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Statement of the Shadow Financial Regulatory Committee on

Welcome Actions by the Securities and Exchange Commission

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The Securities and Exchange Commission has had a new chairman, Christopher Cox, since August 3, 2005. In the last year the Commission has taken three steps that this Committee applauds. In addition, the Shadow Financial Regulatory Committee notes that the Commission has supported these measures unanimously, a welcome change from the previous partisan division among the members on a number of high-profile issues.

Monetary Penalties

There has always been an element of irony in the SEC's imposition of monetary penalties against corporations for violations by corporate managers of federal securities laws that had already resulted in losses to their shareholders. This adds a second loss to the burden shareholders have already borne.

Securities violations are committed by individuals acting in their capacities as officers, directors, or employees of corporations. To deter such conduct, it is appropriate to assess monetary penalties directly on those responsible. Penalties assessed against the corporation, which fall on its current shareholders, present a more complicated issue. Earlier this year, the SEC recognized this fact and tried to bring some clarity and consistency to what had been a murky policy by issuing a statement on financial penalties.

In particular, the SEC's statement identified two principal factors in future decisions about corporate penalties: (1) whether the corporation itself received a direct and material benefit from the violation, to the advantage of current shareholders, and (2) whether the penalty could be used to compensate injured shareholders. The statement also laid out some additional elements that might be appropriate to consider in particular cases.

How the various factors are to be balanced is left to the SEC's discretion, and therefore it is uncertain whether the statement marks any significant shift in Commission enforcement policy. But it represents a welcome attempt to better explain and rationalize its decisions.

Compensation Disclosure

The Committee supports the recent proposal by the Commission to strengthen public company disclosure requirements relating to executive and director compensation. Under the current rules, companies are required to disclose annually, in tabular form, certain elements of compensation paid to their principal officers and directors. However, as corporate compensation arrangements have become increasingly complex and varied, investors have had increasing difficulty comparing them across different companies.

Furthermore, many corporations do not disclose the full amount of executive and director compensation.

The Commission has proposed new disclosures that retain the tabular approach, but supplement and refine it in an effort to bring greater completeness and transparency to this area. The Committee takes note of these specific proposals.

First, companies would be required to include an overview narrative -- a Compensation Discussion and Analysis -- that would discuss and analyze the material factors underlying the company's policies relating to compensation and perquisites, explaining the data shown in the tables.

Second, a new Summary Compensation Table would report total compensation, paid currently or deferred in the last fiscal year and two preceding years to the company's top executives and directors. Deferred compensation includes options, restricted stock and similar grants.

Third, the disclosures also include the value of retirement and other post-employment benefits of executives and directors, including any such benefits payable in the event of a change in control of the company. The Committee agrees, however, with commenters who suggest that companies be required to disclose the value of post-retirement perks that firms promise their executives.

Taken together, the proposed requirements should improve investors' understanding of the compensation policies and practices of public companies, which can only improve the efficiency of the capital markets.

New Trading Platforms

Regulation NMS, adopted by the Commission, became effective August 29, 2005. The goal of this regulation was to centralize and integrate through electronic interfaces the trading of all but the smallest U.S. publicly traded stocks (those not traded on the National Market System). To accomplish this goal, the SEC developed a complex set of regulations. The Committee thought at the time that these new regulations would place a straight jacket on innovation in market trading systems.

It is natural for securities markets to fragment as new mechanisms for trading evolve. Those that provide value will flourish and ultimately become significant market players. Others will fail. The SEC should encourage such innovation.

A recent example, which the Committee applauds, involves an exemption to Liquidnet (a private company). Liquidnet has developed a very successful trading platform that addresses an issue that is important to institutional investors. Institutions often do not want to reveal their trading intentions for fear that broker-dealers and other professionals will front run them. For instance, if a trader intends to purchase a large number of shares, that trader might worry that others would use information of this intention to the trader's disadvantage.

Liquidnet addresses this problem by preserving the secrecy of institutional intentions and importantly excludes traders, who might engage in "objectionable behavior" (in the SEC's language). This exclusion is inconsistent with Regulation NMS. To its credit, on September 27, 2005, the SEC gave Liquidnet an exception that allowed it to limit access to its market to acceptable investors.

The Committee applauds this action and urges the SEC to offer new trading platforms similar exceptions when there is a conflict with SEC regulations. Indeed, the Committee continues to believe the SEC should abandon Regulation NMS entirely. The Commission should encourage competition and not stifle it.