

**The Responsibility of the Securities and Exchange Commission  
for  
Efficiency, Competition and Capital Formation**

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**Reforms for the First 1000 Days**

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## **ISSUES ADDRESSED**

### **Executive Summary**

**Since the adoption of the National Securities Market Improvement Act (NSMIA) in 1996, the Commission has been required by statute to consider, in addition to the protection of investors, whether its action will promote efficiency, competition and capital formation. The Commission has largely ignored this statutory obligation, preferring to describe its mission solely as the protection of investors. Specifically citing the NSMIA language, the Court of Appeals for the DC Circuit recently remanded the independent chairman rule because the Commission failed to consider the economic effect of the rule on the mutual fund industry. This paper explores important areas of the Commission's jurisdiction where attention to its statutory obligations would produce more balanced policies in the future.**

### **Introduction: The SEC's Responsibility to Promote Efficiency, Competition and Capital Formation**

It is an indication of Congress's seriousness about the NSMIA language that identical directions to the Commission were inserted in each of the three principal statutes the Commission administers—the Securities Act of 1933, the Securities and Exchange Act of 1934, and the Investment Company Act of 1940. For almost 10 years, however, the SEC has treated this obligation as no more significant than the required cost-benefit analysis that accompanies its rules. The recent decision by the DC Circuit, remanding the independent chairman rule for additional consideration by the Commission, demonstrates that the Commission has failed over many years to understand that Congress was seeking a balance in the SEC's rule-making activities. The agency was still to pursue the protection of investors, but in doing so must recognize that it also has a responsibility to promote efficiency, competition and capital formation. This does not in any sense mean that the Commission should relax its efforts to protect investors. As noted throughout this paper, investors are often best protected, and their interests most effectively advanced, by promoting efficiency, competition and capital formation.

### **1. Promoting a Global Capital Market**

For years, the SEC has created obstacles to the development of an international securities market by insisting that foreign companies use US GAAP for financial disclosure and refusing to acknowledge that foreign securities exchanges and foreign brokers can accept unsolicited orders from US investors without registering with the SEC. Although this has been done ostensibly to protect investors, it has the opposite effect. Investors are best protected if they can diversify their portfolios, particularly with the securities of seasoned foreign companies.

## **2. Reforming Enforcement**

The SEC's enforcement program does not take sufficient account of its substantial impact on share values. Enforcement proceedings are opened without adequate consideration, have an adverse market effect on share prices, and then are often not closed when the staff determines that there is no basis for a charge. Again, this harms investors instead of protecting them. Companies are not advised whether they are targets or merely incidentally involved in investigations. And when the staff does determine that there is a basis for a charge, the defendant company is not informed of the evidence the staff will use to make its case to the Commission, diminishing the value of a Wells submission. Because companies know that they can seldom avoid a charge under these circumstances, they are forced—because of fear of adverse publicity—to settle cases that the SEC could not win in court.

## **3. Regulation of Mutual Funds**

The stay entered by the Court of Appeals in the independent chairman case has given the Commission an opportunity to take another look at this rule. The basis of the court's original remand was that the Commission failed to consider the economic effects of the rule—specifically its obligation to promote efficiency, competition and capital formation. If these issues had been considered, the Commission might have come to a different judgment, since the additional costs involved could affect the ability of the industry to compete with other forms of collective investment. In addition, an independent chair and more independent directors are not remedies that are likely to address the problems of late trading and market timing.

## **4. Regulation NMS**

Stripped to its essentials, the Commission's decision to extend a trade-through rule to the electronic markets was based upon the notion that the absence of a rule prohibiting trade-throughs would discourage investors from displaying limit orders. There is no evidence for this, and even the SEC's own data shows trade-throughs to occur in less than 2 percent of all trades. Instead of implementing a regime that could negatively effect competition and market innovation, the Commission should at least determine whether the underlying rationale for the rule—that it is necessary to encourage limit orders—has any validity. This can be done through a carefully controlled pilot test similar to what it recently elected to do with the short sale rule.

## **5. Regulation of Markets and Broker-Dealers**

The impending mergers of Nasdaq and the New York Stock Exchange, converting both into private, profit-making organizations, offer the Commission an opportunity to rethink the regulatory structure for exchanges and brokers. In this connection, two reforms seem appropriate: (i) eliminate any direct regulatory responsibilities for exchanges themselves, and (ii) permit qualified groups to offer their services—as the NASD does today—as contract regulators for exchanges and broker dealers. Not only will this improve the quality of regulation by introducing competition, but it will ease entry into the business of offering trading facilities,

benefiting investors.

## **6. The Commission and the APA: Policy-making Through Enforcement Proceedings**

The Administrative Procedure Act was adopted in order to assure that industries affected by regulations are given an opportunity to comment on the regulations before they are adopted and to challenge rules in court if they are inconsistent with applicable law or “arbitrary and capricious.” However, increasingly in recent years the Commission has imposed requirements on regulated entities through “undertakings” in settlement of enforcement actions. These settlement agreements have—or acquire—all the force of rules, applicable as “best practices” to an entire industry, negating the protections and benefits of the APA. In addition, the Commission’s divisions adopt staff positions on significant policy issues with which regulated entities must comply, even though the policy has not been published for comment or formally approved by the Commission.

## **7. The Market and Market Data**

Market data—quotations and transactions—is currently distributed through consortiums which set a price for the data and then allocate the revenue stream to their members. Brokers-dealers complained for years that the price of this data is too high, and there is no way of knowing whether the price reflects in any way the true value of the data. Although there might once have been a policy reason to insist that all data be consolidated and sold as a package, that reason no longer exists, and the consortiums that were created to consolidate and sell market data are now government-created monopolies that may be engaged in monopoly pricing, and are likely to be distorting competition. The markets have plenty of incentive to sell their data in order to encourage trading, and modern communications make it possible for intermediary distributors such as Reuters and Bloomberg to do the necessary consolidation if that’s what customers want. The Commission should eliminate the requirement for consolidation and allow the market in data to seek its own level.

## **8. Reducing the Costs of Section 404 of Sarbanes-Oxley**

Section 404 of Sarbanes-Oxley, mandating that companies establish internal controls that are in turn certified as effective by their auditors, has become a very expensive burden for public companies. The most recent SEC statement, after the roundtable on this subject, laid the responsibility at the door of the accounting profession for spending too much time on the details instead of the big picture. However, this view fails to consider the liabilities of accountants in class action litigation, and the fact that they must protect themselves from these liabilities by crossing every T and dotting every I. Instead of blaming the accountants, the SEC should revise its section 404 regulation, which includes a requirement that internal controls cover the safeguarding of assets. This requirement goes beyond the language of the Sarbanes-Oxley Act, which requires internal controls only for the purpose of financial reporting.

## **9. The SEC as the Nation's Primary Regulator of Securities**

Over many years, Congress has adopted legislation that attempts to encourage the development of a national securities market, in which the SEC's policies are not contradicted or overturned by state regulation. In some areas Congress has explicitly pre-empted state regulation, but even where it has not done this there are grounds for the Commission to assert that its jurisdiction should exclude state and local action. Federal and state courts have recognized that state regulation is pre-empted where it is inconsistent with federal rules or where Congress has attempted to occupy the field, even though Congress has not explicitly pre-empted state action. These precedents, together with statutory enactments by Congress such as the Securities Act Amendments of 1975, (calling for a national market system), the National Securities Market Improvement Act of 1996, the Private Securities Litigation Reform Act of 1995, and the Securities Litigation Uniform Standards Act of 1998, all provide strong legal authority for the Commission to seek the pre-emption of state action where it interferes with a uniform national set of securities regulations.

## The SEC's Responsibilities to Promote Efficiency, Competition and Capital Formation

Although the members and staff of the SEC frequently describe their mandate as the protection of investors, this is only partially true. In reality, the SEC has a correlative and equal responsibility to promote an efficient and competitive national securities market that will facilitate capital formation. This obligation is embodied in the National Securities Markets Improvement Act of 1996 (NSMIA), which declares in its preamble that its purpose is “to promote efficiency and capital formation in the financial markets.” Then, in identical language added to each of the three principal securities statutes—the Securities Act of 1933 (the 33 Act), the Securities Exchange Act of 1934 (the 34 Act), and the Investment Company Act of 1940 (the 40 Act)—Congress told the SEC that it has responsibilities that extend beyond the protection of investors:

Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider and determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, *in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.*<sup>1</sup>  
[emphasis added]

The italicized language above shows that these broader objectives—efficiency, competition and promotion of capital formation—have equal standing with the protection of investors. The fact that the language was inserted in all three principal securities laws again demonstrates the importance Congress attached to it. Yet, over the years since this strong affirmative statement by Congress, the Commission has treated this direction much as it treats the requirement for cost-benefit analysis—as a pro forma base to be touched on the way to adopting a rule or regulation, but not as an independent mandate equal in importance to the protection of investors.

A good example of this, and its effect, appears in the Commission's final rule requiring, among other things, that mutual funds have independent chairs. The rule was predicated entirely on the Commission's view that its requirements were necessary for the protection of investors. No significant attention was paid to the question of whether the rule would promote efficiency, competition or capital formation. At the end of the Commission's release, after its discussion of the Paperwork Reduction Act, its required cost-benefit analysis, and its Final Regulatory Flexibility Analysis, there is a section on “Consideration of Promotion of Efficiency, Competition and Capital Formation.” The essence of this section is that the effect of the rule will be positive because it will “reduce the risk of securities law violations...and thus increase investor confidence in mutual funds.” Although the Commission had before it a study suggesting that mutual funds with non-independent chairs performed better than those with independent

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<sup>1</sup> Public Law 104-290, October 11, 1996, 110 Stat. 3424 (1996), Sections 106(a), (b) and (c)

chairs, it did not consider whether this possibility, if true, might promote efficiency and competition among mutual funds, and thus capital formation.

The NSMIA language has now been construed by a court, which stayed the implementation of a Commission rule because of the Commission's failure to comply with its obligation to consider efficiency, competition and capital formation. In *Chamber of Commerce v SEC*,<sup>2</sup> the District of Columbia Court of Appeals concluded that the Commission had violated the Administrative Procedure Act when it failed to consider the possibility that disclosure might be a reasonable and less costly alternative to requiring an independent chair for a mutual fund. The Commission's obligation to consider such alternatives arose from what the court described—citing the NSMIA language codified in 15 USC 80a-2(c)—as the Commission's "statutory obligation to determine as best it can the economic implications of the rule it has proposed."

Nor can the court's decision be viewed, as some have suggested, simply as a cost-benefit analysis of some kind. The court made clear that its position was based on the specific language of NSMIA:

Although the Commission may not have been able to estimate the aggregate cost to the mutual fund industry of additional staff to the mutual fund industry...it readily could have estimated the cost to an individual fund, which estimate would be pertinent to its assessment of *the effect the condition would have upon efficiency and competition, if not upon capital formation....*[U]ncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of *the economic consequences* of a proposed regulation before it decides to adopt the measure.<sup>3</sup> [emphasis supplied]

"In sum," the court then concluded, "the Commission violated its obligation under 15 U.S.C. 80a-2(c), and therefore the APA [the Administrative Procedure Act], in failing to consider the costs imposed upon the funds by the two challenged conditions." This is not cost-benefit analysis; it is a clear requirement that the Commission consider other economic factors concerning the competitiveness and efficiency of mutual fund operations before making a rule that might impair these elements of a competitive capital market.

The court's decision has even more importance because the Commission's stated purpose in the rule-making was the protection of investors, a fact it emphasized again and again in its representations to the court. For example, the Commission's brief in opposition to the Chamber's request for a stay of the rule begins "Petitioner Chamber of Commerce seeks an unwarranted stay of two important investor protections..." By requiring the Commission to consider the

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<sup>2</sup> Slip op., June 21, 2005.

<sup>3</sup> Slip op., p. 16-17.

economic implications of a rule that contained “important investor protections,” the court made clear that investor protection is not the only duty of the Commission; it must also give serious consideration to other objectives specified by Congress—its “statutory obligation” in the court’s words—to promote efficiency, competition and capital formation.

The Commission’s failure, in the past, to observe and implement a clear directive from Congress in NSMIA is a serious lapse by a regulatory agency, and one which we believe the Commission should hasten to repair. In this paper—recalling that the NSMIA language was inserted by Congress into the 33 Act and 34 Act as well as the 40 Act—we will examine many of the Commission’s actions from the perspective of whether they will increase the efficiency and competitiveness of the securities markets, and thus their tendency to promote capital formation. In the course of this analysis, we will see that much of what the Commission has done in recent years has not met this test.

## **Promoting a Global Capital Market**

One of the clearest examples of the Commission’s failure to fulfill the NSMIA mandate is its resistance to steps that would encourage the development of a global capital market. The benefits that US investors and the nation’s economy would derive from a global securities market are difficult to overstate. For investors, the ability to create more stable portfolios of equity and debt through diversification of assets would be a major benefit; additional competition for the investor’s dollar would produce more efficiency and lower investment costs; and lower investment and trading costs will lower capital costs and produce stronger economic growth. Also, since capital will flow to the companies that operate most efficiently, reducing obstacles to capital flows will promote economic growth around the world and improved trade opportunities for American companies. When Congress called upon the Commission to consider efficiency, competition and capital formation in the rule making process—in addition to the protection of investors—it could well have had an efficient, competitive, globalized market in mind.

Yet the Commission’s staff over the years has thrown up one regulatory roadblock after another—all in the name of protecting investors. Ironically, as almost all academic studies show, investors would be best protected if they were able to diversify their portfolios with securities traded in foreign markets.<sup>4</sup> Thus, in failing to observe the directions of Congress in NSMIA, the Commission’s opposition to global securities market intervention may harm the very investors the SEC is supposed to protect.

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<sup>4</sup> See, e.g., William J. Baumol and Burton G. Malkiel, “Redundant Regulation of Foreign Security Trading and U.S. Competitiveness,” *Journal of Applied Corporate Finance*, Vol. 5, no 4, Winter 1993, p 19.

Two relatively simple proposals could break this logjam:

1. Allow foreign based companies from countries in which International Financial Reporting Standards (IFRS) are used to sell their equity and debt securities in the United States without having to go through the costly process of reconciling or restating their financial reports in conformity with generally accepted accounting principles (US GAAP); and

2. Allow US investors to gain access to shares traded on foreign securities markets without requiring those markets to register as securities exchanges in the United States.

Together, these proposals would allow the development of a robust international securities market, with all the benefits this would provide to investors and the economies of participating countries. Historically, the SEC staff has raised objections to both these initiatives. That opposition should be reconsidered.

*Permitting the use of International Financial Reporting Standards (IFRS) in addition to GAAP*

The SEC's objections to the use of any financial disclosure system other than US GAAP seems based on two arguments: (i) US GAAP is a superior system of financial disclosure, and any use of another system—including IFFRS—will deprive investors of necessary or important financial information; and (ii) allowing foreign companies to report their financial results under a non-GAAP system would place US companies at a competitive disadvantage. The Commission's two positions are inconsistent. If US GAAP were in fact a superior form of financial disclosure, it would place US firms at a competitive *advantage*, not a disadvantage, since investors would prefer to buy the shares of companies about which they have more information rather than less, and US companies would also then have lower costs of capital.

However, at least one well-designed academic study has shown that there is very little qualitative difference between financial statements prepared under IFFRS and those prepared under US GAAP. In a study by Christian Leuz of the Wharton School, presented at a conference at the American Enterprise Institute in March 2002 published in 2003<sup>5</sup>, the author compared bid-ask spreads and share turnover in a German securities market which permitted listed companies to issue their financial reports either in US GAAP or in IFFRS. Bid-ask spreads are widely accepted as proxies for the quality of the information available to investors. In markets where the information is deficient, spreads widen, while in markets where there is good information spreads are narrow. Similarly, share turnover is an indication of the degree of liquidity in a market, which in turn is a reflection of the availability and quality of information.

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<sup>5</sup> Christian Leuz, "IAS versus US GAAP: Information-Asymmetry Based Evidence from Germany's New Market," *Journal of Accounting Research* 41 (2003): 445-472. The AEI 2002 paper is at [http://www.aei.org/events/eventID.196,filter.all/event\\_detail.asp](http://www.aei.org/events/eventID.196,filter.all/event_detail.asp)

The Leuz study showed that the differences in the spreads and share turnover between companies that elected to state their financial reports in US GAAP or in IFRS were statistically insignificant, strongly suggesting that investors considered the information quality available in both systems to be comparable. This is an important point; if US GAAP is not a manifestly superior system of financial disclosure, it should not be an obstacle to the development of a global capital market.

Another factor that should be considered is the essential weakness of *all* accrual accounting systems—including both US GAAP and IFRS. As accounting specialists know, all such systems are subject to manipulation and error because they are based to a substantial degree on predictions about an unknowable future.<sup>6</sup> The extent to which receivables will be collected, the rate at which a productive asset will depreciate, the degree to which products will be returned or subject to warranty claims, and the expected return on pension trust assets in the succeeding year are a few examples of the many judgments that management must make in preparing financial statements. They are all management estimates—predictions about an unknowable future—based on management’s experience and knowledge. For that reason, they cannot be effectively audited. Yet they all have a substantial effect on reported earnings under both US GAAP and IFRS.

This universal deficiency in accrual financial statements—even audited statements—is the reason that many in the financial world are fond of the expression “Earnings are an opinion; cash is a fact.” Indeed, financial experts, when they attempt to estimate the value of companies, use a discounted cash flow method and not reported earnings. For the same reasons, the purported benefit of a single universal accounting system—the ability to compare companies across an industry or across markets—is largely illusory if reported earnings are the basis for comparison. Comparing cash flows, which cannot be so easily distorted or manipulated by management judgment, would be a better means of comparison.

This is not to say that audited financial statements are worthless, but it does suggest that the reverence for US GAAP displayed by the Commission’s staff is misplaced. US GAAP is simply not so significantly better than IFRS that it should be an obstacle to the substantial benefits that would accrue to investors and the US economy from the development of a global securities market.

#### *Allowing access by US investors to foreign securities markets*

Giving US investors access to foreign securities can be done most efficiently by permitting foreign exchanges to place access terminals in the United States and permitting US brokers-dealers to become members of foreign exchanges. Although it is currently possible for

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<sup>6</sup> See, e.g., Baruch Lev, “Corporate Earnings: Fact and Fiction,” *Journal of Economic Perspectives*—Volume 17, Number 2—Spring 2003—Pp. 27–50, at 30-33

US investors to purchase securities on foreign markets under existing SEC rules, it is an expensive process. In the case of the US, retail investors must engage a US broker, who in turn must engage a foreign broker; foreign brokerage services are considerably more expensive than US brokerage. Although institutional investors such as mutual funds or pension funds may go directly to a foreign broker, this is still a high cost process which ultimately reduces the yield that is realized by pension beneficiaries or mutual fund shareholders.

The reason for this cumbersome system is the SEC's insistence that foreign markets may not offer their services in the United States unless they register as securities exchanges, a costly and time-consuming process that foreign exchanges are unwilling to pursue. Similarly, foreign brokers are not permitted to solicit business from US investors unless they are acting through or accompanied by a US broker. As a result, foreign markets are reluctant to allow US brokers or institutional investors direct access, lest they be required to register as US exchanges, and foreign securities brokers are reluctant to deal with US investors directly lest they be accused of violating US laws. What's more, SEC-fostered ambiguities about what is permissible under US laws has also prevented US broker-dealers from becoming members of foreign exchanges. In a "concept release" in 1997, the Commission admitted as much, noting:

The Commission to date has not expressly addressed the regulatory status of entities that provide US persons with the ability to trade directly on foreign markets from the United States. While some access providers may be registered as U.S. broker-dealers because of their other activities, the lack of regulatory guidance in this context has discouraged other parties from offering US persons foreign market access. Similarly, foreign markets have been reluctant to permit US persons to become members of their markets without assurance from the Commission that they would not be required to register as national securities exchanges.<sup>7</sup>

In the 8 years and three different chairmanships that have intervened since this was written, the SEC has not acted to clarify this point, and as a result the possibility that a vigorous international capital market might develop has been impeded.

This would all be changed if the Commission were to adopt a mutual recognition system for securities markets in the EU. In such a system, the US would recognize the adequacy of EU market regulation, and the EU would do the same for the US system. This would permit US brokers to become members of foreign securities exchanges, and US institutional investors to become—where permissible—members of foreign exchanges. Foreign brokers would also be able to become members of or otherwise place orders directly on US exchanges. Clearly, by driving down trading costs through competition, reducing brokerage expenses, and reducing resistance to international capital flows, this step would promote efficiency, competition and capital formation—exactly the goals of Congress in NSMIA.

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<sup>7</sup> Release No. 34-38672; File No. S7-16-97

Thus far, the Commission's staff has resisted this reform, arguing that US investors would not be sufficiently protected if foreign markets were made more accessible. In the same concept release, the Commission's staff cited three reasons why access to foreign securities exchanges would create risks for US investors:

1. the lack of comparable information about foreign companies that do not meet SEC reporting and disclosure requirements;
2. trading risks in foreign markets; and
3. the SEC's inability to enforce the antifraud provisions of US securities laws.

None of these objections should be obstacles to the integration of the securities markets across the Atlantic.

*Lack of comparable information.* First, it is important to understand that purchasing or selling shares in a secondary market is considerably less risky than purchasing shares in an initial public offering. The price of the shares in a secondary market already reflects a good deal of information that has been available to investors over the time the security has been trading. Second, companies have an incentive to provide accurate information to the market, in order to encourage trading in and liquidity in their shares. We have already addressed the question whether US GAAP and IFRS provide comparable financial information, and it appears that they do. As for non-financial information, institutional investors are able to fend for themselves in deciding whether to trade if this information is lacking, and US retail investors will be trading through US brokers, who must observe suitability standards and can be required to inform investors if the financial information is not adequate or available.

*Trading risks in foreign markets.* The rules on reporting quotes, transactions and exposing limit orders are comparable in EU markets to similar rules in the US. In fact, the electronic EU markets compare favorably to US markets in the firmness of their quotes, the speed with which transactions are reported to the public, and the absence of frontrunning.<sup>8</sup>

*Insider trading.* All EU exchanges have rules against insider trading,<sup>9</sup> and while it might be argued that these are not as effective as US rules, that is simply a factor that investors should take into account in accessing those markets. It is not a reason to deny US investors the opportunity to improve their portfolios through diversification into foreign publicly traded securities. Moreover, institutional traders are clearly able to fend for themselves in these markets,

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<sup>8</sup> Benn Steil, "Building a Transatlantic Securities Market," Council on Foreign Relations, 2002, [http://www.cfr.org/publication/8282/building\\_a\\_transatlantic\\_securities\\_market.html?jsessionid=76a2ae314eed0a7901480c5b6662faf9](http://www.cfr.org/publication/8282/building_a_transatlantic_securities_market.html?jsessionid=76a2ae314eed0a7901480c5b6662faf9), p. 47

<sup>9</sup> *Ibid.*

and US brokers—whose services would be necessary for US retail investors—can be required to warn US investors of the possibility of insider trading.

It is of course possible to argue that some US investors may encounter difficulties when they venture into foreign markets, just as they do in US markets, but while the Commission is charged with protecting investors, it has also been charged since 1996 with promoting efficiency, competition and capital formation—all goals that would be served by encouraging the development of a global capital market. To insist on the elimination of all risk for US investors before they can trade in foreign markets is to elevate investor protection—through narrowing investor options—above every other goal Congress has specified for the Commission. By recognizing that it has a broader mandate under the NSMIA language, the Commission will both discharge its statutory obligations and help investors to protect themselves through portfolio diversification.

## **Reforming Enforcement**

The Commission's enforcement process—in which, for SEC-regulated entities, we include the work of the Office of Compliance, Inspections and Examinations (OCIE)—reflects both a failure to understand the contemporary impact of its activities on shareholders and investors, and a serious lack of elementary fairness. It may well be that when the staff's procedures were developed decades ago they were satisfactory for a securities market less sensitive to the consequences of an enforcement action, but that is not today's reality. Now, citing SEC Regulation S-K, securities lawyers routinely advise their clients promptly to disclose the existence of an SEC investigation, and these disclosures have an impact—sometimes a significant impact—on stock prices.

This market effect might be warranted by later developments—cases like Enron and WorldCom in which companies were found to have violated laws or regulations—but all too frequently it is not. The Commission has almost no procedures in place to advise companies that the investigation they disclosed has been abandoned, so the risk premium built into the stock price by the disclosure of the Commission's investigation can remain there for years while investors wait for the other shoe to drop. This obviously increases capital costs, reduces efficiency and impairs capital formation. In short, the market impact of a poorly conceived SEC investigation – or of one that drags on for years without resolution – can harm investors as well as regulated entities and public companies.

### *Information requests*

An enforcement action frequently begins with a newspaper article, investor complaint or anonymous "tip" about a company. Advancement within Enforcement Division (ENF) or OCIE frequently depends on finding and bringing solid and dramatic cases, occasionally prompting a race among the various units in each division—including competition between the agency's "home office" staff in Washington and staff in the regional and district offices—to be the first to open a Matter Under Inquiry (MUI). This results in a letter, or sometimes a simple phone call, asking a company or group of companies to provide information to the staff that would be relevant to determining whether a violation of the law or regulations has occurred. A MUI can be

opened at the request of any ENF line attorney, and must be approved by a senior ENF manager, usually someone at the Associate Director level. After that initial high-level review, however, things often spin out of control.

MUI requests are often drafted very broadly, without regard to the likely economic cost of full compliance. Where the request calls for years of e-mail messages or other documentation, it can entail significant and costly efforts by lawyers inside and outside the affected company. Responses to these requests are then submitted to the ENF line attorney responsible for the MUI. The staff of OCIE and ENF don't always coordinate their actions, so SEC-regulated entities can occasionally receive different requests from both ENF and OCIE, potentially requiring double the cost to comply with each. Anecdotal discussions with lawyers who represent companies in securities investigations suggest that some of the more extensive requests for documents can require many millions of dollars in lawyers' time to fulfill.

In addition to ENF information requests, OCIE apparently has authority to inspect records at mutual funds and broker dealers whenever this seems in the public interest. This broad grant of authority, coupled with a generally more aggressive enforcement approach, has led to what many industry participants believe is a dramatic increase in information requests and industry wide "sweeps" seeking information on specific business practices. If an OCIE official reads a newspaper account that seems to raise a compliance issue, the official is authorized to send an information request to the firm mentioned in the account, or to send a broadcast inquiry—known as a sweep request—to other firms in the industry that may be engaging in similar practices.

These inquiries can become burdensome "fishing expeditions" that unnecessarily raise the costs of doing business without benefiting investors. For example, it is becoming routine for OCIE to request all e-mails or other documentation that might be relevant to a particular issue in which OCIE is interested. We have seen sweep requests that ask for over 20 *categories* of documentation, and a summary of sweep requests over the last two years that involve 13 separate topics. Oftentimes, the subject of a sweep is so broad that it may involve searching literally millions of e-mails, an exceptionally time-consuming and costly task even if the latest search technology is used. Regardless of the technology, e-mails and similar items still must be read to ensure they are actually responsive to the request and do not, for example, involve privileged material. This process can cost a firm millions of dollars in legal fees and tie up a significant portion of senior staff time. The Commission should clearly exercise some control over this costly process.

#### *Termination of enforcement actions*

If it turns out that the staff's initial suspicions do not warrant further review, the MUI can be terminated easily, but if this is not done within 60 days the SEC's computerized case tracking

system automatically escalates the MUI to the status of an "informal investigation."<sup>10</sup> Informal investigations are not easy to close—there are many steps and approvals involved. Accordingly, if the questions on the basis of which the original MUI was opened are not resolved within 60 days, the consequences, particularly for investors, become quite troubling. The company is then advised that the original inquiry has become an informal investigation. While this sounds more serious, it need not be based on any more information—or on any greater SEC staff consideration—than the original news article, complaint or tip that stimulated the MUI. It is important to note, however, that although the approval of a senior ENF official was necessary to open a MUI, no approval is necessary for a MUI to "roll" into an informal investigation. Thus, informal investigations can be, and often are, opened without ever being touched by human hands; what started as a quick look into a potential violation has now become a disclosure item for the affected public company. As a result of this automated process, investors suffer as the company's stock price declines on the news of an SEC investigation.

However, if the informal investigation now underway does not turn up violations of law or related SEC regulations, the line attorney who originally opened the MUI must now spend a lot of time to close the matter—including an extensive closing memorandum that includes such things as summaries of witness interviews and recorded testimony. The line attorney has little incentive to do this promptly, so that the investigation may linger on the shelf for months, or sometimes years, while the attorney who opened it pursues cases more likely to be productive. Thus, in effect, an investigation may have been abandoned but the company involved may not have been so advised. In fact, the enforcement division's policy concerning the termination of investigation is to provide notices to witnesses and companies only about the termination of a so-called "formal" investigation, and then only to those specifically named in a Formal Order. Former ENF staffers explain this policy as growing out of a fear that companies and individuals will cite the termination notice as proof that they are law-abiding. A simple statement, published on the SEC's website, that publicly explains the meaning of a termination notice, would seem adequate to address the staff's legitimate concerns.

Of course, counsel for a company or individual may always ask the staff if an investigation is complete. Such requests, however, are not without risk. Lawyers representing companies are justifiably reluctant to ask about investigations that seem to have been abandoned, because they know that such an inquiry might induce ENF to look into the matter again. Better, they have learned through experience, to let sleeping dogs lie. But meanwhile, shareholders of companies that remain in investigatory limbo continue to suffer a loss that seems directly contrary to the Commission's investor protection mission.

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<sup>10</sup> There is no significant difference in gravity between an "informal" investigation and a "formal" investigation. Regulated entities such as broker-dealers, mutual funds and investment advisors have a statutory obligation to furnish information to the Commission upon request. Non-regulated entities such as issuers do not. If the staff requires a subpoena in order to get information from a non-regulated party, the Commission must delegate subpoena authority to the staff via a document called a Formal Order of Investigation, hence converting the matter into what is called a "formal" investigation.

One other peculiarity of SEC investigations is worth noting: companies are not told whether they are targets. This is particularly troubling when an investigation is concerned with trading in a company's stock. It is often not clear from the designation and announcement of a case whether it is a company is the subject of an investigation or only those who may have engaged in trading of its stock. Once an investigation has moved to the "formal" stage, as most trading investigations eventually do, counsel can request a copy of the underlying Formal Order and then usually determine whether the staff is looking at trading, or the company, or both. Prior to the issuance of a formal order, however, a company must often rely on the willingness of ENF staffers to disclose the nature of the investigation, a disclosure that is sometimes difficult to obtain.

ENF policies and procedures for tracking cases and issuing so-called termination letters also suffer from another major lapse: the issuance of termination letters is tied to the administrative "closing" of a case file, not to the point in time when the company is no longer under active investigation. Under current ENF procedures, a case cannot be closed until all relief ordered in all related enforcement action has been accounted for, either by receipt of the funds or a Commission decision to write-off the judgment debt. So, for example, a case can be opened in the name of a public company, a Formal Order issued indicating that both third-party traders and the company are the subjects of the investigation, the investigation can take years and produce no action against the company. If, in this example, one or multiple enforcement actions are brought under this case name, a termination letter would not be sent to the company until the Commission had collected or written off the last dollar owed from the last judgment entered. Because litigated cases typically take one to two years to reach final judgment, and because collection of fines and disgorgement can take another one to three years to either collect or for the Commission to write off, a company under initial suspicion would not receive a termination letter until perhaps five years after ENF had stopped investigating it.

### *Charges, Wells submissions and settlements*

Sometimes, of course, investigations ripen into actual charges, and for this the staff needs the approval of the Commission. The Commission is the prosecutor, judge and grand jury in these cases, a situation that led the Commission to develop the procedural form known as the Wells submission. In the early days of the Commission, this was done in closed proceedings at which the party to be charged had no opportunity to make its case to the Commission. In the early 1970s, as a result of the Wells Commission, this unfairness was partially rectified through what has become known as a Wells submission—an opportunity for a party to present a written statement to the Commission as to why it should not be formally accused of wrongdoing. There is no oral argument opportunity, and the defendant is not present when the issue is taken up by the Commission. In contrast, ENF provides both a written "Action Memorandum" to the Commission and ENF representatives orally present their case. The defendant does not see all the evidence that the staff presents. Although informal contacts between ENF staff and defense counsel can provide some sense of what facts are important, there is no requirement that the staff reveal all the salient facts that it will present to the Commission, so that the defendant preparing the Wells submission is often handicapped in determining what issues it should address. The

Wells submission, then, is only a partial remedy for the inherent unfairness associated with this process

Most presentations to the Commission by the staff result in actual charges. Parties know this, and frequently prefer to settle rather than suffer the adverse publicity associated with both the formal charge and any protracted litigation. There are, as a result, very few litigated cases involving SEC charges against public companies or regulated entities such as broker-dealers. The staff knows of the companies' vulnerability, and is thus in a strong position to force parties to settle cases that the Commission might not otherwise be able to win, or win completely, in court. This is a familiar prosecutor's tactic, but the SEC staff is able to take it somewhat further. Because the staff is in control of the information presented to the Commission—and the defendant company is unaware of what the staff is presenting—the staff is also able to force disclosures from parties that even prosecutors cannot often obtain. One familiar tactic of recent vintage is to ask the company to waive attorney-client privilege, so that ENF can represent to the Commissioners that the company has been “cooperative.”

### *Necessary reforms*

These procedures are not worthy of an agency that operates according to standards of elementary procedural fairness, or is truly concerned about protecting the interests of investors. From a purely economic point of view, the enormous waste of assets that flows from excessive and unnecessary actions by the SEC's enforcement staff are a deadweight loss to the economy and a specific loss to investors in a company that is investigated but never charged with wrongdoing. A few procedural reforms would go a long way toward rectifying this situation:

- As MUIs age toward 60 days, line attorneys should be required to get the written approval of the Associate Director who originally approved the MUI to allow the matter to become an informal investigation. MUIs should not automatically roll into informal investigations through an automated process.
- If a matter becomes a formal or informal investigation, the SEC staff should notify the parties whether they are targets or simply sources of information. If in the course of an investigation a party that was originally identified as a target is no longer considered a target, the party should be promptly notified.
- If an investigation has been completed in the sense that a settlement has occurred or a judgment obtained, the unaffected parties should be notified that they are no longer subject to any Commission jeopardy. There is no reason to wait until a case is formally closed.
- In connection with every Wells submission, the party making the submission should be advised of the specific facts that will be presented to the Commission by ENF.
- As long as the decision to proceed with a charge is made by the Commission in a closed meeting, the ENF staff will always have considerable leverage to extract settlements from companies and other parties in cases that could not be won in court. Some mechanism must be put in place that ameliorates this situation. One such mechanism is the General Counsel's

responsibility to advise the Commission as to whether, in the General Counsel's view, the case can be won. It's not clear how seriously the General Counsel takes this responsibility, and the Commission should make clear to the General Counsel that his or her advice in this respect is considered a significant check on abuse of the Commission's power. It is noteworthy that the NASD has an entirely separate organization—independent of the enforcement section—that advises the board on whether the NASD's case is substantial enough to prosecute.

- The Commission currently receives staff reports on the number of investigations open and the number that are active. The general data in this report—without including the names of parties—should regularly be made public by the Commission. An active investigation should be defined so that the public can determine whether investigations that are no longer active are being closed.
- Parties should not be asked to waive attorney-client privilege unless they assert advice of counsel as a defense—and even then sparingly, perhaps in cases where fraud may be involved.
- The Commission should appoint an ombudsman with authority to investigate complaints by parties about violations by the staff of the procedures established by the Commission, or the Commission's Inspector General should be given the authority to investigate public complaints about staff violations of the Commission's rules for enforcement actions.
- OCIE information requests should be subject to some control, preferably through directions from the Commission to the OCIE senior staff that require some sensitivity to the costs that sweep requests entail. The ombudsman, if one is appointed, or the SEC's Inspector General, should investigate the costs of sweep requests that seem excessive and report to the Commission.
- One general control over the scope of OCIE requests would come naturally from the priorities of the divisions within the SEC responsible for regulating or enforcing laws and regulations. OCIE functions outside these divisions and is thus not subject to their priorities. As a result, the Commission might give some consideration to folding OCIE back into the divisions that use investigation and inspection functions, and thus might use these functions more efficiently.

Adopting these reforms will demonstrate that the Commission has become aware that its enforcement activities now make it in a very real sense a participant in the securities market as well as a regulator.

## **Regulation of Mutual Funds**

The Commission's recent rule, requiring that the chair of a mutual fund and 75 percent of the fund's directors be independent of the investment adviser, is another example of the Commission's single-minded focus on what it defines as "investor protection" rather than on providing investors with an efficient and competitive mutual fund industry that will enhance

capital formation. The enforcement of this rule has now been stayed because the Commission failed to observe its obligations under NSMIA, and this offers an opportunity to reconsider the effect of the rule in a broader context than that in which it was originally promulgated. To be sure, one of the important purposes of the Investment Company Act of 1940 was to control an adviser's conflicts of interest by assuring that at least a few of the fund's directors are independent of the adviser. But the balance originally struck by Congress was that 40 percent—and not 75 percent—of a fund's directors should be independent, and the Commission seems to have forgotten entirely why Congress made this deliberate choice.

In testifying on this issue, David Shenker, the chief counsel of the Investment Trust Study, which established the factual basis for the 40 Act, noted that:

The bill as originally introduced . . . required that a majority of the board be independent of the management. However, the argument was made that it is difficult for a person or firm to undertake the management of an investment company, [and] give advice, when the majority of the board may repudiate that advice. It was urged that if a person is buying management of a particular person and if the majority of the board can repudiate his advice, then in effect, you are depriving the stockholders of that person's advice. . . . [T]hat is why the provision for 40 percent of independents was inserted.<sup>11</sup>

Thus, it appears that Congress itself struck a balance—requiring less than a majority of a fund's directors to be independent, but recognizing at the same time that investors were choosing the investment adviser and not the directors of the fund to manage their investments. In the release that imposed the 75 percent requirement and the independent chairman, and in its brief opposing the Chamber of Commerce's request for a stay, the Commission argued that adding additional independent directors and an independent chairman would not be costly in relation to the benefits that could be anticipated from compliance activities and prevention of conflicts of interest. But in making this point—even if its numbers are correct—the Commission revealed the narrowness of its vision and its failure to understand that Congress in 1940, and Congress in adopting NSMIA in 1996, wanted the Commission to consider issues broader than simply preventing conflicts of interest.

Even modest additional costs for more independent directors and an independent chair will be burdensome for small investment advisers, and will thus make it less likely that new competitors will enter the business of advising mutual funds. Although ease of entry is a key factor in fostering competition in any industry, the Commission seems never to have considered this. The more duties heaped on the independent directors, the more compensation they will have to receive for the additional time spent on the fund's business. An independent chair can be particularly costly, since he or she will have to spend a great deal of time becoming familiar with the fund's business, and a great deal of the adviser's management time will have to be devoted to

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<sup>11</sup> *Hearings on H.R. 10065 Before the House Subcommittee. on Interstate and Foreign Commerce, 76th Cong., 3d Sess., at 109-110 (June 14, 1940)*

the education of the independent chairman. The costs of new independent directors and an independent chair will of course be paid by the shareholders of the funds, reducing the yield on this form of investment and its competitiveness with other forms of investment management. The additional costs also make mutual funds less efficient operators and thus increase the yield they will have to achieve for a given level of risk and the cost of capital for all companies.

Although David Shenker's description of the drafter's intent in 1940 is clear enough, there are probably several other reasons that Congress did not want mutual funds to be managed by a group of independent directors. For one thing, despite the recent excitement about the virtues of independent directors, it is important to recall that because of their very independence—their lack of a stake in the company—they have little incentive to spend much time or effort on making sure that the shareholders receive good returns on their investment. In reality, the directors who have this interest in mind are the non-independent directors—those affiliated with the adviser—who recognize that if the shareholders are not satisfied they can easily seek redemption of their shares.

Redemptions by mutual fund shareholders are particularly painful to investment advisers, since redemptions both reduce their compensation—which is based on a percentage of the fund's assets—and require them to find other investors in order to avoid having to sell securities to meet redemption obligations. This is a powerful form of market discipline on fund managers, exercised entirely by shareholders, and completely ignored by the Commission in its effort to impose independent management on mutual funds in order to “protect investors.” In 1940, however, Congress probably recognized that the ease with which shares can be redeemed in open-end companies—mutual funds—offered shareholders an easy way to protect themselves. So one can readily see why Congress was willing—despite the known existence of conflicts of interest between the investment adviser and the fund's shareholders—to place most of its reliance on the ability of shareholders to protect themselves rather than the limited incentives of independent directors.

Finally, mutual fund shareholders could reasonably believe that they would be better off in terms of the return on their investment with fewer independent directors and with a non-independent chair of the fund. That's why the Commission's refusal to consider disclosure as an alternative to requiring an independent chair was so significant to the court in the Chamber of Commerce case. It demonstrates that the Commission had no concern for the question of whether mutual funds were performing as economic entities, but considered only the question of how to eliminate conflicts of interest. It had lost any sense of balance about how it would administer the 40 Act. Recognizing this, the court sent the rule back for further consideration of the issues of efficiency, competition and capital formation, which the court characterized a “statutory obligation” of the Commission that it had obviously failed to take seriously.

As noted recently by Professor Roberta Karmel, a former SEC commissioner and a frequent commentator on 40 Act issues, the Commission's independent chair rule is “troubling” because it “can justify virtually any intrusion into the business conduct of an investment company based on some notion, however fanciful, that a new rule will guard against some conflict of interest inherent in the running of a mutual fund. However, contrary to popular current thinking, a conflict of interest is not a violation of law. Mutual funds and the securities

industry generally are rife with conflicts of interest because funds and other securities firms are intermediaries between parties with opposing interests. Investors in mutual funds, like investors in other securities, are seeking honest, competent and professional management, not some ideologically pure corporate structure.”<sup>12</sup>

### *The deficiencies of the independent chair rule*

But the Commission’s independent chair rule has greater deficiencies than simply its failure to take into account the full range of the Commission’s statutory obligations. Even if the commission had duly considered efficiency, competition and capital formation when it adopted the rule, it would be difficult to justify these particular regulatory requirements as rationally adapted to address the violations which the Commission cited as the basis for the rule. The violations of the 40 Act involving in late trading, for example, were perpetrated by investment advisers. The boards of directors of the affected funds were not involved, and as far as is known were unaware of the problem.

The Commission has never made it clear how requiring an independent chair and a board composed to the extent of 75 percent by independent directors would have prevented this kind of dishonesty. The Commission never charged the directors of any of the funds where late trading occurred with any dereliction or breach of their duties to shareholders, even though they failed to discover that late trading was going on. The Commission cited the failure of the advisers to inform the directors that the adviser was permitting late trading, but has not explained why a board that is made up primarily of independent directors and an independent chair would be any more likely to have been told. Indeed, because of the unfamiliarity of independent directors with how funds actually operate, it is far more likely that a diligent and honest non-independent director would have discovered the adviser’s violations.

In its apparent zeal to use the late trading and other scandals as an excuse to increase the percentage of independent directors on mutual fund boards, the Commission did not apparently realize that non-independent directors have far better chances of discovering wrongdoing and far greater incentives to stop or report it when they do. This is because independent directors will always remain ignorant of what is going on in the adviser’s offices, but non-independent directors may not. And if non-independent directors learn of wrongdoing, they are going to want to stop it or report it because they now have what might be called guilty knowledge—if they become aware of wrongdoing and ignore it they can be prosecuted by the SEC, and sued civilly, for failing to discharge their fiduciary duties to the shareholders of the fund that is being victimized.

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<sup>12</sup> Roberta Karmel, *New York Law Journal*, August 18, 2005, p3

For these reasons, there is not much that can be done to redeem the independent chair rule. It was wrongly conceived because it failed to comply with the Commission's statutory mandate for promoting efficiency, competition and capital formation, but—even if it had met that standard—there is no rational way to relate the requirements of the rule to the abuses it was intended to fix. Now that the Court of Appeals has imposed a stay on the rule's implementation, the Commission should consider withdrawal or substantial revisions in the rule.

## **Regulation NMS**

In contrast to the independent chairman rule, the Commission's recent adoption of Regulation NMS<sup>13</sup> might be seen as a closed matter that should not be revisited. However, the rule will have such a profound effect on efficiency and competition in the securities market that the outcome might have been different if the Commission had considered efficiency, competition and capital formation as required by section 3(f) of the 34 Act. In adopting Regulation NMS, the Commission elected to retain a trade-through rule—and thus a decisive regulatory role in the trading process—by extending the essential elements of the rule to all market centers. This will have a highly adverse effect on competition and efficiency, but was implemented on the basis of very weak evidence that it would protect investors.

A so-called trade-through occurs when an existing limit order is by-passed and an execution is effected at a price that is inferior to the price in the limit order. For example, if the lowest offer for a stock is \$19, and a trade is effected at \$20 the person who elected to purchase the stock at \$20, despite the existence of the lower \$19 offer, is spoken of in market parlance as having “traded-through” the better price. The new trade-through rule in Regulation NMS would prohibit this, requiring that the best price available in any electronic market be accessed before a trade may be effected at an inferior price in that or any other market.

It may seem counter-intuitive that a customer may want to buy at \$20 when there are offers in the market at a lower price, but that has to do with trading strategies. For example, the customer may want a very large number of shares, and is afraid that if he stops to pick up the lower price shares he may miss an offer of a large number at a slightly higher price. He may think that he will do better, on average, in buying the larger number of shares at an inferior price than by chasing the market price as it moves up.

In its Regulation NMS release, the Commission drew two conclusions that dictated the retention and extension of the trade-through rule: (i) that the best execution requirement, which the Commission itself is supposed to enforce as an obligation of all brokers, is insufficient alone

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<sup>13</sup> Release No. 34-51808; File No. S7-10-04

to ensure that customers receive the best price when giving their broker a market order—an order to execute a purchase or sale at the market price when the order arrives at the trading venue; and, (ii) that the trade-through rule is essential to encourage investors to post more limit orders—orders that are executable only if the price specified in the order is met or improved. These assumptions are highly speculative, and this suggests that the implementation of Regulation NMS should be preceded by a pilot program for testing whether the Commission’s assumptions were sound.

### *Best Execution and Market Orders*

The U.S. Court of Appeals for the Third Circuit recently provided a good summary of best execution when it observed, “the duty of best execution, which predates the federal securities laws, has its roots in the common law agency obligations of undivided loyalty and reasonable care that an agent owes to his principal. Since it is understood by all that the client-principal seeks his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction.”<sup>14</sup>

Therefore, in explaining why it opted to retain and extend the trade-through rule despite its complexity and costs, the Commission must explain why the duty of best execution does not already effectively operate as a common law trade-through rule, negating the need for Commission action. As it should, the Commission attempted to answer this very question in the adopting release. Its brief rationale can be summarized as: (i) the duty, by itself, does not actually require brokers to get their customers the best displayed price on every order; and (ii) investors cannot ensure for themselves that they always receive an execution at the best displayed price.

Both of these rationales, however, are unconvincing and completely ignore alternative approaches. First, it is clearly incorrect that the duty of best execution does not require an agent to obtain the best price on every customer market order. The case law is clear and for the Commission to imply otherwise is surprising. Second, in both explanations, the Commission fails to explain why it does not take more direct action to address these alleged shortcomings.

For example, if it were true that the duty of best execution does not clearly protect every market order then the Commission could simply issue an interpretive release clarifying that the duty of best execution applies to every such order. Similarly, while the Commission expresses its concern that customers cannot monitor the execution quality of their market orders, it fails to explain why this concern cannot be adequately addressed through an enhanced surveillance and enforcement process. Market regulators such as SROs should already be monitoring for trade-

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<sup>14</sup> *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (3d Cir.), cert. denied 525 U.S. 811 (1998)

throughs that result in a violation of the duty of best execution. If they are not, the Commission should correct this problem rather than impose a market-wide trade-through prohibition on every participant in nearly every circumstance. The idea that a trade-through rule was necessary to protect market orders seems clearly fallacious.

### *The SEC's Theory on Limit Orders*

Given that relatively simple and less costly alternatives exist to protect market orders, it must follow that the only rationale for the trade-through rule must be that it was necessary to protect limit orders. Indeed, in the adopting release the Commission stated that “market participants that execute orders at inferior prices without protecting displayed limit orders are effectively free-riding on the price discovery provided by those limit orders.” The Commission concluded that trade throughs create “a disincentive for investors to display limit orders and ultimately could negatively affect price discovery and market depth and liquidity.” This is a far more sophisticated argument than the Commission’s rationale for protecting market orders, but is there any reason to accept the Commission’s view?

The Commission offered no empirical support for its view that trade-throughs suppressed or reduced the number of limit orders displayed in a market, although that is a fact that could have been determined through a Commission study. While in theory the Commission’s view might have some validity, we must keep in mind that it is on the basis of a theory—and a theory alone—that the Commission is imposing a regulation that will prevent traders from directing their brokers to execute orders to buy or sell at the price the trader wants.

Ironically, the Commission’s rule—even in the Commission’s own terms—does not prevent trade-throughs and hence does not have the effect of encouraging limit orders. For example, markets A, B and C are displaying the following prices for security X:

Market A—19, 19.10 and 19.20;

Market B—19.50 and 19.60; and

Market C—19.80 and 19.90.

If an investor comes into the market with an order to buy shares of X at 20, the trade-through rule now requires that the broker take the shares that have the *best* displayed price in *any* market. That would be 19 in A, 19.50 in B and 19.80 in C. The broker can ignore the other prices, even if they are better than 20, and—if his customer so directs—execute the rest of the order at 20 or above.

Moreover, while the Commission confidently set forth its theory in support of a trade-through rule, several markets were functioning in the real, non-theoretical world without a trade-through rule and without any significant complaints from investors or a noticeable shortage of limit orders. Indeed, ECNs—which have never been subject to a trade-through rule—have grown dramatically over recent years in the market for NASDAQ listed securities, and *only* accept limit

orders. Under these circumstances, the Commission should bear a heavy burden to establish that its theory is valid, despite real-world observations to the contrary.

Indeed, a study by the Commission's own office of Economic Analysis, completed before the new trade-through rule was adopted, found that only 1.9% of the shares executed on NASDAQ—where there was no trade-through rule—traded through a better displayed price. This result, essentially confirming that a combination of best execution and the natural desire to obtain the best price was highly effective in preventing trade-throughs, should have been sufficient to persuade the Commission that its rule was unnecessary. Under the Commission's logic, however, even trade-throughs at a level of less than 2 percent are sufficient to discourage the display of limit orders. Even assuming this were true, it does not seem sensible to impose a rule that impairs the efficiency of trading in the securities markets in order to assure—even if the rule were fully effective—that the last 1.9 percent of trade-throughs are eliminated. Once again, the Commission seems to have devoted itself completely to a theory which it believed would protect a very small number of investors, without considering whether its action would impair efficiency, competition and the promotion of capital formation.

In this connection, it is important to note that best execution and competitive market forces may be implemented at very low cost. In contrast, a trade-through rule regime imposes significant costs, including additional regulation. First, since a trade-through rule effectively requires markets to route orders to other markets, the Commission was now required to cap access fees—the fees that a market can charge for accessing its quotes. Price fixing became necessary because requiring traders to access every market that was displaying the best quote gave markets considerable pricing power. Second, because the rule required a distinction between automated and manual markets, the Commission was compelled to define a fast or an electronic market by regulating response times and, given the complexity and impact of the rule, the Commission will end up dictating other technical decisions made by each market center. In sum, the end result of the trade-through regime is dramatic increase in the Commission's involvement in the day-to-day operation of each market. These are all costs that the Commission should have considered, but did not—costs that clearly have an adverse effect on market efficiency and hence on the cost of capital and the amount that investors must pay to execute transactions.

While the direct costs of this increased involvement are significant, the indirect and intangible costs may be more significant. In particular, the new regulatory regime contemplates an automated price-time priority market and essentially pushes all markets toward that market structure. Thus, to the extent that a new market type is developed that operates on a completely different principle, one that may eventually prove to be superior to a simple price-time priority market, the new market type will be required to receive an exemption from the Commission. This places the fate of any new innovative market in the hands of regulators and virtually guarantees the continuation of the status quo.

It is clear that the SEC elected to implement a trade through regime based solely on its theory that the absence of such a rule will discourage limit orders. The fact that the Commission lacked significant empirical evidence to support this theory, coupled with the costs associated with the larger and more complicated regulatory scheme it adopted, strongly suggests that the

Commission gave no consideration to efficiency, competition and capital formation in developing Regulation NMS. It is not difficult to see that this complicated rule has adverse effects on efficiency and competition, and by raising the costs of trading securities would impair rather than promote capital formation.

Even if we grant that encouraging a small number of additional limit orders is worth the costs of the rule, there is still a question whether the rule will have this effect. Since the issue turns on the validity of the Commission's judgment, it seems prudent—before significant costs are imposed on the market—to ascertain whether the Commission had it right. Accordingly, before allowing the rule to go fully into effect, the Commission should institute a carefully constructed pilot program—like the test it recently authorized for short-sales—that will test whether a trade-through rule of the kind included in Regulation NMS will in fact increase the use of limit orders.

### **Regulation of Markets and Broker-Dealers**

High-profile recent failures in the self-regulatory system at nearly every exchange led the Commission to issue a concept release in March 2004<sup>15</sup>, asking for comment on various potential changes to the current SRO system. Currently, each registered stock exchange and association is also deemed to be a self-regulatory organization (SRO) with responsibility to regulate the trading activity of its members and, depending on the member and SRO, its maintenance of books and records, its financial integrity and the protection of its customers. Congress elected to rely on self-regulation for many reasons, including the belief that it would be more efficient for markets to regulate their complex inner workings than to have the SEC do it directly. Congress may have been comfortable with this idea in part because exchanges were mutual organizations—already made up of and governed by members—and in that sense were similar to not-for-profit or cooperative organizations. Regulation of ordinary profit-making companies was a familiar function of the government; regulation of mutual organizations was not.

Nevertheless, there was and is an inherent conflict of interest in the SRO model, between the interests of the public in enforcing federal securities laws and the economic interests of the exchange members who control its operations. This conflict has contributed to periodic scandals, such as the collusion in price fixing found on NASDAQ and the recent findings on interpositioning and front-running on the NYSE. The emerging problems with SRO regulation eventually caused a separation of the regulatory function of the National Association of Securities Dealers (NASD) from its function as the operator of the NASDAQ trading system.

But the growth of for-profit organizations functioning as trading venues, and the pending privatization of the NYSE and NASDAQ through mergers with ordinary business corporations

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<sup>15</sup> Release No. 34-50700; File No. S7-40-04

that were functioning as electronic communications networks, now promises to change the SRO and securities exchange landscape completely. Mutual organizations are likely to disappear entirely, and be supplanted by privately-owned profit-making corporate forms. This offers the opportunity for a complete rethinking of the SRO structure by the Commission, with a view not only to the protection of investors but also to how to encourage efficiency, competition and capital formation.

The Commission's concept release asks for advice from respondents on many different structures—ranging from enhancements to the current SRO system to establishing direct Commission regulation of the securities industry as a whole, including the various exchanges and trading venues. This was a sensible way to approach the issue, but the release did not address or consider the one issue that is perhaps paramount in any regulatory structure—how to assure competition and innovation in the regulated industry. It is a classic and undesirable feature of regulation that it tends to raise barriers to entry into the regulated industry. Although the Commission's release discussed the new competition among exchanges as an important factor to be considered in developing a better regulatory structure, it seemed completely oblivious that this competition arose out of a loophole in the Commission's own regulatory scheme, which allowed electronic markets (known as electronic communications networks, or ECNs) to develop without having to apply for or be approved as regulated exchanges. Since their inception, ECNs have functioned outside the regulatory structure in place for exchanges, and it is significant that they have met with widespread investor approval. So much so that they now dominate trading in the securities listed on NASDAQ.

Accordingly, the most important element of any new regulatory structure for exchanges will be to replicate the flexible regulatory structure that has encouraged the growth of ECNs, while providing for regulation where it is appropriate. Accordingly, any regulatory structure that is ultimately put in place should be one that will not stifle the competition and ease of entry that will encourage the innovation and updating of trading systems as technology improves.

Treating this as a priority suggests that the best solution will be the complete separation of the regulatory function from the trading markets themselves. The first benefit of this structure would be ease of entry. Under current SEC rules, the key factor contributing to the time-consuming and costly review of an exchange application is the Commission's consideration of the applicant's ability to perform its required regulatory duties. The willingness of several market participants to invest millions of dollars in SROs that have no assets other than an exchange registration highlights the severity of these barriers to competition. The cost and time involved in order to get approval to regulate is undoubtedly a major impediment to entering the trading system as a regulated exchange.

If exchanges were no longer to function as SROs, there would be no further need for the current regulatory distinctions among exchanges, associations, ECNs and Alternative Trading Systems. Differing regulation for entities that perform the same economic function only distorts competition as each category attempts to capitalize on the benefits of its designation to the detriment of its rivals. The elimination of these essentially arbitrary distinctions would level the playing field for all the competing markets.

Under these circumstances, the Commission could create one designation for a trading venue—whether it’s called a trading center or an exchange—and an application to enter the trading business could be approved in a matter of weeks. By reducing the current barriers to entry, such a change would increase competition among markets and assure that new ideas for trading are introduced into and tested in a competitive market. Similarly, the long-static regional markets would lose the subsidy inherent solely in holding a difficult to obtain designation as a regulated exchange, and would have to start competing and innovating to survive.

In order to receive approval as a trading center or exchange, a new trading venue would have to be regulated by someone—the NASD, the Commission, or another regulatory organization of some kind. In our view, the best regulatory structure is also a competitive one. The NASD is already the regulator of an exchange and of all broker-dealers. It would be a natural candidate to regulate other exchanges or trading centers, but once the principle of regulation by contract is accepted there is no reason that other competing regulators should not be allowed to function in the field. Regulators themselves often become sclerotic and resistant to change and new ideas over time, and the important trading market can be kept flexible and receptive to innovation if two or more organizations were authorized to perform the regulatory function, all competing for business. In order to take account of economies of scale, these regulatory bodies should be authorized to regulate broker-dealers as well as exchanges or trading centers. In other words, each could be an NASD-like entity that would be approved by the SEC to perform the same function as the NASD performs today. Under this plan, trading centers and broker-dealers would contract with SEC-approved regulators for regulation and supervision at a negotiated fee.

An important benefit of introducing the trading center concept would be the elimination of the current rule-filing process for trading centers. Although regulatory entities would have rules of conduct for the trading centers they regulate, the trading centers would not have to obtain the Commission’s approval for their trading rules. A similar approach was recently adopted by the Commodity Futures Trading Commission. In recent years, ECNs have captured a substantial portion of the trading in NASDAQ securities, although they operate under rules of their own devising, without any approval by the Commission and no substantial complaints from the trading public. This should be an adequate demonstration that the antiquated approval process for trading rules is no longer necessary and should be scrapped. The Commission, however, should still retain rules, applying to all trading centers, such as “fair access” and “non-discrimination.”

The concept of using multiple competing regulators will of course be controversial. Many will think of it as setting up a “race to the bottom.” This, however, is not the experience with multiple competing regulators where it has been tried. There are three regulators of banks in the United States—the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. They coordinate their activities, but the competition among them keeps each of them sensitive to the need to stay on top of changes in the banking industry. An even more apposite case of competitive regulation is corporate law. There, all business corporations are chartered, and their corporate activities regulated, by the states. In this case of multiple competing regulators, the state of Delaware has become the preferred jurisdiction of incorporation, even though many of the companies chartered there do no business at all in

Delaware and have operating no offices there. Academic studies have shown that companies obtain improved stock prices when they incorporate in Delaware—not because it’s an easy regulator, but because it is perceived as a tough one. Shareholders see the clear rules of Delaware corporate law, the well-informed courts and the care with which the Delaware legislature updates the corporate law to keep pace with technological changes as major benefits of a Delaware charter. Many other academic studies find regulatory competition improves upon regulation in other areas.<sup>16</sup>

Similarly, broker-dealers and trading centers will both have a significant incentive to select regulators with solid reputations and sound regulatory programs. Low fees will be a consideration, as they should in the interests of efficiency, but the most important question will be whether customers and traders are confident about the regulator’s skill. In addition, of course, the Commission would still exercise oversight responsibility in the same manner as it does today, assuring that no race to the bottom occurs.

### **The Commission and the APA: Policy-making through Enforcement Proceedings**

The Administrative Procedure Act of 1946 (APA) requires the Commission and other administrative and regulatory agencies of the United States Government to make rules and regulations by providing a public notice of the rulemaking and an opportunity for public comment. The obvious purpose of this process is to give those affected by rules and regulations an opportunity to have a say in their provisions, to provide an opportunity for court review of final decisions, to advise the public and the regulated industry of the policies the agency is following, and—not least—to assure that it is the agency itself and not its staff that is making the policies. Accordingly, it would be an evasion of this purpose if a regulated industry were compelled to comply with policies that are adopted without these safeguards—that are adopted by the staff without notice and an opportunity for comment. In recent years, however, the Commission appears to be increasingly bypassing the notice and comment process and adopting policies at the staff level that have not been subjected to review or approval by the Commission or the process of notice and comment contemplated by the APA.

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<sup>16</sup> See, e.g., Jean-Marc Suret, Cécile Carpentier, “Centralized or Competitive Securities Regulation: What Canada can learn from the US and the EU,” 2003 [http://www.fsa.ulaval.ca/personnel/suretjm/documents/Centralized\\_or\\_Competitive.pdf](http://www.fsa.ulaval.ca/personnel/suretjm/documents/Centralized_or_Competitive.pdf) ; Sunder, Shyam, "Standards for Corporate Financial Reporting: Regulatory Competition Within and Across International Boundaries" (November 2001). Yale ICF Working Paper No. 00-75; Yale SOM Working Paper No. AC-12. <http://ssrn.com/abstract=290599>

One area where this seems to occur with some frequency is in the enforcement process, where defendants are required to agree to extensive “undertakings” in the context of a negotiated settlement with the Commission. One of the most prominent examples of this phenomenon occurred when the Commission reached a “global settlement” with 10 broker-dealers that addressed potential conflicts of interest arising out of the influence of their investment banking sectors over their research departments. As part of the settlement, the broker-dealers agreed to undertakings that fundamentally changed the relationship between their investment banking and research, without the Commission ever publishing the proposed changes for public review and comment. While the list of undertakings in the global settlement are too numerous to list here they included mandatory separation of the investment banking and research departments and enhanced disclosure requirements.

These requirements cannot be considered remedies or penalties exacted because of the defendants’ violations of securities laws or regulations. They would only be such if the managements of these particular firms were deemed to be fundamentally less honest or trustworthy than the managements of other firms—an allegation that was never made by the Commission in connection with the settlement. Instead, requiring the separation of investment banking from research appears to be a prophylactic measure that—if it is necessary for some broker-dealers—should be applicable to all. It is likely to be having that effect, since counsel and compliance officials are almost certainly advising broker-dealer clients—those not involved in the original settlement—that it is now necessary to separate research and investment banking, and that failure to do so will result in harsh punishment if the SEC later finds that a research recommendation may have been influenced by an investment banking interest. A requirement that is now considered a best practice, and in reality applicable to all regulated companies similarly situated, is in effect a rule or regulation. Yet, in this case, it was not subjected to the notice and comment procedures required by the APA.

Another example of this trend is the settlement with Putnam Investment Management, MFS Financial and many other entities that agreed to certain undertakings after Commission findings of unlawful market timing and late trading. The undertakings in these cases, while also too numerous to list all here, included revised corporate governance standards requiring a majority of independent directors and extensive compliance procedures. Again, unless these requirements were penalties for the violations of laws or regulations—and this is difficult to see—they had no place in an enforcement settlement. On the other hand, if they were intended to establish a new standard for how all mutual funds should be governed, they should have been embodied in a rule and subjected to a process of notice and comment. In fact, this was later done by the Commission, with a regulation that has now been stayed by the courts because the Commission failed to comply with the requirement that it consider efficiency, competition and capital formation when it engages in rule-making.

This result demonstrates why compliance with the APA is important, and why evasion of this process enables the Commission’s staff to impose requirements that either exceed the Commission’s powers or fail to meet the full scope of its obligations as mandated by Congress. It also shows that making policies and imposing requirements through the enforcement process can deprive a regulated industry of its right to have Commission actions reviewed by a court for

compliance with the law. Until these policies are actually embodied in a rule or regulation, there is no “final agency action” which can be appealed.

The increasing propensity to include what are essentially rule changes in enforcement undertakings is not accidental. In a 2004 speech, then enforcement director Stephen Cutler stated:

Enforcement, traditionally, indeed, almost by definition, has been thought of as a reactive function. But, in the last couple years, thanks in part to the actions of the New York Attorney General, expectations, as well as our aspirations in this area have changed. It is no longer considered sufficient to simply jump on violations of law and mete out appropriate sanctions. These days, the concept of effective enforcement necessarily includes “seeing around the corner.” What that means to us is identifying trends, practices, and risks within our capital markets that could be exploited to the detriment of investors. Ideally, if we are able to spot these issues in their infancy, we can prevent them from growing into full-fledged, confidence-eroding scandals.

This language suggests that making policy through enforcement actions was not accidental, but is in fact a deliberate effort by the Commission’s Enforcement Division, irrespective of the requirements of the APA. If, in “seeing around the corner,” the Division finds trends, practices and risks that might harm investors, they can be stopped by enforcement actions. This has got it exactly backwards. The Enforcement Division should be proceeding against persons and institutions that violate known and published rules, not establishing those rules itself by forcing settlements that create new rules. The SEC has also exhibited a tendency to make policy through speeches by senior officials. In this case, the Chairman or the head of a division will make a speech outlining his views on a particular issue; shortly thereafter, regulated entities are then told by the staff that the pronouncement is now considered SEC policy, again without benefit of the process contemplated by the APA.

The Division of Enforcement is not the only division within the Commission that has increasingly engaged in rulemaking outside the rulemaking process of the APA. The Division of Market Regulation also often makes important policy decisions internally without either going through the rule-making process or receiving full Commission approval. For example, in January of 2005 Market Regulation published a proposed rule on the corporate governance of exchanges. One of the key aspects of the proposal was the requirement that the boards of directors of SROs be composed of a majority of independent directors. Market Regulation, however, had for years taken the position—without any basis in a rule or regulation—that SRO boards must be composed of at least 50% independent directors. New exchanges applying for regulated status, had also long been required to have at least 50% independent directors to receive approval. By the time the rule was proposed, all existing exchanges had already changed their board structures, responding to pressure by then Chairman Levitt and by Market Regulation. In other words, the staff was now embodying in a regulation a policy it had been following for years, but without ever obtaining the approval of the full Commission through a rule-making, or giving the regulated industry an opportunity to comment on whether the policy made sense. Once the entire industry had converted to the governance structure that the Commission wanted, it was unlikely that there would be any opposition to the rule.

A final example is the policy of the market regulation division that exchanges cannot directly share more than 50% of their market data revenue with their members. This is not based on any provision of the 34 Act, nor has it been embodied in any rule or regulation that was adopted by the Commission pursuant to notice and comment. It is simply a policy of the Division, applicable to all regulated entities as though it were a rule. And if an exchange were to seek a change in its rules, so that it could share more than 50% of its data revenue with its members, it would be told that such a proposed rule change would not be approved. After receiving messages of this kind, SROs, which must place a great value on a good relationship with the staff, nearly always elect to amend the rule as “suggested,” thus preventing any challenge to a policy that has never even been considered formally by the Commission itself.

Some latitude for staff policies is necessary, of course, but the Commission should make clear that any significant policies that are applied to a whole industry should be vetted through the APA process.

## **The Market and Market Data**

Broker-dealers have complained for many years about the cost of the real time market data they need in order to properly advise and act for their customers. Despite many reviews of the issue, the SEC has not succeeded in substantially changing a system that has resulted in excessive costs for the data itself and distorted incentives for market participants. The fundamental problem, again, is the Commission’s intervention in a market that would function perfectly well if left alone. Accordingly, the Commission should withdraw the rules that currently govern this area and allow market data to be sold by trading centers at a price determined by market forces.

The SEC’s regulation of market data began following the 1975 amendments to the 34 Act that created the National Market System. The Commission’s regulations require each SRO (i.e. exchanges and NASDAQ) to establish procedures for the collection and dissemination of quotation and last sale data. The data must then be transmitted to a consortium composed of all other markets trading the same securities and ultimately consolidated into a single stream. The consortium then distributes this data stream to the public through market data services, or vendors, such as Reuters and Bloomberg. In addition to the requirement for consolidation, the Commission’s Vendor Display Rule requires vendors and broker-dealers to disseminate the consolidated data from all markets, not just one of the markets that contributed data. Thus, for example, Reuters is precluded from disseminating top of book information for the NYSE alone even if the customer expressly requests only NYSE data.

Because of market structure and competitive conditions at the time, the Commission’s requirements may have made sense when they were initially adopted. The NYSE was then the dominant market in most major securities, and the SEC may have been concerned that a rule was necessary to assure that the NYSE disseminated its data on a non-discriminatory basis and at a reasonable cost. Moreover, in the absence of a requirement for consolidation, the Commission could have been concerned that investors might receive incomplete or misleading data, or that

vendors might refuse to purchase data from new or smaller marketplaces, effectively blocking their entry into the national market system that Congress had conceived in the 1975 amendments.

The Commission's requirements, however, bestowed monopoly power on the consortiums, since they had now become the sole source of market data. As a result, each consortium now sets the price it will charge for the data it collects. There is no way to know if a consortium's price reflects the true market value of the data or is a monopoly, profit-maximizing price. While, in theory, the SEC is required to ensure that market data fees are "fair and reasonable" and "not unreasonably discriminatory," in practice the SEC has few criteria with which to make such a judgment, and has been very reluctant to act as a rate-maker, very rarely involving itself in controversies concerning appropriate rates. Broker-dealers complain that the price for market data is too high, and if they are correct all investors are paying excessively high fees for their transactions as market data costs are passed through to the ultimate customers. Once again, it may be that the Commission's exclusive focus on regulation as the means to achieve investor protection has harmed investors rather than helped them.

Another impact of the market data scheme is its distortion of competition among the various marketplaces. For example, it is generally recognized that the data disseminated by regional exchanges trading NYSE-listed securities is not very valuable because they rarely quote at the best price and generally only try to match the prices at which the NYSE is trading. Yet, since each regional exchange is a member of the consortium, it still is entitled to receive a share of consortium revenues. According to SEC statistics, the various consortiums take in more than \$400 million in annual data revenues. For NYSE listed securities, the revenue is distributed to each SRO based on the number of transactions effected by each participant. Thus, even though the regional exchange data is not very informative, the regional exchanges receive a significant percentage of their revenue from market data. This guaranteed revenue stream has effectively subsidized the existence of the regional exchanges and may have sapped their incentive to innovate and compete.

Despite these widely recognized deficiencies, there have been few meaningful changes to the market data scheme conceived approximately 30 years ago. While the SEC's recent Regulation NMS will incrementally change how the consortiums allocate market data revenue among themselves, it fails to address the cost of market data to investors or provide any opportunity for introducing competition or innovation in the production or dissemination of market data. The SEC should now consider reforms to modernize this scheme as well as achieve a more balanced approach that seeks to eliminate monopolies and introduce competition.

Given the market's structure at the time the Commission's regulations were adopted—especially the dominance of the NYSE—the rules on consolidation and dissemination of data may have been justified. However, changes in the market since then cast doubt on whether it is still necessary to require the creation of a consolidated stream of data, to prohibit the dissemination of data other than as consolidated, and to permit a consortium of sellers to set a monopoly price for all buyers. Many markets now compete in the trading of the same stocks, and it would obviously be difficult for a market to attract trading interest if it did not make its quotation and transaction data available to all potential investors.

Recognizing this fact should enable the Commission to modernize the current regulatory scheme for market data. Because competition among markets provides a strong incentive for the dissemination of data, the Commission can eliminate the requirement for central consolidators and the Vendor Display Rule. Vendors, in fact, have their own incentives to consolidate, but might also offer data from only one or more sources, as their customers might direct. Competing with one another, vendors would then buy data from each trading center, and would charge users a price that the market determines is the value of that data. Competition among vendors would keep that price low. Consolidated data would probably fetch a higher price than data from only a single market, but economies of scale or other market factors—such as the nature of broker-dealer demand—might dictate that only consolidated data is economically practical to disseminate.

If the Commission believes a rule of some kind is still necessary, it could require simply that each trading center make its data available on a non-discriminatory basis, and on “fair and reasonable” terms. The Commission would only intervene in extreme circumstances. Freeing up the market for data, then, is likely to provide investors with more and better data at a lower price, and thus fulfill the Commission’s mandate to promote efficiency, competition and the promotion of capital formation.

### **Reducing the Costs of Section 404 of the Sarbanes-Oxley Act**

The theory underlying the controversial section 404 of the Sarbanes-Oxley Act (S-Ox) is apparently that better internal controls will produce better and more accurate financial statements, and that in turn will “restore investor confidence”—confidence that had supposedly been impaired because of the financial scandals first at Enron and then at WorldCom in 2002.

Before examining the tangible and intangible costs and benefits of section 404, it is important to note that it is not accurate to say that investors lost confidence in the markets, in financial reporting, or in the honesty of corporate managements after either Enron or WorldCom. The Dow industrial average rose after Enron in November 2001, which indicates no loss of investor confidence. On June 26, 2002, the day that WorldCom announced the discovery of its fraudulent financial statements, the Dow lost six points. Thereafter, it rose 150 points through July 8, which again indicates that there was no loss of investor confidence because of WorldCom itself. On July 9, however, the President went to Wall Street and made a speech calling for greater regulation of public companies. On that day the Dow fell 179 points. The next day, July 10, the Senate passed the Sarbanes bill unanimously, and the market fell an additional 283 points. These facts are consistent with concern on the part of investors about the substantial costs that would result from S-Ox, and not with a loss of confidence that S-Ox was intended to repair.

Indeed, Section 404 of the Sarbanes-Oxley Act has proven to be immensely expensive to public companies. There are as yet no academic studies that assess the costs of section 404 itself, but anecdotal information from a large number of companies indicates substantial increases in costs, with greater proportional costs falling on smaller companies than on large ones. The initial SEC estimate of costs was \$91,000 per company on average, suggesting that the SEC staff had little understanding of what their regulation actually required. The most frequently cited study,

by the Financial Executives International, which reported in July 2004 the results of a survey in which 224 members who responded, concluded that smaller companies spent an average of \$3 million on compliance with section 404, and larger ones an average of \$8 million. Respondents to the FEI survey indicated that they expected their audit fees to increase by 53% in the future. The big four accounting firms, which as auditors have a central role in 404 compliance, have all had substantial double digit increases in earnings over the past two years, and the one academic study of audit fees reported by the Fortune 1000 found an average increase in fees of \$2.3 million, a 40% increase from 2003 to 2004.<sup>17</sup> Most of these increases are likely to be attributable to the attestation costs associated with section 404, since this was the major change in auditors' functions between 2003 and 2004, and of course auditors costs are only a fraction of the costs companies had to pay to outside consultants or their own employees to set up the internal control system required by 404.

These and other costs associated with S-Ox are causing a large number of small companies to go private or to sell out to larger companies because they can't afford the costs of being public companies. A recent academic study, analyzing both LBOs and going private filings with the SEC in recent years, found substantial increases in both LBOs and the number of companies going private. The former increased from 115 in 2001 to 521 in 2004, and the latter from 65 in 2001 to 114 in 2004.<sup>18</sup>

This should be of particular concern to the Commission—especially if it begins to take seriously the mandate from Congress to consider efficiency, competition and capital formation when it imposes regulations. With section 404, the Commission may have reached the point at which the costs of the regulations it has imposed are actually reducing the access of small companies to our capital markets.

#### *Reducing the costs of section 404*

The costs associated with section 404 can be reduced. The act requires a report by management on the adequacy of the company's internal controls, and an audit by the company's independent accountants, attesting to management's conclusions. In its implementing regulations, the Commission defined internal controls for purposes of section 404 to include "policies and procedures that:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and disposition of the assets of the registrant;

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<sup>17</sup> Susan W. Eldridge and Burch T. Kealey, "SOX Costs: Auditor Attestation under Section 404," June 2005, p2.

<sup>18</sup> William J. Carney, "The Costs of Being Public after Sarbanes-Oxley: The Irony of 'Going Private,'" Law and Economics Research Paper Series, <http://papers.ssrn.comabstract+672761>, pp13-14

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a *material* effect on the financial statements." [emphasis added]

The first two requirements obviously have some relevance to the preparation of financial statements, but the third speaks to control and safeguarding of assets. This has only a limited relationship to financial reporting, and then only when the loss of assets is so great as to be "material"—an extremely rare occurrence for public companies. In the release in which it defined internal controls for purposes of section 404, the Commission noted that the third definition had previously been adopted as an element of internal controls in connection with the implementation of the Foreign Corrupt Practices Act. In that connection, the control of a company's assets would be important, since one of the key issues addressed by that legislation was the payment of bribes in foreign countries. It is unlikely that Congress—which was focused on financial reporting—was contemplating control over the disposition of assets when it enacted section 404.

In April 2005, responding to complaints about the costs of section 404, the Commission convened a roundtable to discuss ways to reduce this burden. But in May the Commission issued a statement essentially blaming accountants for requiring too much detail and not focusing on "material" issues when they audited companies' internal control disclosures. With all due respect, this isn't very realistic. It ignores the fact that the Commission itself—in Staff Accounting Bulletin 99—made the concept of materiality completely dependent on context, and also ignores the liability that accountants may incur when, in hindsight, a loss occurs that could have been prevented by an internal control. To protect themselves against such an eventuality, accountants justifiably believe they must be punctilious in their reviews.

However, if the Commission is truly interested in reducing the costs of section 404 compliance, it can do so by eliminating the requirement that includes internal controls for safeguarding assets as part of the definition of such controls for purposes of section 404.

## **The SEC as the Nation's Primary Regulator of Securities**

Finally, we would like to explore another issue that is closely related to the congressional direction in NSMIA that the Commission, in addition to its responsibility for investor protection, also assume responsibility for creating an efficient and competitive securities market that will promote capital formation.

If we step back and look carefully at the securities laws adopted by Congress in the last 30 years, a clear pattern emerges. Unlike any other area of the economy, Congress has consistently attempted to assure that a *national* securities market will develop—a market

unimpaired and unrestricted by inconsistent state laws. NSMIA, indeed, is only one of a number of enactments that show Congress taking action when it appeared that the securities market would become balkanized and inefficient, or when inconsistent state laws made the uniform administration of the securities laws difficult. These actions strongly suggest that Congress would not object if the Commission were to take the position in litigation or otherwise that the preemption of inconsistent state enforcement and regulatory activity was necessary in order to create a national securities market.

A brief discussion will make the pattern of congressional concern clear. In the Securities Act Amendments of 1975, Congress directed the Commission to establish a national market in which investors everywhere in the United States would have access to the securities trading facilities on equal terms.<sup>19</sup> Then, in 1980, Congress was again concerned that inconsistencies between state and Federal securities laws were interfering with necessary uniformity. Instead of preempting state law, however, Congress enacted a new section 19(c)(1) of the Securities Act, which authorized the Commission to cooperate with state securities officials so as to “assist in effectuating greater uniformity in Federal-State securities matters.” But Congress made its concerns clear with this language:

It is the declared policy of this subsection that there should be greater Federal and State cooperation in securities matters, including—

- (A) maximum effectiveness of regulation,
- (B) maximum *uniformity* in Federal and State regulatory standards,
- (C) *minimum interference in the business of capital formation*, and
- (D) a substantial reduction in costs and paperwork to diminish the burdens of raising investment capital...<sup>20</sup> [emphasis added]

A good example of Congress’s concern for uniformity in securities matters is found in its treatment of class actions. In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995, which tightened the requirements for bringing and maintaining securities class actions under federal law.<sup>21</sup> However, within only a few years, it became clear that plaintiffs’ counsel were able to use the more lenient requirements of state class action rules to initiate and maintain class actions that were inconsistent with the federal standard. Accordingly, in 1998, Congress adopted the Securities Litigation Uniform Standards Act, which established uniform rules for securities class actions and preempted state class action rules.<sup>22</sup> Thus, although

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<sup>19</sup> Public Law 94-29, June 4, 1975; 89 Stat. 97 (1975)

<sup>20</sup> 15USC 77s(d)

<sup>21</sup> Public Law 104-67, Dec. 22, 1995, 109 STAT. 737 (1995)

<sup>22</sup> Public Law 105-353, Nov 3, 1998, 112 Stat. 3227 (1998)

Congress is generally reluctant to preempt state law, when it finds that uniform national rules are necessary to permit the operation of an efficient capital market it will act to take authority away from the states.

NSMIA itself is an example of this. Not only did Congress enjoin the Commission to promote efficiency, competition and capital formation in the securities market, but it preempted state regulation in several areas where state action had begun to create inefficient non-uniformity in the application of the securities laws—where, in other words, the states were impairing the quality of the national securities market. Thus, NSMIA preempted state laws in three areas: (i) state blue sky laws that prohibited the sale of securities on the basis of merit; (ii) state regulation of brokers' capital, financial responsibility and reporting requirements, among other items; and (iii) most state authority over registered investment companies and investment advisers. Thus, where Congress saw state law interfering with the development of a uniform national market it did not hesitate to adopt preemptive legislation.

Explicit statutory preemption is not the only way that inconsistent state laws can be preempted. Courts will generally hold that federal rules apply where Congress has appeared to occupy the field, even without explicit preemption, and where state laws are deemed to be in conflict with federal rules. A strong case can be made that Congress intended that the Commission be the sole regulator of the securities market and the activities within it—especially in light of NSMIA's mandate to promote efficiency, competition and capital formation—and that in pursuance of this mandate the SEC should intervene in state proceedings and argue that it alone was intended to be the sole regulator of securities activities on a nationwide basis.

This is especially true where state action has been initiated by state attorneys general under general anti-fraud laws that were not intended specifically to cover securities activities. In a recent case, the Supreme Court of West Virginia held that the state attorney general could not proceed against a securities firm for issuing misleading analyst reports, because the legislature had not specifically intended that the law be used for this purpose.<sup>23</sup>

There is very strong precedent—established, ironically, by state courts—that SEC regulation under congressional authority has occupied the field and excludes state action. Since 1977, the SEC has had a regulation governing broker-dealer disclosure of the remuneration they receive from all sources for effecting trades. Amidst a controversy over payment for order flow in 1994, the SEC studied the question whether payment for order flow was a violation of the broker's duty of best execution and concluded that it was not. Instead of prohibiting payment for order flow, the SEC amended the rules applicable to brokers and required disclosure of this additional remuneration. Thereafter, in a number of cases filed in state courts, payment for order flow was attacked as a violation of a broker's fiduciary duty to its customer. In these cases, the courts of Minnesota, New York, California, Illinois and Pennsylvania all found that the SEC's

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<sup>23</sup> West Virginia v. Bear Stearns & Co., July 7, 2005

actions had preempted any state action on the issue. The courts' theories varied, some finding implied preemption because of inconsistency with a Commission rule, while others found that an inconsistent state rule would be in conflict with the federal rule and should be preempted for that reason. The New York Court of Appeals and the California Court of Appeals both found that the Congressional intent to establish a national market system—expressed in the 1975 Securities Act Amendments—was sufficient to preempt a state rule that might conflict with this clearly expressed national policy.<sup>24</sup>

Thus, there is a considerable congressional and court foundation for the SEC to assert its primacy as the sole regulator of the securities markets, and in the interests of assuring efficiency, competition and the promotion of capital formation, it should consider doing so.

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<sup>24</sup> See *Guice v. Charles Schwab*, 674 N.E. 2d at 290 (1996) and *McKey v. Charles Schwab*, 79 Cal. Rptr. 2d 213 (1998)