

## MEMORANDUM

To: Public Comment Files on Dodd-Frank Act Implementation

Title IV, Regulation of Advisers to Hedge Funds and Others: Systemic Risk Reporting; Exemptions for Certain Advisers; Family Office Exclusion

Title VI, Improvements to Regulation of Bank and Savings Associations Holding Companies and Depository Institutions: Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds

Title VII, Wall Street Transparency and Accountability: Definitions; Mandatory Clearing of Security-Based Swaps, End User Exception and Security-Based Swap Clearing Agencies

Title IX, Investor Protection and Improvements to the Regulation of Securities: Study – Fiduciary Duty

Public Comment File on Work Plan for Global Accounting Standards

Public Comment File on Short-Term Borrowing Disclosure

Public Comment File on Concept Release on Equity Market Structure

From: Jennifer B. McHugh

Re: Meeting with the Financial Services Forum (the “Forum”)

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On October 6, 2010, Chairman Mary L. Schapiro met with members of the Financial Services Forum, where she provided an overview of the SEC’s Dodd Frank Act implementation efforts, including those related to new SEC responsibilities with respect to private fund advisers; the SEC’s study of the obligations of broker-dealers and investment advisers; the SEC’s upcoming swaps-based rulemaking; and the implementation of the prohibitions on financial firms of proprietary trading and certain relationships with hedge funds and private equity funds. Chairman Schapiro encouraged the Forum members to submit comment letters on these Dodd-Frank implementation projects through the SEC’s public comment process. In addition, Chairman Schapiro discussed the SEC’s recent rule proposal on short-term borrowing and encouraged to Forum members to comment on it. She also reiterated her focus on addressing market structure issues. Chairman Schapiro’s talking points are attached.

Chairman Schapiro was joined by SEC Chief of Staff Didem Nisanci and Senior Advisor to the Chairman Jennifer McHugh.

The following members of the Forum were present [list provided by the Forum]:

Robert H. Benmosche, President and Chief Executive Officer, AIG

Lloyd C. Blankfein, Chairman and CEO, The Goldman Sachs Group, Inc.

Richard K. Davis, Chairman, President, and CEO, U.S. Bancorp

Jamie Dimon, Chairman and CEO, JPMorgan Chase and Company

C. Robert (Rob) Henrikson, Chairman, President, and CEO, MetLife, Inc.

Joseph (Jay) L. Hooley, President and CEO, State Street Corporation

Abigail P. Johnson, President, PWI, Fidelity Investments

Lewis B. Kaden, Vice Chairman, Citigroup, Inc.

Robert P. Kelly, Chairman and CEO, BNY Mellon

Brian T. Moynihan, President and CEO, Bank of America Corporation

Michael A. Neal, Vice Chairman, General Electric, CEO, GE Capital

John F.W. Rogers, Managing Director, Goldman, Sachs & Co.

John R. Strangfeld, Chairman and CEO, Prudential Financial, Inc.

John G. Stumpf, Chairman, President and CEO, Wells Fargo & Company

James D. Weddle, Managing Partner, Edward Jones

Thomas J. Wilson, Chairman, President and CEO, The Allstate Corporation

Barry Zubrow, Chief Risk Officer and Executive Vice President, JPMorgan Chase and Company

Robert Nichols, President and COO, Financial Services Forum

**Talking Points**  
**Financial Service Forum**  
**Mary L. Schapiro**  
*Chairman, U.S. Securities and Exchange Commission*  
**Washington, DC**  
**October 6, 2010**

**Introduction**

- I appreciate the opportunity to meet with you because it affords me a chance to have a discussion about the road ahead as we implement Dodd Frank and take additional steps to restore investor confidence in our capital markets.
- Since becoming Chairman, my focus has been on finding ways to reform the way we do things at the SEC – to make it a better, sharper, more responsive agency.
  - We’ve brought in new leadership, streamlined our procedures, engaged in an active rulemaking program, and begun to break down silos so that there’s greater coordination among our divisions.
- But we’ve also been hard at work in two critical areas that are of particular importance right now:
  - Helping to shape and now to implement the Dodd-Frank Act;
  - And, working on ways to improve the resiliency and fairness of our markets – the need for which was highlighted by the May 6<sup>th</sup> sudden market decline.
- So I thought I’d spend some time touching upon those areas

**A More Effective SEC**

- One of my most important jobs as Chairman has been to raise the agency’s performance across the board -- creating a more agile structure, building a more effective team and becoming more technically sophisticated.

- We began by bringing in a team of new dynamic leaders who shared my commitment to collaboration across organizational lines.
- We restructured to better reflect the challenges we face
  - Just as we restructured and re-energized our Enforcement program last year, we are now in the midst of a similar reform of the Examination program. The results have been a greater ability to move quickly, more experienced people on the front lines by eliminating a layer of middle management, and making more effective use of limited resources and personnel.
  - In addition, we created a new Division of Risk, Strategy and Financial Innovation, to keep up with the latest products and trading strategies.
- We're improving the quality of an already talented and dedicated team.
  - In an agency that historically has been dominated by lawyers, we have focused on hiring analysts, portfolio managers, traders and other industry professionals.
  - We're upgrading technology to improve data management and we're building a new database for tips and complaints.
  - We're investing in IT that allows us to manage the terabytes of data we gather every month far more efficiently.
- And, we also continue to advance an aggressive rulemaking agenda that – while considering the needs of all stakeholders in the financial markets – focuses first on investor protection and fair markets for all investors. We've adopted or proposed more than a dozen rules ranging from curtailing pay to play practices by investment advisers, creating a uniform audit trail and imposing new custody controls – to limiting 12b-1 fees and improving corporate disclosures.
- Together, these internal reforms and investor-focused rulemakings have significantly strengthened our ability to protect investors, encourage capital formation, and support the growth of the American economy.

## **Dodd Frank**

- Of course, we have also been quite active with Dodd-Frank Act implementation. That law requires us to do more than 100 rulemakings, establish 5 new offices and conduct 20 studies.
- I wanted to highlight a few areas of Dodd-Frank implementation that are particularly significant and, I expect, of interest to you.

### **IA/BD Study and Potential Follow-On Rulemaking**

- One area of particular interest in our Dodd-Frank implementation efforts relates to the standards of conduct applicable to broker-dealers and investment advisers.
  - The SEC is charged with doing a study on the varying obligations of broker-dealers and investment advisers.
  - In addition, the Act gives us rulemaking authority to establish a uniform fiduciary standard of care for broker-dealers and investment advisers following the study.
- Already we received over 3,200 public comments on this issue.
  - One of the challenges presented in this debate is how to impose a meaningful uniform fiduciary standard of conduct on broker-dealers and investment advisers, considering the varying business models of these financial professionals. In addition, we need to keep in mind that the ultimate goal is to enhance retail investor experiences, not deprive them of choice.
  - In addition, the study asks us to go beyond mere consideration of standard of conduct, but also to identify gaps and overlaps in the regulation of broker-dealers and investment advisers. It is important to keep in mind that for a fiduciary standard of conduct to have a positive impact, it needs to be backed up by an effective regulatory regime and a meaningful examination and enforcement program.

### **Private Fund Adviser Registration**

- Another significant area of responsibility for the SEC under the Act involves our oversight of private fund managers – hedge funds – beginning in July 2011.

- The mandated registration and systemic risk reporting by private fund managers represents a strong signal from Congress that enhanced oversight of the activities of private fund managers is necessary to enhanced market stability.
- We also will be issuing rules to gather data from private fund managers for systemic risk and investor protection purposes. The statute provides a fairly detailed list of required information, including leverage information, counterparty credit risk exposure, types of assets held, and trading practices.
- We have been working closely with the FSA to coordinate our information and data demands to lessen the burden on funds when reporting becomes effective.
- Finally, we will be proposing shortly, definitions for Venture Capital Funds and Family Offices, which are exempted from registration.

### OTC Derivatives

- And a third focus of the Act involves OTC derivatives. Over the next twelve months:
  - We will continue working with the CFTC to effectuate the mandatory clearing and trading requirements, outline the governance and ownership options for securities based swap clearing agencies, delineate how Swap Execution Facilities will operate in order to satisfy the “multiple to multiple” requirements of the Act and establish definitions and regulatory regimes for swap dealers and Major Swap Participants.
  - And we will be working with other regulators to establish capital and margin requirements, and “real-time” public reporting.
- And we are working to ensure that all swaps users benefit from the emergence of a swaps market structure that brings the benefits that result from a centrally cleared market.
  - We are exploring ways to encourage robust competition, broad access, high liquidity, and increased transparency.
- One area where we are focused is on the need to have harmonious OTC regulatory regimes across jurisdictions to avoid the emergence of regulatory arbitrage or inefficiencies across markets. It appears that the Dodd Frank approach is generally consistent with other jurisdictions, but our staff is focused on working through the details with other regulators in order to assure an appropriate level of consistency.

- Another area of early focus is the implementation of the Volcker Rule. The Financial Stability Oversight Council has 4 more months in which to finalize its study and make recommendations to the regulators. At the SEC, we are very focused on how to define market making and underwriting activities which are permitted under the rule so long as they do not exceed the “expected near term demands of customers or counterparties”. Similarly, certain hedging activities are permitted and we will need to define those.
- I think some of the most important issues here relate to the fact that these permissible activities in fact, become non-permissible, if they would result in a material conflict of interest between the bank and its customers or counterparties.

### **Market Structure**

- As you are aware, since I have been Chairman of the SEC, we have also concentrated our energies on market structure issues. And Friday’s publication of the May 6<sup>th</sup> report prepared by the staffs of the SEC and CFTC has highlighted the need to continue this focus.
  - The report required an extraordinary amount of data analysis, in-depth interviews with 40 market participants and synching up data among dozens of trading venues.
- There was a severe price dislocation in the E-Mini futures contract that was triggered by a substantial sell order of a single large trader. The sell order was a large, automated order that was executed according to an algorithm that took trading volume into account, but did not account for price or time.
  - That sell order was executed during a time of significant uncertainty and negative sentiment in financial markets.
  - The execution of this order exacerbated an existing liquidity shortage, resulting in a severe price decline in the E-Mini. And, through cross-market arbitrage, this price decline spilled over into the equity markets.
  - In turn, these price declines, led to a liquidity crisis and a temporary breakdown of orderly price discovery in the equities market more broadly. Trades were executed at absurd prices. 20,000 of these trades (in over 300 securities) were broken

because their prices deviated by more than 60% between 2:40 and 3:00. But as we know, many other trades – including trades by retail investors who had stop loss orders in place – were not broken because they did not meet the 60% threshold.

- The devastating impact of May 6 on the psyche of American investors really required that we take immediate steps to address the symptoms even before we clearly understood what the disease was.
  - We quickly worked with the exchanges to develop a pilot program of circuit breakers for S&P 500 and Russell 1000 stocks and many ETFs — circuit breakers that provide a trading pause if prices move by 10 percent or more within a five-minute period. This allows time for market participants to regroup and assess the value of a stock.
  - And we approved Exchange rules that give objective criteria on when trades will be broken as a result of aberrant prices. These standards should be known by investors in advance of a market failure, not determined after the fact as was the case on May 6.
- The events of May 6 highlight the need for the review of our market structure that we launched nearly a year ago. It's a review intended to ensure that our markets are as fair and efficient as possible.
- Going forward we're looking at:
  - The pros and cons of imposing market maker obligations on high frequency traders;
  - The need for algorithms to be programmed with risk management controls that can throttle back order entry in appropriate circumstances;
  - Elimination of Stub Quotes;
  - The impacts of the strategy of submitting large volumes of orders only to later cancel them, sometimes called quote stuffing;
  - A limit up/limit down procedure that would directly prevent trades outside specified parameters; and
  - Data integrity and latency issues.



- The structure of today's markets undoubtedly offers advantages. Execution costs have declined dramatically, for both institutional and retail investors. And, we should not attempt to turn the clock back to the days of trading crowds on exchange floors. But we must carefully consider whether our market structure rules have kept pace with the new trading realities.

### Window Dressing

- Beyond Dodd-Frank implementation and market structure issues, we continue to be focused on improving information available to investors.
- Particularly relevant to this group is a proposal we issued on September 17<sup>th</sup> that is designed to enhance disclosure of a company's short-term borrowing practices – what some refer to as balance sheet “window dressing”.
- At its core, the rule's aim is to enable investors to better understand whether short-term borrowings reported at the end of reporting periods are consistent with amounts outstanding throughout the reporting period.
  - Investors would get more than a period-end snapshot – and thus better evaluate ongoing liquidity and leverage risks – especially since short term borrowings for some companies can vary significantly over a particular quarter.
- Among other things, companies would be required to disclose
  - the average amount of short term debt outstanding during the period and the maximum amount outstanding during the period.
  - In addition, companies would be required to provide disclosure about the purposes of the short term debt, the impact on liquidity and capital resources, and the reasons for material differences between the average short-term borrowings and the period end number.
- Comments on this proposal are due on Nov. 29 and we will be very interested in your views on the workability and effectiveness of our approach.
- Also on September 17, the Commission issued an interpretive release providing guidance about existing requirements for MD&A disclosure about liquidity and funding.

- The interpretive release is a reminder that companies should not use financing structures or disclosure techniques to mask a company's true debt levels.
- We felt that this was a particularly important message to reiterate coming out of the financial crisis.

### FASB and Accounting Issues

- Before I conclude, I should say a word about FASB and accounting issues that I know are very much on your minds.
- First, as you probably are aware, the FASB board is moving from a board of 5 to a board of 7.
- Last week FASB published the results of their outreach to investors.
- As that report states, most investors consulted believe that better information about risks inherent in loans (interest, credit, and liquidity) would be an improvement to financial reporting, but they do not uniformly consider fair value as a measure in income or on the balance sheet as the best way to provide that information.
- Instead, many investors are supportive of expanded disclosure about those risks accompanied by improved disclosure of fair value information.
- In addition, we have the issue of accounting convergence very much on our radar. The issues are not simple.
  - One concern I have is that IFRS is not the monolithic standard that many believe it to be. Political realities could lead to different standards in different countries.
  - We also need to be mindful of the costs of conversion, particularly for smaller companies, as we move forward.
  - And always we need to remember that accounting standards must serve the needs of investors. As a result, I support independent accounting setting bodies that can be insulated from political pressure.

### Conclusion

- So I think it is clear that we have a good deal of work on our plate, but I think we're up for the job.

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