Keynote Address at Columbia Law School Conference on Current Issues in Securities Regulation: The 'Hot' Topics

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Thank you, John [Coffee], for your kind introduction.

Before I begin my remarks, I am required to tell you that the views I am expressing today are my own and do not necessarily reflect those of the Commission, my fellow Commissioners, or the staff of the Commission.

It is a pleasure to speak in front of an audience that cares so passionately about securities regulation. You are taking the time to think about what is and is not working in our securities laws. And, more importantly, you are thinking about possible solutions to make our laws work better.

The issues that you are discussing today are all important. There are panels on money market funds, dark pools, and high frequency trading. As aptly noted by the name of the conference, these certainly are some of the "hot" topics in securities regulation. They present complicated issues. And while each topic has its own intricacies, all of them would benefit from greater transparency.

That's why today I thought I would start out by talking about the importance of transparency in our securities markets. Then, I'll talk about two areas where the Commission has recently enhanced transparency: the municipal securities market and the private equity market. I will conclude with some thoughts on exchange traded funds (ETFs) and the broader market impacts of new structures that seek to relax the transparency requirements for these funds.

The Importance of Transparency

Transparency has long been central to effective securities regulation. While it's not the only tool the Commission has in its toolbox, it's foundational. Felix Frankfurter, one of the principal drafters of the Securities Act of 1933, was a notable disciple of transparency, as was reform advocate Louis Brandeis.[1] As Brandeis famously said, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[2]

As we've seen for 80 years at the Commission, this electric light has helped make our markets fair and efficient. Done right, it enables us to be confident that in a world of competitive pressures and seemingly endless options, families *can* make smart choices and take responsibility for their own futures. The informed decisions of our individuals, families, and institutions are one of the most efficient ways for businesses to access the capital they need to grow, prosper, and create jobs for millions of Americans; while also enabling them to benefit from the productive efforts of the businesses they invested in, so that they can save for retirement and pay for their children's educations, and more.

In no small part due to transparency, America continues to have the most vibrant securities markets in the world. But there is still room for improvement, starting with the municipal securities market.

Transparency in the Municipal Securities Market

Municipal finance has been essential to the growth of our nation and, in particular, New York. The first municipal bond on record in the United States was an 1812 New York offering that helped pay for the digging of a canal. Municipal securities also funded the Croton Aqueduct, which helped meet the growing demand in New York for things that many of us take for granted, such as clean water and water to fight fires.[3]

State and local governments, through municipal finance, continue to provide the bulk of our current infrastructure funding nationally, helping to provide roads, schools, and countless other services.[4] This creates jobs both in the short and long-term, gives businesses the confidence to operate, and enhances our citizens' quality of life.[5]

In order to continue to support our nation's infrastructure, state and local governments continue to need capital. And that capital comes primarily from ordinary investors, who own over 70 percent of the market directly or through investment companies.[6]

In recent years, there have been significant improvements in transparency in this market thanks to the work of the Municipal Securities Rulemaking Board (MSRB), which has harnessed the power of technology through its free, electronic repository of information called the Electronic Municipal Market Access system, or EMMA. The SEC also brought new attention to this market by implementing Congress' mandate that municipal advisors — those who help our state and local governments in their financing efforts — register with the Commission. In addition, the SEC has brought a series of enforcement actions that held issuers accountable for the disclosures that investors rely upon.[7] But large gaps in transparency in this market still exist. This has significant costs to retail investors, who are unable to demand competitive transaction pricing because they lack basic information.[8]

Calls to bring greater transparency to this market are not new. The Commission issued a 2012 report that identifies some of the ideas that I will highlight.[9] And several of my fellow Commissioners have expressed support for bringing more transparency to this market.[10] There is momentum to press ahead, and I want to discuss two areas where regulators should move forward.

The first is to provide basic post-trade pricing disclosure on customer confirmations for principal transactions. Despite the transaction information being readily available on EMMA, investors do not receive disclosure on their confirmations showing the transaction costs that they pay when they buy or sell a municipal security in a principal transaction. This is significant because virtually all customer transactions in this market are principal trades.[11] Earlier this week, the MSRB published a proposal to provide this disclosure on customer confirmations.[12] I encourage you to weigh in on all aspects of the MSRB proposal, as well as the related proposal by the Financial Industry Regulatory Authority (FINRA), and in particular whether the disclosure of the price differential should be a percentage of par value, a total dollar amount, or both.

While post-trade transparency is important, it is only one side of the coin. It must be complemented with greater transparency before trading takes place. Here, there remains a lot more work to be done. Ordinary investors do not have the most basic of information, such as who in the market is interested in buying or selling a municipal security, and at what price. Firm bid and ask quotes are generally unavailable, and municipal bond dealers usually do not provide firm quotations electronically. The limited information that does exist typically is only available to institutional investors and participating dealers. In addition, it is provided primarily through electronic networks operated by alternative trading systems (ATSs), or through municipal bond dealers that are broker's brokers.

We need to provide ordinary investors with more equal access to this information. This should promote competition and lead to better prices for investors.[13] Determining the best way to do it requires deep thinking. One option that we should explore is amending Regulation ATS to require public disclosure of pricing information. The Commission also could require broker's brokers to publicly disclose pricing information. If we chose this path, we will need to work through challenging issues. For example, should such a rule apply to all electronic networks? Should it apply to all of the transactions on the networks, or

only those that exceed a threshold? While there are no easy answers, and we must be careful to avoid unintended consequences that could lead to less transparency, these are alternatives that are worth considering given the sizeable benefits that could come from greater sunlight in this space.

Institutional Investors Need it Too — Transparency and Private Equity

Private equity, a market where most of the investors are institutions, also is benefitting from greater transparency. Public and private pension funds, endowments, and foundations accounted for 57 percent of all investments in private equity in 2013.[14] This means that teachers, police officers, firefighters, and our public and private universities are relying on private equity for their financial security.

At the same time, private equity has played an increasingly important role in deploying capital to growing businesses and reforming those that are underperforming. Many of our most promising businesses that make products that we use every day have relied on private equity. To name just a few, private equity helped nurture and fund Microsoft, Sports Authority, and Burt's Bees.

As with the municipal securities market, in recent years there have been important advances in transparency in the private equity space. Most investment advisers to private equity funds must now register with the Commission, and file important information regarding advisory operations and past disciplinary events.[15] Investors appear to appreciate the increased transparency they are receiving, and there is evidence they want more.[16]

Investors in private equity are often sophisticated, but the range of sophistication varies. A teacher's pension fund from a small state generally does not have the same market power, or as many employees, as a large university endowment. In addition, regardless of market power or investment acumen, it's unrealistic to expect investors to be able to replicate the access our examiners have to an adviser's records, staff, and operations. Indeed, our Office of Compliance Inspections and Examinations (OCIE) has identified what it believes to be violations or material weaknesses in controls concerning fees and expenses in many of the exams where examiners evaluated these issues.[17] Now these are new registrants and a new inspection regime, and the violations may vary in severity, but these exams reveal that institutional investors too can benefit from increased transparency, as well as from the oversight that the Commission brings.

And while oversight and exams are critical, I still believe that transparency — and the investor choice and accountability that comes with it — is a much better approach as a first line of defense. Two places where I encourage advisers to private equity funds to consider improving their own disclosures are fees that are charged to portfolio companies and performance information.

An investor's ability to understand the fees that they will be paying is one of the most important tools for evaluating any investment — and for encouraging healthy competition in the marketplace.[18] Unfortunately, there is evidence that fee disclosures in private equity are lacking in important ways.[19] For example, our exams have uncovered that some funds are separately paying "consultants" for services that they provide to portfolio companies, even though they look and act like employees of the adviser. These "consultants" may even be described as members of the advisory team on the firm's website and in marketing materials. Without more specific disclosure, many investors would reasonably believe that they are employees of the adviser that are being paid from the agreed upon management fee.

Our staff also has identified several cases in which investors are paying the adviser separate fees for services that the adviser provides to a portfolio company under "monitoring agreements." These agreements often extend for long or indefinite terms that are far greater than the fund's expected holding period, and thus far beyond the time that the adviser provides services to the portfolio company. They frequently include provisions that accelerate payments when a portfolio company is taken public or sold, resulting in fees that can amount to tens of millions of dollars or more.[20] The fees, however, often are not disclosed with much detail, if at all, at the time an investor commits capital to the fund.

Let me be clear. There is nothing wrong with an investment adviser being fully compensated for services provided. That's called getting paid to do your job! But transparency and clarity about compensation are key to making that compensation accountable and competitive. Advisers should avoid relying on a technical interpretation of an ambiguous provision in a complex agreement to surprise investors with important information after the fund has closed. Our markets benefit when parties clearly disclose fees to the investor before he or she makes an investment decision. No one likes paying for something, and then getting slapped with hidden and unexpected expenses. Not only is it fundamentally unfair, it also could undermine the health of the companies that private equity firms are supposed to help grow and thrive.

The only thing that may be more important to investors than fees is performance information, which in private equity is generally presented as an internal rate of return (IRR). This is another area where better disclosure would be helpful.

Some advisers provide the IRR of past funds with scant detail on how it is calculated. For example, the IRR of a fund that includes the performance of a significant number of unrealized investments that are valued by the adviser could mean something materially different to investors than an IRR based solely on realized investments. Further, an IRR that is presented as a net return could be inflated if it includes returns on capital contributed by the fund's general partner, who typically does not pay a management fee or carried interest, or by preferred investors who pay reduced fees. This has the potential to misrepresent performance.

I think that it is fair and reasonable to ask an adviser to clearly describe the assumptions it makes when calculating returns, and make the underlying components of the returns more transparent to all potential investors. Simple transparency, that's what this is about. And again, when done right, this helps make our markets competitive, allowing investors' choices to reward those who do well and hold accountable those who don't.

ETFs — A Movement to Less Transparency?

I want to turn now to some thoughts on ETFs. Recently, the Commission has been considering novel exemptive applications for actively managed ETFs that propose to provide less transparency regarding their portfolio holdings than has been traditionally required.[21]

While the structures that have been proposed differ, they are illustrative of the growing complexity of exchange traded products (ETPs), of which ETFs are the most popular. The first ETFs, which began trading in 1993, sought to replicate the returns of broad-based stock market indexes such as the S&P 500. Since then, ETFs have become significantly more complex, offering exposures across geographies, industries, currencies, commodities, and real estate. To achieve their investment objectives, a growing, yet still small, number of ETFs employ sophisticated strategies involving options, swaps, futures, forwards, and other derivatives.[22]

As they have become more complex, ETFs have become increasingly popular with retail and institutional investors. Over the past decade, total net assets in ETFs have increased twelvefold, from $151 billion at the end of 2003 to $1.8 trillion at the end of June of this year.[23] Yet even with this impressive growth, they still comprise just slightly more than 12 percent of combined assets in registered open-end funds.[24]

Most of the growth has been in index-based ETFs. ETFs have not gained much of actively managed funds' market share because the Commission and its staff have traditionally required them to disclose their portfolio holdings each day.[25] While this has been necessary to ensure that the arbitrage mechanism works as intended, and all investors are treated equitably, it has discouraged fund sponsors from offering actively managed ETFs, because they fear that daily disclosure could allow competitors to front run their investment strategies. The daily transparency requirement has, in effect, provided a practical ceiling on the aggregate size of ETFs.

Exchange Traded Managed Funds (ETMFs), which more closely resemble a mutual fund than an ETF, along with similar products with relaxed transparency, have the potential to break through this ceiling.[26] While the potential cost savings to investors are significant, ETPs raise broader questions that I have been struggling with since the "Flash Crash," when the orders of a single Kansas City trader sparked a precipitous drop in the prices and liquidity of ETFs.

If ETFs continue to grow in market share, what are the effects on our broader market structure? For example, will it amplify volatility in the underlying securities held by ETFs? If so, is that necessarily bad, or does it enable more efficient price discovery? What are the effects on liquidity and capital formation? Are the effects different depending on whether the growth is in passively managed ETFs, actively managed ETFs, ETMFs, or other ETPs?

Are there systemic risks that we should be monitoring? ETFs, unlike mutual funds, rely on an interconnected web of participants, some of whom are affiliated with large banks. What happens if one of the authorized participants drops out of the market? Will others pick up the slack, even in times of stress? If not, what are the consequences? Would there be larger spreads in the secondary market? If yes, how would investors react? What happens if one or more ETFs suspend the creation and redemption process?[27] As ETFs increasingly invest in less liquid assets, could redemptions amplify fire sale risks?

The answers to these questions are less clear than the potential benefits to investors, which are significant. Nevertheless, answering these questions is critical to protecting investors, ensuring fair, orderly and efficient markets, and facilitating capital formation —broad goals that include financial stability. I worry that these larger questions have been getting lost in the current ETF exemptive application and exchange listing process, where each product is considered independently, without the kind of broad attention that is necessary to garner the depth of public input I think we need on these questions.

The Commission has a cross-divisional team that is monitoring the growing ETP industry and its broader market and systemic impacts. This is an area where we would benefit immensely from public input. I have therefore asked the Chair to have the staff prioritize a written request for comment to the Commission to provide a formal mechanism for getting public input on these and other issues related to ETPs.

Conclusion

I have covered a lot and want to leave you with three thoughts. First, we have the most vibrant financial markets in the world because they are so transparent. History has demonstrated time and time again that modest up-front costs that come from additional transparency are more than made up for by the added liquidity, reliability, and competitive returns that come when markets function as they should. Second, transparency matters to both retail and institutional investors. Last, as we consider changes in transparency, for example in areas like ETFs, we must be cognizant of the broader effects on our markets and the entire financial system. Thank you for inviting me to be with you this afternoon. I look forward to hearing your thoughts and working on these issues with you going forward.

[1] *See* Kenneth Durr and Adrian Kinnane, "431 Days: Joseph P. Kennedy and the Creation of the SEC (1934-35)," SEC Historical Society, available at: http://www.sechistorical.org/museum/galleries/kennedy/politicians_b.php.

[2] Louis D. Brandeis, "Other People's Money," available at: http://www.law.louisville.edu/library/collections/brandeis/node/196.

[3] *See* David M. Cutler and Grant Miller, "Water, Water Everywhere: Municipal Finance and the Water Supply in American Cities," NBER Working Paper 11096 (Mar. 2006), available at: http://www.nber.org/papers/w11096.pdf.

[4] Between 2003 and 2012, state and local governments financed more than $1.65 trillion of infrastructure investments through tax-exempt bonds. *See* Report by National Association of Countries and National League of Cities, "Protecting Bonds to Save Infrastructure and Jobs" (Feb. 2013).

[5] *See* U.S. Department of Treasury, Office of Economic Policy, "Expanding our Nation's Infrastructure through Innovative Financing" (Sept. 2014).

[6] Based on data from the most recent Federal Reserve Board Flow of Funds Report (Second Quarter, 2014), available at: http://www.federalreserve.gov/releases/z1/Current/z1.pdf.

[7] *See, e.g.*, In the Matter of the State of Kansas, Release No. 9629 (Aug. 11, 2014).

[8] It is more expensive for investors to trade municipal securities than to trade corporate bonds or equity securities. One study estimates that effective spreads on retail-sized trades of $20,000 are 1.98% for municipal bonds, compared to 1.24% for corporate bonds and 0.4% for equities. *See* Lawrence Harris & Michael Piwowar, "Secondary Trading Costs in the Municipal Bond Market," Journal of Finance 61, 1361-1397 (2006), available at http://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2006.00875.x/pdf.

[9] SEC Report on the Municipal Securities Market (July 31, 2012) (Municipal Securities Report).

[10] *See* Commissioner Michael Piwowar, Remarks at the 2014 Municipal Finance Conference (Aug. 1, 2014); Commissioner Daniel Gallagher, Remarks at MSRB's 1st Annual Municipal Securities Regulator Summit; Chair Mary Jo White, Remarks before the Economic Club of New York (June 20, 2014).

[11] Municipal Securities Report at v.

[12] *See* MSRB Regulatory Notice 2014-20 (Nov. 17, 2014), FINRA Regulatory Notice 14-52 (Nov. 17, 2014).

[13] Analysis by the United States Government Accountability Office (GAO) showed that institutional investors generally trade at more favorable prices than retail ones. *See* GAO Report to Congressional Committees, "Municipal Securities: Overview of Market Structure, Pricing, and Regulation" (Jan. 2012).

[14] *See* Private Equity Growth Capital Council, "Fact and Fiction," available at: http://www.pegcc.org/education/fact-and-fiction/.

[15] All registered private fund advisers must file Form ADV and most of these advisers also report fund specific information on Form PF. According to data from Form ADV, as of November 3, 2014, 1,250 advisers registered with the Commission had at least one private equity fund client. These advisers provided investment advice to over 9,400 private equity funds with gross assets of more than $2 trillion.

[16] A recent study by Pivot Partners found a stark disconnect between the perceptions of general partners and limited partners on transparency. Although 92% of general partners believe they are providing their limited partners with all the information they need, more than half of the limited partners disagreed. *See* IAG and Thompson Taraz, "The Reputation Risk in Private Equity Report - Clear Intentions: How trust and transparency impact LP decision making." *See also* Gretchen Morgenson, "Behind Private Equity's Curtain," New York Times (Oct. 18, 2014).

[17] *See* Andrew J. Bowden, Director, OCIE, Remarks at Private Equity International, Private Fund Compliance Forum (May 6, 2014).

[18] In addition to being more transparent on fees, an adviser should have appropriate processes in place to ensure that fees are allocated in a way that is consistent with its policies, procedures and disclosures. *See, e.g.,* In the Matter of Lincolnshire Management, Inc., IA Release No. 3927 (Sept. 22, 2014) (adviser to private equity funds failed to follow expense allocation policy, resulting in the portfolio company owned by one fund paying more than its fair share of joint expenses that benefited the companies of both funds).

[19] *See, e.g.*, In the Matter of Clean Energy Capital, LLC and Scott A. Brittenham, IA Release No. 3785 (Feb. 25, 2014) (adviser to private equity funds failed to disclose and improperly allocated certain expenses to the funds, including the rent, salaries, and other adviser employee benefits such as tuition costs, retirement, and bonuses.)

[20] *See* Mark Maremont and Mike Spector, "Blackstone to Curb Controversial Fee Practice," Wall Street Journal (Oct. 7, 2014).

[21] *See* Precidian ETFs Trust, et al.; Notice of Application, IC Release No. 31300 (Oct. 21, 2014); Order Disapproving a Proposed Rule Change to Adopt NYSE Arca Equities Rule 8.900, Release No. 34-73424 (Oct. 24, 2014). *See* Eaton Vance Management, et al.; Notice of Application, IC Release No., 31333 (Nov. 6, 2014); Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to Listing and Trading of ETMF Shares (Nov. 7, 2014).

[22] The investment strategies for ETPs that are not registered under the Investment Company Act, such as exchange traded notes, can be even more complicated since they are not subject to the restrictions under the Act, such as those concerning leverage.

[23] *See* ICI Research Perspective, "Understanding Exchange Traded Funds: How ETFs Work" (Sept. 2014).

[24] *Id*.

[25] *Id.* As of June 2014, there were 78 actively managed ETFs, compared to over 1,250 index ETFs.

[26] Like mutual funds, ETMFs would be bought and sold at prices linked to net asset value and would seek to maintain the confidentiality of their current portfolio positions. Like traditional ETFs, ETMFs would trade on an exchange, and directly issue and redeem shares in creation units through authorized participants.

[27] *See* Arash Massoudi, Tom Braithwaite and Stephen Foley, "Bond market sell-off causes stress in $2tn ETF industry" (June 21, 2013).

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