The Role of the SEC

Remarks of
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I. Introduction

I am very pleased to speak with you today. I would like to welcome you to the United States and to the SEC's International Institute. I am confident that you will find it an interesting and educational experience. Over the next two weeks, you will hear from a number of experts, speaking on a wide variety of topics. Let me encourage you to ask them questions and engage them in discussions about the issues. You really have a unique opportunity here to learn about the U.S. system. At the same time, we appreciate that we can learn a lot from all of you about your markets and systems of regulation. I know we will all have a productive two weeks. I hope that my comments regarding the role of the SEC in the regulation of U.S. capital markets will provide a good introduction, and a useful framework from which to encounter the specific substantive areas.

Before I go into the specifics of how the SEC is structured, I'd like to make a few general comments about the importance of regulation. I know that in many of your countries, there is an important move toward economic reform and opening the markets, which we have all come to know as "deregulation". But please, do not mistake free markets for unregulated markets. There is a very big difference. I don't think anyone would argue with the characterization of the US markets as free, but they are most certainly also regulated markets. And, it is in part the existence of sound regulation that gives our markets their competitive advantage.

The foundation of successful securities markets is investor confidence and the basis for investor confidence is a fair and efficient market where ALL participants - large and small, insiders and outsiders, sophisticated or not, can be exposed to the risks and rewards that the market provides on an equal basis. If investors believe that markets are rigged against them, that insiders have better information or are manipulating prices, that brokers are not disclosing important information to them or that companies have lied in their financial statements, then investors simply will not participate. Without participants, a market is of course, nothing but a theoretical abstraction. Thus, the goal of regulation is to ensure that indeed the

forces of supply and demand operate freely, that manipulation and insider trading are prevented, that all investors are treated fairly and that the financial integrity of intermediaries is assured.

II. The Role of the SEC

The Commission is the regulatory agency of the U.S. government responsible for the administration of the federal securities laws. The SEC is an independent regulatory agency in that its members are appointed by the President with the approval of the Senate. Commission members do not serve at the pleasure of the President; that is they cannot be removed from office by the President until the end of their terms. As a result, the Commission is less subject to political change. The Congress, as I will discuss later, passes the laws which the SEC must implement and enforce but it also exercises active oversight of the Commission through its appropriation of funds for Commission operations and through a more informal process of requiring the Chairman to come before Congress to testify about important issues on a frequent basis.

The statutes that comprise the federal securities laws provide a system of regulation for the issuance of securities (also known as the "primary" market), and the subsequent trading of those securities

(referred to as the "secondary" market). At their core, the federal securities laws protect the investing public and the interests of the public in the securities and financial markets by providing for full disclosure of all significant information regarding the companies that issue securities, and prohibiting fraud and manipulation by participants in the issuance and trading of securities. These laws are designed to keep the markets fair and honest, and they provide the Commission with the authority to ensure that publicly held companies, broker-dealers, investment companies and advisors, and other participants in the securities markets comply with all the applicable laws and regulations.

There is substantial diversity to the specific statutes under the jurisdiction of the SEC. The Securities Act of 1933 is the central disclosure statute, designed to provide prospective and current investors with material information, foster investor confidence, facilitate capital formation, and inhibit fraud in the offering and sale of securities. The Commission also administers the Securities Exchange Act of 1934, whose provisions are designed to prevent inequitable and unfair practices in the exchange and over-the-counter markets. The other significant area of authority arises from the companion Investment Advisers and Investment Company Acts of 1940, which

regulate the activities of mutual funds and money market funds, and those persons that are in the business of giving investment advice.

Obviously, the SEC is staffed and structured to facilitate the effectuation of our mandate. The Commission is headed by a Chairman and four Commissioners, who are appointed by the President, with the approval of the Senate, for staggered five year terms. No more than three of the five commissioners may belong to the same political party. The SEC is organized as an independent, non-partisan regulatory agency. We have about 2700 employees; mostly lawyers, but also accountants, financial analysts, examiners, engineers, investigators, economists, and the occasional geologist. Over half of the agency's staff is located in this building, and the rest are spread across the country in our 12 regional and branch offices. In the home office, here in Washington, the staff is organized into five major divisions: (1) Enforcement, which, logically, enforces the statutes and rules through the use of its administrative and civil authority; (2) Corporation Finance, which, among other responsibilities, administers the disclosure, securities registration and tender offer rules; (3) Market Regulation, whose responsibility includes oversight of the primary and secondary trading markets and the regulated entities associated with trading, such as exchanges and

brokerage firms; (4) Investment Management, which administers the Investment Advisors and Investment Company Acts; and (5) the Office of the General Counsel, which acts in the role of legal advisor to the Commission and the various divisions. We also have an Office of International Affairs, and Offices of the Chief Accountant and the Chief Economist. The regional offices enable us to be closer to public companies who file reports with us, and more importantly, closer to the regulated entities such as brokerage firms and investment companies that we inspect for compliance with the securities laws. It obviously also facilitates our enforcement efforts to have attorneys located throughout the country. Over the course of the next two weeks, you will learn in detail about the work of each of these offices in applying, interpreting and enforcing the securities laws.

Broadly speaking, the SEC fulfills its statutory obligations -- given to us by the Congress -- in two primary ways -- through rulemaking and enforcement. I will address enforcement a bit later and I'd like to focus on rulemaking right now. When the Congress passes a law regarding the securities market, the law is usually quite general and it is either explicit or understood that the SEC will write rules and regulations to implement that law. The process of writing

rules is governed by the Administrative Procedures Act or the "APA". The APA requires the Commission, and all other government agencies, to write rules with the participation of the affected industry and the public in general. Thus, the process, although a bit cumbersome -- and I'll describe it in a moment -- seeks to ensure that those who will be most affected by what the SEC will do, have a chance to explain to us why the proposed rule is good or bad, how it will impact their business, how we might accomplish the same goals at lower cost, and so on. This input is really critical for us to effectively make rules in very technical areas.

In essence, after a law is passed, the staff writes rule proposals which the Commission votes to have published in the Federal Register -- a compendium of all government rule proposals and final actions. This Federal Register notice sets forth the rule and a full explanation of it. The public then has the opportunity for -- usually 60 days -- to write letters to the Commission commenting on the rule proposal. These comment letters are often very helpful and form the basis for rewriting, modifying and in some cases even abandoning the proposed rule.

After the staff and commission have received and read all comment letters and made appropriate changes to the rule, the Commission will vote to approve, modify or disapprove it. If approved, it will be published again in the Federal Register as a final rule and within a short period of time -- usually 30 days -- it becomes effective. The staff my then follow up with the people most impacted by the rule, by giving interpretive or other advice.

In order to do our job, we coordinate our authority and resources with various organizations in myriad ways. We share the registration and regulation of broker-dealers and investment advisors as well as the registration of securities with state securities organizations; we share the regulation of the domestic secondary markets and the detection of insider trading, manipulation, and other types of fraudulent trading activity with the self-regulatory organizations, such as the New York Stock Exchange and the National Association of Securities Dealers; on some occasions we share enforcement coordination with the Federal Bureau of Investigation ("FBI") and the Department of Justice, CFTC and banking regulators; and we share the regulatory responsibilities accompanying the growth of the investment of the funds of U.S. investors abroad and the entry of foreign money into the United

States markets with our counterparts in the securities commissions and administrations in other countries. I would like to focus a little on these relationships.

A. NASAA

As you all know, the United States is composed of 50 states and each state plays a role in securities regulation. The coordination of federal and state securities regulation is accomplished largely through the SEC working with a single, umbrella organization, the North American Securities Administrators Association, or "NASAA." NASAA does most of the speaking for the interests of the states. This dual system of federal-state securities regulation has existed since the adoption of the federal regulatory structure in 1934. Issuers seeking access to capital, as well as industry professionals, must comply with both federal securities laws and applicable state regulations. Because we share regulatory responsibilities with these state securities administrations in practically every area of securities regulation, we continually must strive to provide and increase uniformity in matters that involve both state and federal regulation, and attempt to reduce burdens on market participants through coordination. As you can imagine, the costs of such a dual regulatory structure are not insignificant and increasingly this system

is being blamed, at least in part, for the high cost of capital in the US. On the other hand, while there is substantial doubt about whether we need the fifty states to approve new offerings or to register the broker-dealers that are already registered with the SEC, we readily concede that the states have a very important role to play in the enforcement arena and we welcome them as a first line of defense against fraud. The SEC and individual states have cooperated with great success in a number of enforcement actions, particularly where there has been fraud in the sale of low-priced or penny-stocks to the public.

B. The Self-Regulatory System

As I noted, we also maintain a very close working relationship with the exchanges and the NASD; these are the most important regulatory relationships the SEC has. Collectively, these entities are called self-regulatory organizations, or SROs, and that title is illustrative of the role they perform in monitoring of the markets.

Given the breadth and depth of activity in the U.S. markets, the variety of products and the number of participants, it would be inefficient and quite likely ineffective to try to develop a system of

wide-scale government regulation. The SEC oversees more than 8,000 securities firms, ranging in size from tiny firms with one or two employees to global giants. These firms collectively handle trading with a value of about $5 trillion a year. Because of the sheer number and size of the entities, the SEC cannot carry out the task of oversight alone. Instead we rely on a pattern of regulation combining both industry and government responsibility. While responsibility over all participants converges at the SEC, the system also disperses oversight responsibilities among a number of industry entities. Oversight is thus built into the system.

It is useful to picture market oversight in the US system as an integrated structure shaped as a pyramid. AT the broad base of the pyramid are brokerage firms responsible for assuring the ethical conduct of their employees. At the next level are the self-regulatory organizations - the exchanges and the NASD. Finally, at the top of the pyramid is the SEC. You will hear from the Division of Market Regulation, later this week about the obligations of brokerage firms to supervise their employees to ensure they are dealing fairly with the public, so I will not dwell on that aspect of self-regulation. I would like to focus on the middle level of the pyramid - the SROs.

Much of the initial surveillance and investigatory work concerning the daily trading in the markets is performed by the SROs. This reflects the belief, first expressed statutorily by Congress, and strongly maintained today, that, with proper oversight, the SROs can be much more effective than the Commission at reviewing trading and broker-dealer activity. The SROs are required to conduct periodic examinations of brokerage firms. They are also required to monitor trading activity of their members. If there is evidence of improper trading, the SROs are expected to investigate and if necessary, bring disciplinary action.

The SROs, which must be registered with the Commission, receive and maintain the authority to enforce compliance by their members, namely the broker-dealers, and the associated persons of broker-dealers, with the legal requirements of the federal securities laws, as well as the rules of the SROs. Importantly, the rules of the individual SROs may, and often do, place even higher standards on the conduct of the member firms than is required by SEC rules.

Practically, this means that daily trading reviews, monitoring of financial stability, audits of firms' sales practices and such are performed by the SROs, not the SEC. Through the years, the SROs

have developed systems and procedures, skills and institutional history, that make them effective at detecting aberrational price movements, volume surges, or activity concentrations. Particularly in the case of the primary markets, such as the NYSE and NASD, they have committed significant resources to the development of computer systems designed to capture trading data. These systems provide preliminary analysis, and are quite accurate at detecting, or "flagging," potentially fraudulent or manipulative trading. Further, these systems produce transaction journals, or "audit trails," which summarize daily trading in each security. These systems are not perfect, and are constantly in need of enhancement to stay current with the markets. Fortunately, however, more often than not the SROs have shared our commitment to the continued enhancement of their automated facilities.

The SROs also have proven effective at taking price and volume alerts and performing the initial phases of an investigation. When they become stymied either by the lack of authority to obtain information, or a lack of jurisdiction because it appears that the focus of the investigation is someone other than a member firm or associated person, they refer the investigation to the SEC, thereby utilizing one of the important links of the self-regulatory system.

Another important link in the system is Commission oversight of SRO activities. Congress recognized that although primary exchange surveillance would be more efficient, left alone the SROs might not provide the level of scrutiny necessary for the protection of investors. Therefore, as part of its statutory responsibility, the Commission dedicates significant amounts of staff and resources to its oversight of each aspect of the business of the SROs that might have an impact upon public customers. This can range from the listing of securities to ensure that the SRO is complying with its own listing standards, to the arbitration process, ensuring that customers that choose to resolve disputes in that forum are treated fairly and in a timely manner. We also perform oversight inspections to assess the quality of market and trading surveillance. These inspections review the systems in place, as well as the caliber and thoroughness of investigations. The inspection program also is charged with ensuring the regulatory effectiveness and the due process protections of the SROs' own disciplinary programs.

Finally, the Commission maintains its oversight through its rulemaking and rule approval functions. Under the Exchange Act, any time an SRO decides to amend any of its rules, procedures, or interpretations, it must submit a proposal to the Commission. The

Commission, after providing the public the opportunity to comment, then must make a determination that the proposal is consistent with the purposes of the statute before the proposal is approved.

On the whole, although it requires constant attention and occasional fine-tuning, I believe the self-regulatory process continues to be an effective one, adapting and growing along with the markets.

C. Federal Cooperation

The SEC is an enforcement agency. Without active and aggressive enforcement of the federal securities laws and rules governing disclosure by issuers, trading by market participants, the honesty of the relationship between the broker and the customer, all the rules would be meaningless. In the vast majority of cases, the SEC acts on its own in the enforcement area: the Commissioners meet every week to approve the commencement of investigations, the initiation of legal actions or the settlement of cases already brought. Our cases against securities law violators can be brought in federal court before a judge or in our own administrative court before an administrative law judge who is an employee of the SEC. If a person or company is found to have violated the securities laws, he may be

censured or enjoined or ordered to pay a fine, give back profits, suspended or even barred from working in the securities industry. If the wrongdoing is serious, the SEC might refer the case to the U.S. Attorney to bring a criminal action. Thus, this is another type of coordination for the SEC. We often work with federal criminal authorities to pursue especially serious violations of the securities laws.

In a non-enforcement context, the SEC cooperates and coordinates with other federal regulators such as the Federal Reserve Board and the Treasury Department for the regulation of government securities brokers and dealers, and the Commodity Futures Trading Commission for the activities broker-dealers which are also futures commission merchants.

D. International Coordination

Just as our working relationships with the states and the SROs have helped to keep our markets safe and liquid, and we continually work to try to keep regulatory hurdles and duplicative requirements to a minimum, it is a primary objective of the Commission to work both internally and with foreign regulators in our efforts to enhance international competition and to promote the integrity of the

international marketplace. This commitment to competition stems from the belief that competition, in the U.S. and elsewhere, has been the catalyst for new products and operational improvements to our markets, that, in turn have enhanced the efficiency and soundness of those markets. The Commission firmly believes that a regulatory structure that encourages and fosters new product development will help keep U.S. markets among the most liquid, yet still the safest, in the world, which is why we have supported efforts to accommodate global trading.

Integral to the unimpeded flow of international investment opportunities is good working relations between U.S. and foreign regulators. As I am sure many of you know, the Commission is an active participant in the International Organization of Securities Commissions (IOSCO), which has representatives from over 60 securities commissions globally. IOSCO tries to facilitate the internationalization of the securities markets by acting as a forum for the discussion, exploration, and resolution of issues affecting the transnational marketplace. The Commission also participates in a number of international accounting groups, which seek to develop international accounting standards for multinational issuers. Although maybe not the most exciting topic, efforts in this area are especially

important in eliminating the hurdles to international offerings of securities. We were also active participants in the work of the Group of Thirty, which has focused on the problems of developing an international clearance and settlement system.

Finally, we are very active working on a bilateral basis with other countries, negotiating agreements for surveillance and enforcement cooperation. Agreements of this type have been signed with (UPDATE LIST) Brazil, Canada, the U.K., France, Italy, Luxembourg, Mexico, the Netherlands, Norway, Spain, Japan and Switzerland. We have signed less extensive cooperation communiques with regulators in Sweden, Italy, Costa Rica and Indonesia. These arrangements are an effective means of obtaining information and developing cooperative arrangements between regulators.

This level of cooperation has allowed the Commission to pursue a variety of vehicles designed to streamline the international regulatory process. One such concept is the establishment of a multijurisdictional disclosure system, which can facilitate multinational securities offerings. Such a system currently exists between the US and Canada.

A high level of cooperation is obviously also important in the enforcement area. International cooperation among regulators is essential if we are to do battle with international fraud. I believe that later in the week you will hear about international enforcement efforts,

IV. Conclusion

To summarize the role of the SEC in regulating the markets is as difficult as summarizing the activities of the markets themselves. As the capabilities of the markets adapt to meet changing needs, so must we try to adapt to keep pace with them.

Many of the topics I have touched upon will be dealt with in far greater detail during the course of the program, but I hope I have given you a useful insight into the Commission's role in the U.S. and international securities markets.