are not only enjoying all that Washington D.C. has to offer, but that you are finding our headquarters building accommodating to your needs. We are very honored that so many of you have traveled so far to share your insights under our roof.

This conference — during which you'll examine the role of government in corporate governance — is indeed quite timely. On a global basis, I can think of no other time in history when the interplay between governments, businesses, and providers of capital has been as integrated and essential as it is today.

Kofi Annan, former secretary-general of the United Nations said that arguing against globalization is like arguing against gravity.

While this is undoubtedly so, understanding the inevitability of globalization is just the first step. In a speech to the World Economic Forum in Davos, he also said:

> "Globalization is a fact of life. But I believe we have underestimated its fragility. The problem is this. The spread of markets outpaces the ability of societies and their political systems to adjust to them, let alone to guide the course they take. History teaches us that such an imbalance between the economic, social and political realms can never be sustained for very long."[1]

Although the Secretary General gave this speech over a decade ago, we continue to learn this lesson. Much of the world's economic turmoil during the past 18 months is directly attributable to the fragility of globalization — that is, the inability of the world's governments to keep pace with the changing and evolving markets.

Since the collapse of Lehman Brothers only a year ago, governments around the world have been analyzing the events and factors leading up to the financial crisis, in order to prevent reoccurrence in the future. There are many failures that have been identified, both on the part of market participants as well regulators who are charged with the oversight of markets and financial institutions. The list of problem areas includes credit rating agencies, derivative markets, lack of transparency in financial statements, and excessive risk-taking, to name just a few.

The fact that these problems are shared by the US and the EU is evidence of the seriousness of the problems we have faced over the past year.

However, given the extent of globalization in the financial markets, these problems also require common solutions that we should seek together. A number of such efforts are underway, in organizations such as IOSCO, the Financial Stability Board, and the G20, to name a few. We at the SEC are committed to working with our counterparts around the globe toward common solutions and approaches wherever possible.

Of primary interest to you today, of course, are the problems associated with corporate governance. Here, too, is an area of intense activity for governments and regulators — for it is within individual companies and firms that extreme risks were taken, putting our markets on the verge of collapse.

In particular, boards of directors did not thoroughly question the decisions of senior management to take on risks. Of equal concern, boards often appeared to misunderstand the gravity of risks taken. Senior management took higher returns at face value, without questioning why such higher returns were possible for supposedly safe investments and strategies.

A number of jurisdictions are now taking steps to address these corporate governance lapses. In some countries, high compensation for senior executives in the financial services sector is being seriously questioned, particularly where it is not linked to long-term performance. Greater attention is being paid to the skills of directors, particularly in the area of managing risk.

Another area of concern is increasing the transparency of the governance of financial institutions so that investors can more easily judge the skill sets of directors and find out about the links between risk-taking and compensation. While each jurisdiction may have a different legal structure and approach to corporate governance, these are common themes with which we are all grappling.

In the few minutes that we have together today, I would like to share with you the governance specifically and more broadly, the other activities that are taking place here at the SEC.

First, we are working to curb abusive or unfair trading practices.

When I first returned to the Commission last January, the debate about short selling had reached a fevered pitch. Rightly or wrongly, some viewed short selling as a contributing factor to the steep declines in stock prices and extreme volatility that dominated global markets during much of the previous 18 months.

While it was important for the Commission to demonstrate to the investing public our commitment to ensuring that our markets operate fairly, it was also important that we act in an informed and deliberate way. So, in April the Commission released for public comment two distinct approaches to restricting short selling. We held a public roundtable in May, so that we could hear even more directly the views of investors, issuers, financial services firms, self-regulatory organizations and the academic community on key aspects of these proposals. As a result of all of this input and nearly 4,000 comment letters, last month the Commission proposed an alternative approach that may be both more effective at curbing abusive short selling and easier to implement.

We also are conducting a broad review of other market structure issues, including dark pools, alternative trading systems and high-frequency trading. This afternoon, the Commission will consider proposed rules to ban flash orders, through which select traders see investors' orders before they are sent to a wider marketplace.

Second, we are working to improve the performance of those market intermediaries upon whom investors rely.

The first of these is credit rating agencies. Credit rating agency performance also has been a topic of much debate during these past tumultuous months. In late 2006, for the first time, Congress gave the SEC authority over rating agency registration and qualifications. In the less than three years since, the Commission has undertaken no fewer than five rulemakings. But as much as we have done, there is still more to do.

Rating agency performance — particularly in the area of complex structured products — has shaken investor confidence to its core. Today, the Commission will meet to consider further credit rating agency reforms, covering such issues as ratings shopping, additional disclosures of conflicts of interest, and the potential removal of liability protections.

Another important market intermediary is the investment adviser. In the wake of recent Ponzi schemes and other abuses — most particularly the massive fraud by Bernard Madoff — the Commission has proposed significant changes to the asset custody requirements for investment advisers. Under these proposals, advisors who maintain custody or control of customer assets would have to engage an independent public accountant to conduct an annual "surprise exam" to verify that those assets exist.

Moreover, advisers whose client assets are held within their own or an affiliated house — that is, where assets are not held by a firm truly independent of the adviser — would be subject to even more stringent review and testing of custody controls.

We also are looking at so called "pay-to-play" practices by investment advisers to public pension plans. I believe that pay to play practices distort the process by which investment advisers are selected and can harm advisers' public pension plan clients, who may receive inferior advisory services and pay higher fees. This summer, the Commission proposed rules that are designed to prevent an adviser from making political contributions or hidden payments to influence their selection by government officials.

Third, we are looking to improve the accountability of corporate managers to their owners.

As I mentioned earlier (and without attempting to diminish the recognized failures by regulators), I believe that many of the problems leading to our economic crisis can be laid at the door of poor corporate governance. Too many boards failed in their primary function of diligently overseeing management. As a result, too many managers took on too much risk and made decisions that were too focused on the short-term.

Corporate governance is about maintaining an appropriate balance of accountability between three key players: the corporation's owners, the directors whom the owners elect, and the managers whom the directors select. Accountability requires not only good transparency, but also an effective means to take action for poor performance or bad decisions.

I believe that the most effective means of ensuring corporations are accountable is to ensure that the shareholders' vote is both meaningful and freely exercised. That is why the SEC proposed rules which would remove obstacles to shareholders' ability to nominate candidates for the boards of directors of the companies that they own.

Under the proposal, shareholders who otherwise are provided the opportunity to nominate directors at a shareholder meeting would be — subject to certain eligibility and procedural requirements — able to have their nominees included in the company proxy that is sent to all voters.

Shareholders would also have the ability to use shareholder proposals to modify the company's nomination procedures or disclosure about elections, so long as those proposals do not conflict with state law or Commission rules. We received over 500 comment letters (many from people and organizations in this room today), and are currently reviewing them.

The Commission has also proposed a series of additional measures seeking to improve proxy disclosure and the process by which shareholders exercise their vote. These new disclosures would include expanded information about the relationship between a company's overall compensation policies and the company's risk profile; the qualifications of directors, executive officers and nominees; the Board's leadership structure; and potential conflicts of interests of compensation consultants.

We all know that compensation drives behavior. Last year, the Counterparty Risk Management Policy Group identified compensation schemes as one of five primary driving forces of the economic turmoil.[2] Earlier this year, the Financial Stability Forum issued a report agreeing with this assessment, and suggesting three principles for "sound compensation practices."[3]

These principles call for effective governance of compensation; effective alignment of compensation with prudent risk taking; and effective supervisory oversight and engagement by stakeholders.[4] The Commission's proposals are in keeping with these principles.

And lastly, the Commission approved amendments to the New York Stock Exchange's Rule 452, eliminating the ability of brokers to vote uninstructed customer shares in director elections.

While I have long supported these amendments, I also recognize that eliminating broker non-votes in director elections, along with the potential for proxy access in the 2010 proxy season, will place a greater spotlight on some of the long-smoldering concerns about the mechanics of the proxy voting process within the United States.

I have committed to looking at these additional issues — including OBO/NOBOS and the role of proxy advisory and voting services — in the next few months.

Fourth, we are working to enhance the strength and integrity of important investment products.

In June, the SEC issued for public comment a comprehensive set of proposals to strengthen the regulatory regime around money market funds.

The proposals focus on tightening the credit quality, maturity and liquidity standards for money market funds to better protect investors. It would do this by making money market funds more resilient to risks in the short-term securities markets, like those that unfolded last fall.

In addition, the proposals would require money market funds to stress test their portfolios and to report their portfolio holdings each month, so that investors and regulators can better assess their risk characteristics. The proposals also seek to facilitate an orderly liquidation of any money market fund that has "broken the buck" (that is, re-priced its securities below $1.00 per share).

Finally, the SEC requested comment on whether more fundamental changes are necessary — such as converting money market funds to a floating rate net asset value, in order to protect investors from abuses and runs on the funds. The comment period for these proposals closed earlier this month, and I expect the Commission to act finally in the next couple of months.

Fifth, we are working to improve market transparency.

I strongly believe that It is time to improve the quality, quantity and timeliness of information available to those who buy the municipal securities that are critical to state and local funding initiatives.

In July, the Commission approved for public comment proposals that would provide municipal securities investors with more complete and timelier information about material events that affect their investments, as well as

more information about variable rate demand obligations previously exempt from certain disclosures.

While I consider these proposals to be an important step forward, the Commission hopes to work with Congress to more effectively protect investors in the very important municipal securities market.

Conclusion

As I hope you have sensed, the Commission is operating with an invigorating sense of urgency. Through these ambitious rulemaking efforts, as well as our re-energized enforcement and examination programs, we are returning to the Commission's investor advocacy roots. And while we redefine what we do, we are also redefining how we do it. Our recently-announced Investor Advisory Committee is one way in which we are proactively seeking the input of those for whose benefit we exist.

Thank you, and I would be happy to take a few questions.

Endnotes

[1] Address to the World Economic Forum, Davos, Switzerland (January 31, 1999).

[2] "Containing Systemic Risk: The Road to Reform," August 6, 2008, available at http://www.crmpolicygroup.org/docs/CRMPG-III.pdf.

[3] "FSF Principles for Sound Compensation Practices," April 2, 2009, available at http://www.fsforum.org/publications/r_0904b.pdf.

[4] Ibid.

http://www.sec.gov/news/speech/2009/spch091709mls.htm