THE SHERIDAN ROAD MAP

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MARY SCHAPIRO: IN THE EYE OF THE STORM

At the beginning of 2009 the Securities and Exchange Commission (SEC) faced enormous challenges. Embarrassing revelations regarding its failure with the Bernie Madoff scandal were coming to light as the unraveling credit crisis assured that its next chairman would oversee a regulatory overhaul not seen since the Great Depression. The chairman would need vast experience and the ability to work well across the aisle and with fellow regulators. Mary Schapiro was a logical choice. She served as an SEC commissioner from 1988-1994, including a brief stint as acting chairman, before being named chairman of the Commodity Futures Trading Commission (CFTC) in 1994. She left the CFTC to become president of NASD Regulation in 1996, where she remained through its transition to the Financial Industry Regulatory Authority (Finra), serving as its chairman and CEO until being tapped for SEC chair by President Elect Obama. We talked to Schapiro about what she has been able to accomplish over several volatile years and what important missions are on the horizon for the SEC.

MARY SCHAPIRO *has spent a lifetime in various senior regulatory roles and has had to rely on that extensive experience in taking the reins of the SEC at one of its most critical junctures.*

FUTURES MAGAZINE: *You joined the Commission at an historic and difficult time. What has been accomplished in your tenure and what are your priorities going forward?*

MARY SCHAPIRO: It was an historic time and an incredibly busy time when I arrived here and it is a little hard to list the most important accomplishments because there have been many. The agency has done a pretty remarkable job of reforming the way it operates. I would point out in particular putting in place measures that have helped to prevent another flash crash from happening, implementing important reforms for money market funds after the financial crisis, assembling a pretty big team of experts to write all the rules that are mandated by Dodd-Frank and pushing those rules through the process as well as conducting a number of the studies and pursuing some of the most complex enforcement action coming out of the crisis. That is just a handful; there are a lot more: banning pay to play by municipal advisors or bolstering of custody rules for investment advisors and broker dealers. There are obviously lots of others.

There were a lot of things on our agenda before Dodd-Frank, some of which we have been able to accomplish, many more that we still hope to get to. On the equity side, we have further efforts on market structure reform coming out of this highly fragmented marketplace. We are anxious to go forward with a project we call "proxy plumbing." It is an in depth investigation around how proxies are voted by shareholders: The effectiveness of the system, the role of proxy advisory firms, the conflicts of interest they may face, the issues of how corporations can communicate directly through shareholders rather than through intermediaries. We hope to be able to turn our attention to that this fall and tackle those issues. Then, on the pure retail side, two areas we are particularly interested in getting back to that are not Dodd-Frank related

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are 12B1 fees that are charged to mutual fund investors; clarity around those fees. We have put out a proposal but have not adopted it and we need to do more work on it; limitation and disclosure on it. And (2) disclosure around target day funds, which is a vehicle increasingly used by investors to plan for and fund their retirement. There is a lot of misconception and lack of clarity on how those funds operate. I would like to advance the issue of appropriate point-of-sale disclosure so that investors are getting useful information at a time and in a format that allows them to make the best possible decisions.

FM: *Some of the Dodd-Frank deadlines have been delayed and there is legislation that would push them back much further. How has the political pushback affected you and your staff's ability to work on the rules?*

MS: We really try to ignore the politics and do what the law requires and what we believe is in the best interest of investors. Of the more than 90 mandatory rulemaking provisions [under Dodd-Frank], we already proposed or adopted rules for about two-thirds of them. That has been a huge undertaking, especially for an agency of our size. While some deadlines will pass, the important thing is to get the rules right because that will have the most lasting and important impact.

FM: *Even when Dodd-Frank takes effect, those in Congress who oppose it greatly can alter it by restricting the budgets of regulators. Are you looking at contingencies for the possibility of having a greater workload without additional—or perhaps fewer—resources?*

MS: Even before the added responsibilities that we got from Dodd-Frank, we were an agency with a significant role to play and not always enough resources so it is a set of issues we have dealt with over many years. It is important to remember that under Dodd-Frank the spending for the SEC is deficit-neutral because fees on the industry automatically match whatever our appropriation is. Resources should not be an issue, but they will be of course because we are appropriated and frankly resources have always been a challenge for the agency. And now with the new responsibilities that we are taking on under Dodd-Frank (our share of the currently unregulated derivatives industry, hedge funds that will be required to register with us for the first time, extensive new responsibilities for credit rating agencies, registration of municipal advisors and oversight of that very large group) absolutely will tax the agency going forward. Today we spend less to run the entire SEC than some financial firms spend annually on just their IT budget. While we always try to find a way to do more with the resources, we have and continue to do our best in that regard, at the end of the day, if we don't have sufficient resources, our ability to affectively police Wall Street and implement these new protections coming out of the financial crisis will be at risk.

FM: *On the SEC site is a page that lists elements of Dodd-Frank rulemaking that have been deferred due to "budgetary uncertainty." Do you anticipate this list growing?*

MS: The rulemaking will get done. We will not meet all of the statutory deadlines in Dodd-Frank; we are moving very deliberately to complete the rules but taking the time to get them right. The next step, fully implementing [the regulations], that is where resources are going to be critical. We are required to create five new offices and we have to have permission from our appropriators to move money within our existing budget to create those offices. We don't have that permission yet.

FM: *Many people view inappropriately rated securities and conflicts of credit rating agencies as key drivers of the financial crisis. How has the Commission addressed this?*

MS: I have been talking for a long time about the conflict of interest of credit rating agencies. I have likened the ratings process to college students who get to choose a teacher based on which one will give them an 'A.' We have been committed to adopt the rules that are necessary to increase transparency and improve the integrity of ratings. We started that process well before Dodd-Frank but just a couple of weeks ago we proposed a comprehensive set of new rules under the Dodd-Frank authority that should make the ratings process more objective and transparent. And we are going through all of our rules that are already on the books to eliminate over-reliance on ratings by investors.

FM: *High-frequency trading is now accounting for a majority of securities volume. How concerned are you with this and what steps is the SEC taking to address what some traders believe is an unfair edge by these players?*

MS: I am very concerned that our regulatory structure needs updating to keep pace with the tremendous changes in trading technologies that we have seen over the last few years, and high-frequency trading falls into that category. We already have taken some important steps in that direction. We have adopted the single stock circuit breakers to address the extraordinary volatility that happens when high speed and high volume strategies operate as they did on May 6 in unintended and unpredictable ways. We also have adopted a market access rule that goes into effect fully in November — parts of it go into effect sooner — that requires brokers to use risk and regulatory controls when they provide their customers with access directly to the markets; it has been called banning naked access to the market. We also proposed two measures

Photography by Joshua Roberts

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— that I hope [to be completed] by the time this is published — that would allow us as regulators to have a greater ability to monitor trading and enforce trading rules. Those are the consolidated audit trail and the large trader reporting proposals. One of the issues coming out of May 6 was, because of our highly fragmented equity market structure and the lack of a single consolidated audit trail, it took us a very long time and an enormous amount of effort to recreate the trading that happened on [that day]. Once we can catch our breath from the Dodd-Frank rule making, it would be my hope to turn our attention back to flash trading and dark pools and the concept release that we have out on high-frequency trading issues.

FM: *The Commission has initiated several circuit breaker pilot programs to address what happened in the flash crash. Have you settled on any specific steps you feel will prevent a similar occurrence?*

MS: Right after May 6 we brought all of the exchanges and Finra together to adopt new circuit breaker rules that first applied to all of the S&P 500 stocks, then expanded to cover many more equities and ETFs, and ultimately apply across the board to all equities and ETFs. Borrowing a page from the futures industry we sought comment on a proposal to establish a limit up/limit down mechanism. And we are working very hard with the CFTC and the markets — futures, securities and options — to update the market-wide circuit breakers that were not triggered on May 6 but that haven't been updated in many years and needs to be made more current and relevant.

FM: *Is getting one standard of circuit breakers key here?*

MS: It is very important. First of all it provides certainty for people to know what the circuit breaker is or the limit up/limit down mechanism is in advance, and how that might impact the market. And they can plan their trading more affectively. Having more uniformity and more standardization here will be very good for the market.

FM: *Have you been in contact with European regulators as you worked through the rule writing process? How important is coordination with global counterparts in finalizing rules?*

MS: We have been in extensive contact. Dodd-Frank put the U.S. in the forefront of derivatives reform. It put us on a much faster timeline relative to other jurisdictions. Because we are a first mover, we have had to be actively engaged with securities, derivatives and market regulation in Europe and elsewhere in the world in order to make sure we stay as closely aligned as possible. The G20 and the financial stability board really have all of us agreeing. The same measures need to be taken, the same reforms need to be implemented, but there are some differences and there are timing differences because the U.S. is far ahead of most other jurisdictions. We have had formal conversations, informal conversations and lots of effort through our participation in many international task forces and working groups, and we have spent a lot of time with foreign regulators. The discussions and the collaborations have gone very well. It is so important that we get this right because if derivatives regulation isn't well harmonized and we have significant differences between the U.S. regulatory regime and foreign regulatory regimes, it could create incentives for market participants to move their business elsewhere.

FM: *When we spoke to CFTC Chair Gary Gensler about a year ago, he noted that the two of you had a very good working relationship. How has that evolved over the last year?*

MS: We have a close working relationship. As someone who has chaired the CFTC as well as the SEC, I understand where both agencies are coming from on a lot of the issues and I am acutely aware of the need for close cooperation and collaboration between the two of us. The staffs of the agencies have done an extraordinary job of working together on, literally, a daily basis. We have done joint roundtables, tons of joint meetings, we have had drafting session together, and we have had a positive constructive working relationship.

FM: *How has your experience with the CFTC and Finra helped you to navigate the various jurisdictional overlaps?*

MS: It really gives me insight into the work of other regulators that are really important relationships for us. It has been very helpful to me.

FM: *These are two distinct markets that have different roles. Is there a limit to cooperation and harmonization because of these differences?*

MS: I don't think there is an endpoint to cooperation. I do think that because the markets aren't exactly the same, though lots of products are morphing across the two markets, cooperation should never end. But as a result of the fact that these are two different markets, it might mean at the end of the day that there are rule differences between the OTC [over-the-counter] derivatives regulatory regime under the CFTC and the one under the SEC. But we want to make sure those differences are driven by the fact that the markets are different and not driven by the fact that we just had different perspectives about how to do things. We do have different statutory foundations; we have to honor those. That can drive some differences.

FM: *There has been an explosion in the creation of Managed Futures Registered Investment Companies (RICs) in recent years. The CFTC has amended its rule 4.5 in a way that would make some of these RICs impossible to operate. If there is not rule harmonization between the SEC and CFTC these products will no longer be in compliance. How close are the SEC and CFTC to harmonizing rules that cover managed futures RICs?*

MS: We do have a very open line of communication with our colleagues at the CFTC and we are working with them as they consider whether to adopt the proposals with respect to

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rule 4.5. Just this week our staff from the Division of Investment Management that overseas investment companies participated in a roundtable that addressed harmonization issues that could arise if SEC-registered companies also would have to comply with the CFTC CPO [commodity pool operator] regulations. We will continue to work very hard to avoid any market disruptions that could be caused by having conflicting standards. If we end up in a situation where our standards conflict in such a way that it wouldn't be possible for a registrant to comply with both, we'll obviously work to address that situation. We also have to remember that depending on the conduct that is involved, the application of different regulatory schemes that address different concerns related to the same activity could be the correct result for investors, so we have to work carefully through all these issues.

FM: *One solution suggested is that they become CPOs under CFTC regulation and still be RICs under SEC regulation but some exemptive relief is needed for that to happen.*

MS: Right. I don't know if that is going to be the answer but to make that potential situation one in which they can operate. I try really hard not to endorse any products because it is not a good place for me to be as the regulator. That said, I do think to the extent that the products are there and they are available and they are sold pursuant to appropriate regulation to appropriate investors with the right level of knowledge and sophistication, that we need to make sure the regulatory regime works as affectively as it can to allow business to go forward but at the same time to ensure that investors are protected.

FM: *Some hedge funds are afraid that they may face dual regulation. They argue that the intent of Congress in writing certain elements of Dodd-Frank was to allow a manager to have one primary regulator based on where the preponderance of their activity falls. Do you agree in principle with this? Are there entities where dual regulation is a necessity?*

MS: That is consistent with the way advisors, for example CTAs [commodity trading advisors], are treated today. If the advisor's business predominantly involves providing securities related advice, then the advisor has to register with the SEC and be subject to our rules. Dodd-Frank clearly requires hedge funds and other private funds to register and be regulated as investment advisors under the Investment Advisors Act. This was a key regulatory gap that needed to be addressed, and we think it is important so that the activities of hedge funds will be within the purview of regulators and the public. The law also says that an investment advisor that is registered with the CFTC as a CTA and advises a private fund, is exempt from investment advisor registration.

FM: *Should the regime eliminate all dual regulation?*

MS: I wouldn't go that far. My concern is inconsistent rules, and asking regulated entities to comply with inconsistent rules is not a good result for sure. But dual regulation of firms that are providing products and services that cross over more than one regulator, that can help protect their clients and investors. A good example of that is in the retail mutual fund space where we regulate the securities activities of those funds and the CFTC — under the proposed revisions — regulates the commodity and futures activities of those funds. In addition to [having] another set of eyes on these firms through examination, there are specific rules and other investor protection that are designed by each regulatory regime for the specific areas [in which] that registrant is operating. We don't want inconsistent dual regulation and we don't want excessive dual regulation, but there may well be appropriate roles for both the SEC and CFTC with respect to particular firms or products.

FM: *A lot more advisors will become registered. Will you be able to handle the added workload? Is there a risk that registration will provide a false sense of security to investors?*

MS: In 2010 with the number of investment advisors we had at that time, we were only able to examine 9% of registered investment advisors. On the securities side, there is no NFA [National Futures Association] for advisors, there is no self regulatory organization because Finra only can regulate and examine broker/dealers. If you look back seven years ago, 2004, we had 19 examiners for every $1 trillion of assets under management; we now have 12 examiners for every $1 trillion of assets under management. Our staff-to-assets-under-management number is shrinking and has been shrinking. With Dodd-Frank it will continue to shrink and it is a pretty disturbing trend. It is important to understand that as a result of Dodd-Frank we will take on lots of new regulated entities like securities-based swap dealers and municipal advisors and so forth. There is a category of advisors that will leave SEC jurisdiction and be registered with the states, those with less than $100 million in assets under management. We expect 3,000 advisors to leave the SEC and go to the states but because we are going to be getting hedge fund advisors that are larger and much more complex, at the end of the day, we will be regulating [a lot] more assets under management under Dodd-Frank than we were before. The base line answer is the number of advisors has grown, their assets under management have grown and our examination staff numbers have fallen and that is a disturbing trend. We have a risk-based examination approach and there is a methodology for determining which [advisors] should be subject to examinations in any given year. But that can mean some advisors don't get examined for many, many years.

FM: *With all of the financial innovation of the last decade, is it getting harder to draw distinction between jurisdictions? Is there room for more cooperation between the SEC and CFTC or do the fundamental*

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differences between capital market and futures require two separate agencies?

MS: It absolutely is. When Congress created the CFTC in 1974, of course the SEC already existed at that time, but our jurisdictions could be delineated with relative clarity. Our markets were very distinct. That clarity began to blur as financial innovation took off, mostly because of the development of new derivatives products that had many features or were based on securities products. That introduced a lot of challenges to divining precisely which regulatory regime should be overseeing the new products.

FM: *Don't these agencies have two distinct missions?*

MS: We have pretty much the same mission if you think about it in the broadest sense: To ensure the markets are operating fairly and efficiently and that market participants and investors in those markets have a fair opportunity to [operate] on a level playing field, but our statutory foundations are very different. Obviously the SEC is focused on capital formation, which is quite different from the futures markets which are more about risk shifting, and we have a much deeper and broader retail participation in our markets, although that exists in the derivatives markets. We all care about markets operating with integrity and participants in the marketplace being treated fairly.

FM: *You came to the SEC after arguably the greatest and most embarrassing regulatory failure in history as the SEC failed to spot the Bernard Madoff Ponzi scheme. How have you addressed this in terms of regaining public confidence and ensuring you discover other frauds much earlier?*

MS: We have undertaken very extensive reforms across the agency to ensure that something like that can't happen again. Obviously no regulator can prevent every fraud, but we have streamlined our enforcement procedures, we brought new leadership across the agency, we created specialized units in our enforcement group to become expert and able to move quickly, we implemented risk-based examination to focus on registrants whose business models or practices create the greatest risk, we brought in a lot of new skill sets, we have tried to breakdown the internal silos and we revamped the way we handle tips and complaints, which was key in the Madoff scandal. We increased training dramatically and we put in place a lot of new regulatory requirements that should help prevent something like this from happening again. These are the new rules related to surprise inspections of investment advisors that custody assets at an affiliated entity so that we can ensure that the assets that they say exist really do exist and have been separately audited. We have a whole section of our website that we call post-Madoff reforms that people can go to and see all of the extensive efforts we have undertaken to try and address the failure of the agency in that regard, why these things happened and how we are working to ensure that they never happen again. There is also a section on all of our Dodd-Frank implementation, what our schedule is and what the status of everything is, [as well as] all of the comment letters.

FM: *There is quite a bit of public anger over the fact that nearly three years after our banking and credit system stood at the brink of failure, there have been no criminal indictments. I know you cannot talk about any specific investigations but talk about what steps you have taken? We know you reached a settlement with Goldman Sachs over marketing certain CDOs and more recently with Morgan Keegan & Company and JP Morgan. Do you anticipate more of these cases coming to light?*

MS: We have a reasonably full pipeline of post-financial-crisis cases and we have actually brought cases involving more than 70 firms and individuals coming directly out of the financial crisis including one this week—another JP Morgan case—for bid rigging in the municipal securities market. We are going to continue to bring these cases out. I understand the public anger but I should say the SEC, like the CFTC, does not have criminal authority. We can't put people in jail, we can't criminally prosecute them; what we can do and what we have done is bring very tough enforcement cases, try and get money back and into the hands of harmed investors and then bar people from working in the industry who have really contributed to the violations by their firms. Last year for example — this isn't all coming out of the financial crisis — we returned $2.2 billion to investors in disgorgement off of a total SEC budget of $1.1 billion, so we are a pretty good value in that we returned $2 to investors who were harmed for every $1 of the entire SEC budget as well as assessing very large fines.

FM: *Do these cases just take that long or was there a failure to look at what people were doing with these derivative products?*

MS: The cases are complex to bring after the fact. They are hard to do but we have a great team working on the structured products cases as well as the accounting and disclosure issues with respect to a wide range of financial crisis cases. The way we approached a lot of these cases is the inadequacy of disclosure. If you look at a couple of the cases we brought, you'll see a failure to disclose to investors what was the deteriorating quality of the securities that were being sold.

The Rep Index

Registered Rep Readers *Do It By the Numbers*

1. Percentage of white Americans who own stocks, bonds or mutual funds: **49**
2. Of black Americans: **25**
3. Of Hispanic Americans: **16**
4. Percentage of households whose head is nearing retirement age that have 401(k)-type accounts: **60**
5. Chance that such a household has adequate savings to maintain its standard of living into retirement: **1 in 10**
6. Percentage of baby boomers in 2010 who say they will “never” retire: **25**
7. Percentage of those who said “never” who have no retirement savings: **100%**
8. Percentage of the world’s initial public offerings that came from the U.S. in 1990: **27**
9. In 2010: **9**
10. Percent of IPOs from China: **32**
11. Total revolving credit-card debt owed by American consumers: **$826.5 billion**
12. Total outstanding student loan debt—federal and private: **$829.8 billion**
13. Number of Gold to Go ATMs, vending machines that dispense gold coins and bullion: **17**
14. Change in rate of state worker retirements in the first quarter of 2011, compared to the same period in 2010, in Ohio, California, and Wisconsin, respectively: **27%, 23%, 79%**
15. Out of 127 sovereign nations, the number that Standard & Poor’s gives top-notch AAA rating: **19**
16. Of these 19, the number, besides the U.S., that has a negative outlook: **0**
17. Costs of tax complexity, including citizen time complying with the tax code and government collection efforts: **$431 billion per year**
18. Expressed as overhead percentage of government tax revenues: **30 cents on the dollar**
19. Percent of Americans who received at least one federal benefit (excluding tax breaks) in 2010: **46.2**
20. Percent of the 126 largest public pension plans that assume a rate of return exceeding 8 percent per year: **88**
21. Average annual compound growth rate of the S&P 500 over the past 20 year: **5.69%***
22. Percent of Americans over 65 with incomes under the government’s poverty line in 2007: **9.7**
23. Estimated number of U.S. Facebook users under age 13—the minimum age to register for the site: **7.5 million**
24. Percentage of Americans in 2009 who believed the free market is the “best system on which to base the future of the world:” **74**
25. Percentage of Americans who believe so today: **59**
26. Percentage of Chinese who do: **67**

** The S&P 500 Index is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.*

SOURCES: 1–3 Kaiser Family Foundation; 4 Center for Retirement Research, Boston College; 5 Harper’s; 6–7 Associated Press-LifeGoesStrong.com; 8–10 Dealogic; 11–12 Federal Reserve, FinAid.org; 13 Gold to Go, WSJ; 14 Center for State and Local Government Excellence; 15–16 Wall Street Journal, Standard & Poors; 17–18 Arthur B. Laffer, Laffer Center; 19 Census Bureau; 20–21 Wall Street Journal; 22 The Federal Interagency Forum on Aging-Related Statistics, Older Americas 2010, Key Indicators of Well Being; 23 Consumer Reports; 24–26 GlobeScan Incorporated (Toronto).

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