

**Securities and Exchange Commission Historical Society**  
**The Best of NERA 2009**  
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**LISA FAIRFAX:** Good afternoon and welcome to today's The Best of NERA 2009 broadcast by the Securities and Exchange Commission Historical Society on [www.sechistorical.org](http://www.sechistorical.org). I am Lisa Fairfax, the Leroy Sorenson Merrifield Research Professor of Law at The George Washington University Law School and moderator of what I think will be a very stimulating program today. The SEC Historical Society preserves and shares the history of financial regulation through its virtual museum and archive at [www.sechistorical.org](http://www.sechistorical.org). The museum is free and accessible worldwide at all times. The museum as well as the society are separate and independent of the U.S. Securities and Exchange Commission and receive no government funding. Thus, we appreciate the gifts and grants from many institutions and individuals who make possible the growth and outreach of the virtual museum and archive to 9,000 visitors each month. Since 2004, in partnership with NERA Economic Consulting, the museum has broadcast the annual The Best of NERA program, highlighting top presentations from NERA Economic Consulting's recent Finance Law and Securities litigation seminar. The Society is grateful for the continuing generous sponsorship of NERA Economic Consulting for this series. Past broadcasts from the series can be accessed at any time in both podcast and edited transcript formats in the Best of NERA section of Programs at [www.sechistorical.org](http://www.sechistorical.org).

I am delighted to welcome our guests today and I will introduce them in their speaking order. First, Jan Larsen, Consultant, NERA Economic Consulting, who will discuss recent trends in SEC settlements and policy changes with implications for future enforcement actions, followed by Dr. Marcia Kramer Mayer, Senior Vice President with her proposal for regulatory and legislative changes to help the SEC detect Ponzi schemes quickly and cost effectively. Then Dr. Robert Mackay, Senior Vice President, who will share his insights in recent proposals to regulate credit default swaps in other over the counter derivatives. And finally Dr. Thomas Porter, Senior Vice President, who will discuss the guidance in FAS-157 Fair Market Values and with that I will turn the program over to Jan Larsen.

**JAN LARSEN:** Thanks Lisa and thanks to everyone at the SEC Historical Society for having us here today. I think we can all agree that this has been a dynamic year for the Securities and Exchange Commission. The SEC has a new chair, Mary Shapiro and a new Director of Enforcement, Robert Khuzami. As a result of the Madoff scandal and financial crisis, calls for reform have come from outside and inside the agency with certain reforms already in place. Today, I am going to talk about the implications of this shifting landscape for the SEC's enforcement activities as well as recent trends in SEC settlements. I am going to begin by walking you through the steps that lead from an investigation to an enforcement action and settlement, highlighting recently proposed and recently implemented reforms of the process along the way. SEC investigations can be triggered in many ways, including the review of forms filed with the SEC, routine inspections of persons or entities regulated by the SEC, news reports, referrals from other government agencies, referrals from stock exchanges, information received in other SEC investigations and tips from whistleblowers. On the latter point, the SEC is

planning to request new legislation that would allow it to offer incentives for whistleblowers to come forward in any type of securities fraud case. These incentives could include cash or immunity deals. This would represent a major expansion of the SEC's authority to offer incentives to whistleblowers which is currently limited to insider trading cases.

The first stage of an SEC action is typically something called an informal investigation, also known as an inquiry. At this stage, the commission staff has no subpoena power and must rely on the cooperation of the relevant individuals and entities to gather information. At the conclusion of an informal investigation, SEC staff may recommend that the commission undertake an enforcement action seeking sanctions if they think that the evidence clearly shows that a securities law violation has occurred, or they may conclude the investigation without recommending an enforcement action if they believe that it is unlikely that a violation has occurred, or they may seek a formal order of investigation from the Commission if they believe more evidence is needed.

When the SEC staff request and receive a formal order, a formal investigation begins which differs from an informal investigation in that the SEC staff can compel the production of evidence and testimony rather than relying on the cooperation of the relevant individuals and entities. For a formal order to be approved, the SEC staff must establish that, based on the available evidence it is likely that a securities law violation has occurred. This is one of the areas where there has already been a reform under Mary Schapiro. Previously, formal orders could only be approved at full meetings of all five Commissioners, which could sometimes take weeks to schedule. There was concern within the agency that these scheduling issues could compromise time-sensitive investigations. Because of these concerns, early this year, Ms. Schapiro revised the process for obtaining formal orders so that now they can be approved by just one Commissioner.

The next step after a formal investigation is typically the Wells process. If the staff has determined to recommend that the Commission commence an enforcement action, it typically gives prospective defendants a Wells Notice informing them of the staff's intent. The recipient of a Wells Notice has the opportunity to provide a Wells Submission, which is essentially a brief arguing that an enforcement action is not merited. Upon reviewing the Wells Submission the staff may elect to modify or reverse its recommendation to the Commission. The Commission itself also reviews the Wells Submission before determining whether to follow the staff's proposed course of action.

Up to this point, I have described typical precursors to an SEC enforcement action. However, when the SEC's staff believes that it is dealing with a highly time-sensitive matter with clear evidence of a securities law violation it may skip any or all of the steps described so far and instead recommend that the Commission undertake an enforcement action straight away. Upon the staff's recommendation to bring an enforcement action, the Commission has several options. They may authorize a civil action in federal court, an administrative proceeding before an administrative law judge or no enforcement proceeding at all. Whether the Commission authorizes a civil action in federal court or administrative proceeding depends on several factors including the severity of the allegations, the nature of the conduct alleged, tactical considerations and the type of sanctions sought. For instance, the failure of SEC-regulated entities that properly supervise their employees may only be addressed through an administrative proceeding, while monetary penalties against persons and entities not directly regulated

by the SEC may only be sought in federal court. As an example of tactical concerns, the SEC may only subpoena individuals to appear in federal court if they reside within 100 miles of the court house whereas in administrative proceedings, the Commission has nationwide subpoena power. When the circumstances warrant it, the Commission may bring both types of actions. The SEC has recently proposed new legislation that would neutralize some of the considerations that go into the decision of what type of action to bring. The agency plans to request nationwide subpoena power in federal court as well as penalty authority against all respondents in administrative cease-and-desist proceedings whether they are regulated or not. After an enforcement action has been commenced the next step is resolution. The majority of SEC enforcement actions are resolved through settlements rather than litigation and indeed the process of negotiating a settlement is another area where there has been an important reform under Ms. Schapiro. At the beginning of 2007, former SEC Chairman Christopher Cox instituted what has been called the penalty pilot program. Under this program, SEC staff were required to obtain pre-approved penalty ranges before beginning settlement negotiations with publicly-traded companies. Ms. Schapiro brought the penalty pilot program to an end shortly after taking over as Chairman, citing concerns that the program introduced delays in corporate penalty cases, discouraged SEC staff from seeking penalties in certain cases where they had been warranted and sometimes resulted in reductions in the size of penalties.

The agency also is seeking additional legislative changes that could impact its future enforcement activities. For example, the SEC is seeking penalty authority against aiders and abettors under the Investment Advisors Act. The Treasury Department's recent report, "Financial Regulatory Reform – A New Foundation," advocates several SEC reforms including requiring advisers of private funds such as hedge funds or private equity funds to register with the SEC, more stringent oversight of credit rating agencies and legislation that would enable the SEC to require that the compensation committees of public companies be more independent.

Given all that's been going on behind the scenes, let's take a quick look at recent SEC settlement activity. Through the first half of 2009, the SEC settled with 335 defendants, very much in line with 330 defendants the agency settled with through the first half of 2008. The largest settlements so far this year were the \$200 million settlement with UBS for allegedly facilitating tax evasion and the \$177 million settlement with Halliburton and KBR for alleged violations of the Foreign Corrupt Practices Act. All other settlements in the first half of the year were for less than \$100 million.

Now let's dig a little deeper into what the dollars have been looking like in SEC settlements. I am going to talk a little about average and medium settlement value, but when I do that I am going to exclude \$0 settlements from my calculations. One reason for this is that there are certain SEC cases where the agency either cannot or simply chooses not to seek monetary payments. Including these cases would therefore artificially reduce the average and medium settlement values. For reference, in the first half of 2009, 64% of settlements with companies and 58% of settlements with individuals included monetary payments. Among company defendants whose settlements included monetary payments, the average settlement amount in the first half of 2009 was \$10.1 million, an increase from the average of \$8.4 million in 2008. The medium company settlement, which is the settlement with an equal number of values above and below it, was \$1.6 million in the first half of the year, an increase from the 2008 median of \$1.3 million. If the 2009 median remains at \$1.6 million it will be the largest median value in

any year since the passage of the Sarbanes-Oxley Act. For individual defendants the numbers have been much lower and flatter. The average individual settlement amount was \$1.1 million, equal to the 2008 average. The median individual settlement was \$100,000, as it has been ever year since 2003.

I have reached the end of my time but if you like further information on recent trends in SEC settlements there's a lot more information on our dedicated website, [securitieslitigationtrends.com](http://securitieslitigationtrends.com). Thanks for your time. I am turning the mic back over to Lisa now.

**LISA FAIRFAX:** Thank you. And next we will hear from Marcia.

**DR. MARCIA KRAMER MAYER:** Thank you Lisa and the SEC Historical Society. How does \$65 billion in assets purportedly under management go missing? That's the combined asset value that Bernard Madoff Investment Securities reported to clients on their November 2008 statements, virtually none was real as the world learned days later when the biggest-ever Ponzi scheme came to light. The SEC has taken deserved heat for failing to detect Madoff's massive and long running scam. The official report has yet to be issued on how the watchdog agency allowed itself to be fooled by Madoff's machinations, despite the many red flags that whistleblower Harry Markopolos brought to its attention. Whether the explanation proves to be insufficient resources, inadequate systems, insufficiently savvy staff, misplaced priorities or willful blindness, we need a better way.

Today, I will review aspects of the current regulatory regime and the anti-fraud proposals now on the table and then outline my own proposal for better equipping the SEC to detect Ponzi schemes. The current regulatory regime falls short on three counts.

For starters, most investment advisors aren't required to register with the SEC. A few are exempt because they manage less than \$25 million but others because they have fewer than 15 clients, as each hedge fund advisee counts as just a single client for registration purposes. The registration shortfall is problem number one.

Second, SEC registration as presently constituted is not a game-ender for Ponzi operators. Madoff was a registered investment adviser but he flat-out lied on his disclosure forms. On his last ADV for example filed in 2008, Madoff reported \$17 billion in assets under management, a far cry from the \$65 billion he was telling investors and the negligible sum he actually held on their behalf. Even further from the truth was his reported client count, 23, as compared to the almost 5,000 active accounts that SIPC trustee Irving Picard found as of the firm's demise. Despite the enormity of these misrepresentations, no alarm sounded within the SEC. Perhaps the greater wonder is why no alarm went off at the Palm Beach Country Club. That the SEC has no ready way to validate the representations of registered investment advisors or even to know when they are telling one thing to customers and something else to the commission is problem number two.

A third problem with the current system is that there is no requirement for investment advisers to use an independent custodian. The Madoff firm truthfully disclosed that it did not use one. By permitting advisers to provide self-custody, current regulations facilitate misrepresentations about assets under management.

So what's in the works? Two measures of note. The administration's regulatory reform bill would require advisers of hedge funds to register with the SEC if they managed at least \$30 million in assets. Under a pending SEC proposal, the Commission would effectively mandate a qualified independent custodian. Both measures improve on the status quo from the standpoint of Ponzi scheme prevention and detection but they don't go far enough.

With respect to the custody regs, one concern is that a supposedly independent custodian might be complicit with the scheming adviser. Another worry is that a Ponzi artist might direct some incoming customer assets in such a way that its custodian never learned of them.

As for the Obama Administration's bill, investment advisers to funds are covered, but those with discretion over non-pooled moneys aren't. Notably Madoff did not operate a hedge fund but rather purported to invest on behalf of clients individually. Another weakness in the administration bill is that it gives the SEC no ready means to test the veracity of registrant's disclosures. If the custodian were deceive or complicit, the task of asset validation would fall to the SEC. The law should better equip the Commission to perform this task.

If the Congress and the SEC are serious about protecting investors from Ponzi schemes, they need look no further than the IRS for an approach that is both simple and well tested: multiple-source reporting of entity-specific data. Rather than accept at face value the income components that taxpayers report on their 1040s, the IRS comprehensively cross-checks those claims against W2s, 1099s and K1s submitted by employers, financial institutions and other income payers. When discrepancies are identified, the IRS attempts to reconcile the numbers. The institutionalization of cross checking improves the accuracy of the final numbers not only by correcting errors but by motivating honest reporting in the first instance.

The SEC must be similarly empowered to routinely and cost effectively validate the data that it needs to effectively police investment advisers. Instead of the SEC having to rely on the most self-interested party, the adviser, for routine information on assets under management, I propose a system under which multiple organizations would be required, and individual investors encouraged, to provide the Commission with data about each assets, about each advisor's managed assets.

- Investment advisors with at least \$30 million under management would be required to report quarter-end assets by account identified by name, tax ID and account number.
- Independent custodians would be required to report to the Commission quarter-end assets under management for each adviser-client by position, indicating both size and market value. To give teeth to this mandate, advisers would be required to use an independent custodian.
- Finally, investors would be invited, but not required, to report to the SEC on a new stand-alone schedule their quarter-end assets under management by adviser and account.

The data would feed in to computers programmed to make comparisons efficiently and comprehensively. One would be of total assets under management, measured using adviser data (the sum of the asset values reported for each account) and custodian data

(the sum of the asset values reported for each position). The other set of comparisons would involve account-level assets under management, obtained from the adviser for all accounts, and from participating investors for their own.

For any given date and account these values should agree. If they were large, numerous or recurrent discrepancies for an adviser, a well-focused SEC inquiry would ensue to determine whether any claimed assets were unaccounted for.

The involvement of individual investors is the linchpin of this plan. Even with a truly independent custodian, an adviser could run a Ponzi scheme by having some investment funds deposited into an account that the custodian was unaware of while the firm ran a legitimate operation with assets the custodian saw. An adviser engaged in such asset diversion would report to the SEC only those assets under management that its custodian was privy to. If the SEC had no ready means of learning that the adviser was reporting a lot more to its investors, the scheme might go undetected. That is where investor reporting comes in. What an asset-diverting adviser could not protect itself from under my plan is a random investor reporting her account's asset value to the SEC. Unless the adviser informed the SEC of all account-level assets, any one investor report could trip it up.

In the end, Ponzi scheme prevention and detection requires keeping an eye on customer assets. If investor self interest can be harnessed to motivate at least some advisory clients to report their assets under management and advisers can be made to fund the system, the SEC can tackle the Ponzi problem quickly, effectively and at minimal cost to tax payers.

**LISA FAIRFAX:** Thank you very much Marcia and now Robert.

**DR. ROBERT MACKAY:** Thank you Lisa. What I want to talk about today is credit default swaps. Given the attention that credit default swaps contracts have received in the last year of the credit crisis has unfolded, I think it's important to address this particular financial contract and I really have four goals in my talk today. The first is to help demystify credit default swaps. Secondly, I would like to put credit default swaps in their broader family context with other more traditional credit risk transfer products. I would like to briefly explain how credit default swaps are used to manage risk and detect positions. And finally, I would like to briefly examine how the credit risk of the counter parties in credit default swaps is managed. So, in short I want to quickly address what are credit default swap contracts and how are they used.

For a quick definition, a credit default swap contract is simply a financial contract in which one party, the protection buyer, pays a periodic fee which is known as the credit default spread to another party, known as the protection seller, in return for compensation in the event of default or some similar credit event by a third party that's known as the reference entity. The protection buyer is said to be long on the credit default swap; the protection seller or the provider is said to short the credit default swap. CDS contracts are known can be either physically settled where the long delivers the bond in exchange for par in the event of default or the cash settled where the long pays the short, the difference between the par value of the bond and the current value of the bond.

Let me turn to how the credit default swap is used to transfer credit risk. In my view credit default swaps are in some sense the ultimate credit risk transfer product; they are one of the key financial building blocks in our financial system.

When we think about a corporate borrower, General Motors, for example, issued a bond and investors have bought that bond and expect to receive interest, in principle they may become concerned about the default risk of General Motors as some did over the last year and if they wish to buy protection against that event, they might go to a bank and purchase a credit default swap paying a spread for that, for that protection. So now they actually are as we say long the bond and long the credit default swap and they have eliminated the credit risk of General Motors default, that was of course, they have also to worry about the credit risk of the writer of the credit default swap. Well, it's important to realize that while credit default swaps are sort of in some sense represent the evolution of credit risk transfer products, there's a long family tree here that goes before the evolution of credit default swaps. Let's put it another way, there's a lot of cousins, aunts and uncles and grandparents out there before we get the CDSs. Before credit default swaps there were parent guarantees, an unrated subsidiary of a corporation may want to raise money, given the fact that it is unrated and not a very good credit risk it would have to do so with a high rate, might turn to its parent and ask the parent to guarantee its obligations and then its able to borrow at a rate that reflects the parent's credit rating as opposed to its credit rating, that's actually a structure that's quite similar to the credit default swap. There's also surety bonds or bond wraps, a municipality may for example issue a municipal bond, given the credit rating of the municipality it might face a higher interest rate than it would like, it could turn to an insurance company such as the FJIC and purchase a bond wrap that would pay off in the event that the city failed to meet its obligations. In that case, the issuer of the bond actually pays for the protection as opposed to the purchaser of the bonds.

Finally, there's just traditional very long time banking product letters of credit. A borrower of funds in order to give the lender of funds some assurance of repayment may turn to a bank and pay a fee in order to provide a letter of credit that will meet the obligations in the event that they fail to do so and we could go on. There's trade credit insurance and other types of arrangements either banking products or insurance products that perform very much the same function that the credit default swaps perform. In some cases different parties pay for the protection but it comes down to basically performing the same economic function.

Let me take a moment to talk about how credit default swaps are used. Let me go back to sort of the first example we had. We had an investor that was long a bond on General Motors and then bought a credit default swap on General Motors. Effectively those two positions long the risky bond, long the credit default swaps is equivalent to being a long, a default free bond, I am assuming for now that the writer of the credit default swap doesn't have any default risk. As a classic example on which the credit default swap is simply being used to hedge the credit risk of that risky bonds or some people also think of it as a way of replicating default free deposits. In some cases you may actually go out and buy the bond and buy the credit default swap together and you create because of mispricings in the market, you create a risk free deposit that yields a higher rate of return than you maybe able to get otherwise. Those are two classic uses of credit default swaps. Secondly you may use a credit default swap to replicate a risky bond position, that is, you may go out and sell the credit default swap and simultaneously put your money, say suppose you had a \$100 million worth of bond, you might put that \$100

million in treasuries. So, now you are long default free bond, you short the CDS, you basically have replicated the risky bond position, you maybe able to do that and do it at a higher yield than you could do otherwise.

Finally, two other quick examples, if you go short the CDS contract, that's economically equivalent to being long the risky bond and short the default free bond, in terms of financial arithmetic we have been going through here. The other way of thinking of the short CDS position is basically replicating a financed position in that risky bond. And finally if you just go and buy the CDS itself you are essentially long a default free bond and you are short the risky bond. So essentially what you have done is you have replicated the short risky bond position, that's another way in which you can short that bond if you have a particular perspective on the outlook on the fortunes of that company. Each of those economic relationships describes a particular in which credit default swaps are used either manage a hedge risk or to take advantage of mispricings in the market or to actually take on positions that reflect your view of the likely credit changes in credit risk of that company. In each of these cases the credit risk of that guarantee, we are talking about managing credit risk, we now have to recognize as we learned through such painful lessons in 2008, we have to worry about the credit risk of the credit protection provider. If the corporate parent gives in to financial distress your parent guarantees is not worth much. If the monoline insurer gets into financial distress as happened to a couple of monolines last year, the value of the bond wrap may not worth much. When commercial banks or investment banks get into financial distress the letters of credit with CDS contracts they have written can lose their value. So, it's important in looking at these credit default swaps to actually consider not just the credit that they are actually meant to manage but also the credit of the underlying, the writer of the credit default swaps. We saw the credit default swap spreads for example on monoline insurers rise from under 50 basis points in early '07 to almost 1,500 in mid '08 and after downgrades upto 3,000 basis points. We saw similar increases although not of that magnitude, increase of that type in the credit default swaps spreads for Citi and for Goldman Sachs in the aftermath of the Lehman bankruptcies rising from the 50 basis points range in late '07 into the 3 to 500 basis points range in the fall of '08. So, this credit risk in the credit default swaps and that just raises the question, how is that credit risk managed? Well, if we back up and we just remember the credit default swaps or basically over the counter derivatives contracts, they are bilateral then in nature. You have a bilateral credit exposure that has to be managed and that credit exposure is managed as it is for other derivatives under the [unintelligible] agreement in the credit support and access typically by posting collateral and through payment netting and through marking to market of those positions. Let me close with that and I think we will come back and maybe talk about some other regulatory issues at the end here.

**LISA FAIRFAX:** Absolutely. Thank you very much. And now, Tom.

**DR. THOMAS PORTER:** Thank you Lisa and thank you to the SEC Historical Society for having NERA down here today. I am going to talk about an area I am sure everyone's interested in, which is an accounting area. In particular I would like to discuss the facts and fictions of fair value.

In the recent credit crisis, accounting standards have received a substantial amount of undue blame as being the cause of that credit crisis. The allegation has been that mark to market rules caused financial institutions to reflect unrealistically low values for their portfolios which triggered a variety of dilemmas related to capital requirements and



liquidity. A particular publication by the FASB, the Financial Accounting Standards Board, that sets generally accepted accounting principles, FAS-157, Fair Value Measurements has been a favorite target. I would like to take the opportunity I have today to describe some differences between the notions of mark to market accounting and the concept of fair value that's embodied in FAS-157. I am sure that we are all familiar with mark to market accounting. In using mark to market accounting we usually assign a value to a security that is based on a current market price and the latest trade of that security is often viewed as the market value. I think we all do this at the end of the year when we look at our portfolios, if we have any portfolios left, where we look at the prices of closing prices in the Wall Street Journal to figure out our net worth positions, that's mark to market accounting because you are using the last market price to determine the value of your holdings. However, in financial accounting standards there is a requirement that financial instruments be reflected at fair value and we usually, in the past and it has worked well, measured fair value using mark to market accounting, in other words the latest trade price was regarded as the evidence of fair value. Well, in 2006, the Financial Accounting Standards Board issued a FAS-157 with some clear objectives in mind, first was to provide a single definition of the concept of fair value because fair values is required across a number of accounting standards, the second was to establish a framework for measuring fair value and the third was to provide some expanded disclosures about fair value measurements contained in financial statements. Interestingly, the third sentence of FAS-157 states that "this statement does not require any new fair value measurements." So, despite the fact that FAS-157 has been a target for causing the credit crisis because of its mark to market requirements, its pretty clear that it didn't cause any mark to market requirements, it just changed the way we do those, we determine fair value. So the FAS-157 definition of fair value is the following. It's the price that would be received to sell an asset or pay to transfer a liability in an orderly transaction between market participants. In other words, the accounting definition of fair value of an asset is the price that would be received in a hypothetical transaction that is orderly, it's not a forced transaction or subject to any market imperfections. The way that an entity would go about measuring and disclosing the fair value of an asset or liability would be to use what's called the fair value hierarchy and the fair value hierarchy refers to the relationship between the information used to price an asset and that asset itself. A level one input for fair value is a quoted price in an active market for an identical asset or liability. In other words, a level one is truly a mark to market measurement of fair value because it's using the price in the marketplace as a reflection of fair value. A level two input is one in which quoted prices for similar assets or liabilities are used along with other observable information to determine the fair value of an asset or liability, that's frequently referred to as mark to matrix. A level three input is where unobservable inputs are used to measure fair value and these are frequently referred to as mark to model measurements because inputs that are not directly related to the assets are used to determine the value by estimation.

So, if you think about the fair value hierarchy, it moves from the top level which is a market focused input down to an estimated fair value using a variety of inputs and estimation techniques. FAS-157 emphasizes and prioritizes the use of observable inputs that is levels one and two but FAS-157 also emphasized that this fair value measurement is based on a hypothetical transaction that occurs in an orderly market that is it's not a distressed or a fire sale. Well, despite those definitions that were contained in FAS-157 as it was issued, in the midst of the credit crisis there were substantial criticisms in the marketplace that led FASB to issue some clarifying guidance related to fair value measurements. And this clarifying guidance came in the form of

what is called a FASB staff position and this is an interpretation that is consistent with the standard itself, that has been approved by the Financial Accounting Standards Board and the particular one I am going to talk about here is FSP, FAS-157-4 and it deals with the market activity and the transaction normalcy when trying to determine whether or not to use market prices to determine fair value. FSP, this particular FSP contains a two step test and the first part of the two step test is to question whether the market activity for a particular asset is normal. And it lists several different characteristics, among them are whether there has been only a few recent transactions, whether the current price quotes are current or not, abnormally wide bid-ask spreads. So there are some characteristics listed to be able to answer the question whether the market activity is normal for a particular asset. If the market activity is not normal then you need to go the second test which is to determine whether the transactions that are occurring in the marketplace are orderly or not. And the way that is assessed is to look at certain characteristics like whether there was sufficient time before the measurement date to allow for usually and customary marketing activities, whether the seller is near bankruptcy, whether this transaction is an outlier compared to other transactions. So it is provided with a variety of characteristics to determine whether the transactions that are occurring in the marketplace are orderly. If based on those two tests you determine that the market is not active and the transactions are not orderly then an entity is required to use an estimation technique that uses something other than one that uses the quoted price without significant adjustments, in other words you have to, the FSP provides guidance about using estimation techniques when mark to market accounting doesn't give you fair value. So, fortunately the expanded disclosure requirements in FAS-157 provides a lot of additional information about how firms are determining fair value and I think that provides an enormous amount of information to financial statement users to make an assessment about how, whether or not they agree with the fair values determined by those estimations. And with that I will stop.

**LISA FAIRFAX:** Thank you very much. You guys have all presented some very thought provoking presentations. What I would like to do now is just to have a bit of Q&A about some of the issues you have raised. First, I will ask just a general question to all of you. All of you guys have spoken about problems, products or issues that in one way or other have been the focus of new or proposed legislation so first I would just like to get all of your thoughts on some of that new legislation as it relates to the issues that you have raised. So Jan, I will start with you.

**JAN LARSEN:** I think that when you are looking at the SEC in particular there are a number of issues that needed to be addressed and that are being addressed but one item that I think we have to keep in mind is that when you look at the number of regulated entities per inspecting staff or per staff member within various regulatory agencies, the SEC does not compare favorably to its peer such as for instance the CFTC. The SEC by that measure is under a huge amount of capacity constraint and I think that's something that we might have to look at over more carefully.

**LISA FAIRFAX:** Okay. Robert, do you have any thoughts?

**DR. ROBERT MACKAY:** Yes. I wanted to say a little bit about some of the proposals of the regulating OTC derivatives but I don't want to miss the chance to talk about mark to market accounting since it is so interesting.

**DR. THOMAS PORTER:** I am glad you are coming around, Robert.

**DR. ROBERT MACKAY:** And part of that I want to respond to the notion that mark to market accounting in some significant sense contributed to the crisis. It always struck me that even if we had a historical cost accounting system all of the key players in the economy would have still been looking through to what they thought the real market values were shareholders in a firm. If you carry the assets at historical costs that's not going to mean anything to them, they are going to look through to see what do they think the real values are, when the firm goes out to borrow additional funds. The creditors are going to look through to the real market value, counter parties to derivatives contracts, they are going to mark their exposures to market not to some historical cost notion. Repo counter parties are going to mark the securities that have lit to market not to some historical notion. So all of the forces that led to the de-leveraging in the economy, all of the forces that I think in part played into the credit crisis and the downturn would still have taken place without even in the absence of the mark to market accounting because market participants in their own contractual relationships will simply look through that in my opinion. Let me turn for a moment just quickly to the OTC derivatives side where there is now the Obama administration has a proposal on the table to require a clearing of all CDS contracts and in fact it goes beyond that, it would require clearing of all OTC derivatives, interest rate and currency and other swaps and also not just centralized clearing but actually exchange trading either on a regulated exchange or a regulated electronic execution facility. I think the proposal goes too far, there is a bit of a carve out for non-standardized contracts although if any one contract type is cleared all other contracts of that type would be deemed to be standard so they would get swept in and I think the extension of the exchange trading requirement and the clearing to the interest rates swap, the apex swap, other swap markets is unwarranted by what we experienced, I don't remember those contracts being part of the crisis. The argument on the CDS side, I think there was a movement to more collateralization, probably movement to clearing more standardized CDS, the less standardized CDS, the customized ones I think could be really problematic and clearing house context, so I see some real problems with that proposal but I am sure some of those will be worked out as it works its way through Congress.

**LISA FAIRFAX:** Thank you. I know Marcia you talked a little bit about your thoughts in terms of new regulation in your proposed system.

**DR. MARCIA KRAMER MAYER:** Right. Maybe I will just reiterate it here but I would like to see Congress and the SEC really moving forward in terms of Ponzi scheme prevention and detection. We don't want to be in a situation where a Madoff could do it all over again. I think the single most important measure is the one that SEC proposed in May of this year, which would effectively require an independent custodian for investment advisers. And I like the fact that the Obama Administration bill would go towards getting advisers registered even if their clients were hedge funds rather than individuals. I would like to see it broader in scope there. But what neither of these proposals have is a way for the SEC to really validate the data that comes to it and so I would strongly advocate the adoption of an IRS-type model where the SEC would be getting information on assets under management from multiple sources and could cost-effectively run those through a system without having to launch an investigation. It would just be automatically done and people could gain a lot more assurance that their assets were what their advisors said were.

**LISA FAIRFAX:** Thank you. That validation system is something that a lot of people would appreciate. Tom, let me ask you a slightly different question, because you talked a bit about FAS-157 and I know that subsequent interpretations have validated the use of estimates instead of quoted prices where appropriate. So my question to you is, as companies use more and more estimates how do you think auditors will react to that system?

**DR. THOMAS PORTER:** I think auditors would have or probably do have a preference for the use of quoted market prices because it provides them with a capability to validate the measurements that they say are in accordance with GAAP, so they fulfill some type of a verification objective. So, I think the auditors are going to have to be convinced that quoted market prices are not reflective of fair value as its defined in FAS-157 and to the extent that companies use more estimates, its certainly going to require a heightened audit effort for the auditor to be satisfied that the amounts that are being included in the financial statements are reasonable and in accordance with GAAP but the auditor also takes on a heightened audit risk for doing that and so I think the bottom line of the consideration of the auditor's role is that the use of estimates instead of quoted market prices are likely to increase the cost of an audit overall.

**LISA FAIRFAX:** Thank you. I think that's something a lot of people would be interested in, of course as Robert notes mark to market has gotten a lot of exposure in the same way that credit defaults have gotten a lot of exposure, and seen as the bad guy. I actually have a question for Marcia here though, certainly your proposed regime that draws upon the IRS regime ask for information from a variety of different people and so one concern that of course it may raise is whether or not it compromises privacy, particularly of investors and investment advisors, I just wanted your thoughts with respect to that.

**DR. MARCIA KRAMER MAYER:** I think potentially it could but the way I would like to see the system implemented in a way would be that no account level data would ever become public. So, for individuals who reported to the SEC they wouldn't have to fear that would become public information. And I would also like that non-disclosure provision to extend to an adviser's asset positions. I think that would be a disclosure of proprietary trading strategy if that became known. The IRS has a good record of keeping private information private, I think the SEC could do it as well.

**LISA FAIRFAX:** Very interesting, one follow up question to that though is to the extent your system kind of relies on voluntary input from investors kind of providing their own information, would you need 100% of the investors to participate?

**DR. MARCIA KRAMER MAYER:** I am so glad you asked that. The answer is no and it's a good thing because you wouldn't get anything like that in terms of participation. I think investors would have two self-interested reasons to participate in this. One is that they would learn whether their own adviser acknowledged the assets that their account statement was telling them that they had. Another is to help incentivize their adviser to report honestly. What I would also like to see though would be for Congress to pass a law whereby participating investors would have a higher priority in the event of a fraud-related bankruptcy and would have a greater claim to damages in the event of fraud-related litigation. These would be very good citizens who would be reporting to the SEC, so they should get something in return.

**LISA FAIRFAX:** Thank you. Very, very intriguing proposal certainly. Let me ask you, Robert a little bit about credit default swaps. You talked about what you thought would be the defects in some of the new proposed legislation. Do you have some thoughts on what you think we should do with credit default swaps going forward?

**DR. ROBERT MACKAY:** Yes. And I think it applies to sort of OTC derivatives more generally. In the last few years there has been a significant movement towards greater collateralization of these transactions. There should probably be less reliance or sort of AAA credit ratings of one of the counter parties and more reliance on collateral from the beginning or reliance on collateral with smaller thresholds and I think we have seen in the last five years the percentage of OTC derivatives that are being, that have variation collateral is now quite high something 70% or more. So those trends I think should be encouraged, the market itself was moving towards a voluntary clearing system certainly in the energy complex, through the intercontinental exchange they had developed a complex clearing for a lot of energy contracts, so I think there would be a fair bit of support within the industry for clearing houses themselves but the mandatory requirement for all clearing, standardized contracts and then even some non-standardized, I think it's quite problematic.

**LISA FAIRFAX:** Thank you. And let me ask Tom a question, you talked about the SEC power and authority especially with respect to penalties and I believe there is some kind of Treasury Department recommendations about the creation of some regulatory authorities whose jurisdiction potentially overlap with the SEC and I wondered if you could give us some thoughts with respect to that?

**JAN LARSEN:** Yes. Last month the Treasury Department put out a lengthy report called, 'Financial Regulatory Reform – A New Foundation.' And that recommended a number of reforms of the SEC as well as other agencies. Prior to that report there had been some talk of potentially combining the CFTC and SEC in fact, the treasury report does not recommend that but it does propose adding three new authorities that would indeed overlap with the SEC. There would be a Financial Services Oversight Council which would be composed of the heads of eight financial regulatory agencies including the chairman of the SEC and its job would be to identify emerging risks and to serve as a forum to dispute between regulators. The federal reserve would be given broader regulatory authority including overall large interconnected financial firms, many of which of course would be regulated by the SEC as well and a new consumer protection agency would be established and its authority would include retail securities products that are currently regulated by the SEC. So there is clearly talk of potential big changes ahead.

**LISA FAIRFAX:** I wondered if anyone else had thoughts about that there's been a lot of proposals also on the table just like this Treasury Department one about the creation of new agencies. I don't know if people had thoughts about potential coordination issues with that, whether or not it makes sense to try to create kind of additional agencies to do some of the regulation, for example the credit default swaps or different accounting, I don't know if anybody else had questions and thoughts on that one.

**DR. ROBERT MACKAY:** Just an observation which is, in going back to 1988 after the crash of '87, the President's Group on Financial Markets was established and it's been in operation since then. That group has served as the coordinating function across all of these agencies over that period. Part of what's being proposed now is to take that responsibility and put it into this more centralized group. In some sense and mind you

they were doing all of that, there's interesting questions about sort of why that coordination may not have as successful as it could have been, why some of the agencies had authority to oversee certain entities such as the AIG, may not have done as good a job as we might hope they did. But yet I think some of what is coming up now is not that different than what we had but its institutionalizing in a different way.

**LISA FAIRFAX:** Hopefully, that will make a difference; certainly we will see in the future. Let me close out now. Thank you, Marcia, Robert, Tom and Jan for sharing your excerpts from your papers from NERA Economic Consulting's recent Finance Law and Securities Litigation Seminar. It is quite clear why your presentations were deemed the best at this year's conference; you have some really engaging and intriguing thoughts on a variety of extremely relevant topics. Today's broadcast can be accessed again on demand through the virtual museum and archive and an edited transcript will soon be available.

The museum's next broadcast will be a new program 'Bingham Presents' on Thursday, September 24<sup>th</sup> beginning at 5 PM Eastern Time. The program will be broadcast live from the offices of Bingham McCutchen LLP in New York City and online at [www.sechistorical.org](http://www.sechistorical.org). The online broadcast will be free and accessible worldwide without prior registration. The focus of the program will be The New World of Financial Regulation. My colleague Professor Theresa Gabaldon of The George Washington University Law School will moderate the program. Presenters will include Jesse Eisinger of Condé Nast and Professor Joseph Stiglitz of Columbia University. Please plan to join us on [www.sechistorical.org](http://www.sechistorical.org) on September 24<sup>th</sup>. Thank you again for being with us today.