American Enterprise Institute for Public Policy Research

Financial Services Outlook

September 2007

What Is, What Ain't, What Might Have Been: Chris Cox's Legacy at the SEC

By Peter J. Wallison

The resignation of Commissioner Roel Campos from the Securities and Exchange Commission (SEC), announced on August 9, deprives Chairman Christopher Cox of a crucial vote to pass the most controversial measures now on the SEC's agenda. It also means that there will likely be no more major initiatives during the Cox chairmanship. Cox's actions in support of better disclosure to investors will be seen as the most significant accomplishment of his chairmanship, but his unwillingness to expand the agency's focus to include the health of the capital markets, or to lead the SEC toward reduced regulatory costs and litigation risk for public companies, will be judged as his most significant failures.

Campos's resignation throws into question two of the most controversial issues now under consideration at the SEC. Both were initiated by former chairman William H. Donaldson and continued by Chairman Cox. It is unlikely that these initiatives will go anywhere without the vote of Campos, a Democratic appointee. Given the lengthy nomination and confirmation process of recent years, it is also unlikely that Campos will be replaced before mid-2008, too late for any new controversial actions. Accordingly, unless Chairman Cox begins to work with the Republican members of the Commission—something he has been largely unwilling to do since taking office—there may be no major initiatives from the SEC for the balance of the Bush administration.

Nevertheless, the Cox era at the SEC will have historic significance because of his efforts to improve disclosure to investors—principally by making the SEC's files machine-readable, but also by appointing an advisory committee to consider and recommend improvements in the full range of investor disclosure. The SEC is also on the verge of approving the use of International Financial Reporting Standards (IFRS)—an alternative to Generally Accepted Accounting Principles (GAAP)—for financial reporting by foreign companies in the United States. Both disclosure initiatives will almost certainly have the support of the Republican members of the Commission, so Cox may thus be able to complete his chairmanship by setting the SEC on a course that both improves disclosure to investors and integrates U.S. securities markets with the growing world capital markets.

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Donaldson Initiatives

The Donaldson SEC stirred controversy with three major initiatives: a proposal to allow shareholders to place their own director nominees on company proxy statements ("proxy access"); a regulation requiring mutual fund boards to have independent majorities of 75 percent and an independent chair (known as the independent chair rule); and a regulation (called Regulation NMS) that imposed a restrictive trading rule on the newly emerging electronic securities markets. All three were opposed by the two Republican commissioners, who issued strong dissents on each regulation. But when Cox assumed the chairmanship, he continued Donaldson's policies. He saw to it that Regulation NMS was fully implemented, even though the acquisition by the New York Stock Exchange of a major electronic trading venue—ArcaEX—seemed to eliminate the

original basis for the regulation. He has continued to pursue the independent chair rule, although Donaldson's effort was stayed by the courts in two groundbreaking decisions.[1] Finally, he recently renewed the effort to adopt a proxy access regulation, even though Donaldson had abandoned the idea in the face of strong business opposition.

As discussed below, the two Donaldson initiatives that have not yet been implemented—proxy access and the independent chair rule—are unlikely to be adopted without the vote of the Democratic commissioner who eventually replaces Campos. The same is true of two other potentially controversial Cox initiatives: modification of Rule 12b-1 under the Investment Company Act and increased regulation of municipal securities. Both these proposals are unlikely to draw the support of the Republican commissioners and thus unlikely to be adopted. Accordingly, it is possible at this point to assess Chairman Cox's legacy at the SEC as it will appear at the end of the Bush administration.

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Proxy Access. If Campos had remained at the Commission, Chairman Cox would have been able to secure the adoption, on a 3–2 vote, of a proxy access proposal that the Commission proposed on July 25, 2007. This proposal would permit shareholders to adopt a corporate bylaw requiring a public company to place in the company's own proxy statement the names of one or more shareholder nominees who are challenging the company's slate. The proposal, for reasons outlined in last month's *Financial Services Outlook*, is badly flawed.[2]

Campos left the Commission even before the close of the comment period on the proxy access proposal, and, assuming that Chairman Cox continues to support it, the SEC will remain deadlocked 2–2. Although the regulation would fail in that case, if the SEC staff continues to deny no-action letter requests, the next proxy season is likely to see AFSCME-like proposals in every proxy statement for companies in which labor union pension funds have significant investments. Proxy access—enabling union pension funds and others to put a representative on the boards of public corporations in which they invest—has been a long-term goal of labor groups.

The absence of a clear SEC policy on these requests could create chaos. The SEC's proxy access proposal requires that certain disclosures concerning the sponsors of the bylaw proposal—and ultimately the nominees of those challenging the company's slate—be included in the company's proxy statement. Without the SEC's proposed rule, however, there would be no specific disclosure requirements. Companies would be required to make up their own, subject to legal challenge if they included or omitted information about challengers or their nominees. Moreover, after proposing such requirements through notice-and-comment rulemaking, it would be difficult for the SEC to justify imposing those same requirements ad hoc when proxy statements containing competing candidates for the same board are filed by companies. Thus, without a rule or a policy in place before the coming proxy season, the rules for contested elections could become an administrative nightmare and a costly source of disputes for public companies.

This leaves Chairman Cox with a choice. He can join the two Republican members—who want the Commission to return to and explain the basis for its former policy as required by the court[3]—or he can try to find a middle ground of some kind. It would be irresponsible to leave companies without guidance in the next proxy season, and he is unlikely to do so. If he finds a middle ground, he will have to act quickly because a new rule must be put in place through notice-and-comment rulemaking before the next proxy season begins in January 2008. Whatever he chooses, however, the current proposal is probably dead on arrival.

The Independent Chair Rule. This proposal also seems doomed. Its history is recounted in two previous *Financial Services Outlooks*.[4] The SEC's first regulation, adopted under Chairman Donaldson over the dissents of the two Republican commissioners, was struck down by the D.C. Circuit Court of Appeals[5] because the SEC failed adequately to consider "efficiency, competition, and capital formation" as required by the National Securities Market Improvement Act of 1996 (NSMIA). Nearly identical language had been added to the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940—the three principal statutes administered by the SEC—but the SEC had never taken the requirements seriously. Compliance with NSMIA's mandate had always been treated pro forma, discussed in a few paragraphs at the end of a proposed rule.

Yet what Congress wanted—to change the SEC's focus from solely the protection of investors to a more broad-based and balanced consideration of the effect of the SEC's regulations on the health of the capital markets—could not have been clearer. The statutory language was crisp and direct: "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."[6] The D.C. Circuit's decision was the first time any court had been asked to construe the NSMIA language, and two panels concluded unanimously that the SEC had failed to comply with it.

By the time Chairman Cox took office, the SEC had twice ignored the NSMIA language and twice been rebuked by the D.C. Circuit for doing so. The independent chair rule had been stayed. At this point, Cox could have left things as he found them—with no independent chair requirement for mutual funds—and moved on to other issues. He also had the opportunity to refocus the SEC on the broader mandate implied by NSMIA. He did neither. In June 2006, the SEC signaled its intention to adopt the independent chair rule yet a third time. In this case, the Commission asked for more public comment, especially comment on the costs of the regulation. The SEC's request suggests that the court's problem was that the agency had not solicited enough information about costs when it adopted the rule. This is not true. In both cases, the court made clear that the SEC was required to show that it had considered the impact of its rule on "efficiency, competition and capital formation." None of the questions in the SEC's June 2006 request for comment—specifying the nature of the information that the SEC wanted from the public—focused on the effect of the regulation on "efficiency, competition or capital formation." Indeed, the SEC seemed to be avoiding the NSMIA requirements as though they would just go away. And indeed they will, unless lawyers objecting to SEC demands under any of its major statutes keep in mind that the agency's role, by law, is no longer simply investor protection.

When the SEC issued its request for additional comment on the independent chair rule, however, it also issued a separate statement acknowledging the court's focus on the NSMIA language and noting: "Chairman Cox has asked the Commission's General Counsel to conduct a top-to-bottom review of the Commission's process for complying with the National Securities Markets Improvement Act of 1996 and other laws that require economic analysis of rule proposals." If this study has been completed, it has not been publicly reported or released, but it is important to note how the SEC's statement defines down the significance of the NSMIA language. Although the statute says the Commission must consider, "*in addition to the protection of investors*, whether the action will promote efficiency, competition and capital formation" (emphasis added), the agency is treating the language not as a broadening of its responsibilities as a regulator but as a requirement for more economic analysis of the effect of its regulations. Of course, if the SEC's sole role is only investor protection, the only legitimate question for an economic analysis of a regulation would be its direct and indirect effects on investors. Clearly, that is not what Congress or the D.C. Circuit wanted, and if the SEC goes through with its intention to reissue the independent chair rule, it will probably be slapped down yet again by the same court.

But without Campos's vote, it is unlikely that the independent chair rule will advance during the remainder of Cox's chairmanship. Although the newest Republican commissioner, Kathleen Casey, has never voted on the rule, her record thus far indicates that she would not be sympathetic to it. Paul S. Atkins, the other Republican commissioner, has already voted twice against the rule and would likely do so again. In this case, the SEC would again be deadlocked and the rule not adopted.

Cox's Own Initiatives

Apart from pursuing some of Donaldson's controversial policies, Chairman Cox has made his mark in two less controversial areas. The most important of these has been his sustained focus on improving the financial information available to investors through the use of eXtensible Business Reporting Language (XBRL), which Cox calls "interactive data," and moving to integrate the U.S. securities markets with those around the world by permitting the use of IFRS for financial reporting in the United States. These two initiatives are historic in their significance, and if—as appears likely—there are no other significant actions during the Cox chairmanship, they will be by far the most important actions of his chairmanship.

XBRL and Interactive Data. Today there is a vast amount of financial information about companies available on the SEC's website. The problem is its usefulness and accessibility. If an analyst or an investor would like to know the earnings before taxes of, say, major pharmaceutical companies

that have shares listed in the United States, he would have to download the financial statements of each company, search for the appropriate number in their earnings statements, and make the adjustments necessary to assure the numbers are comparable. This is enormously time-consuming for a professional and beyond the capacity of the amateur investor. But XBRL—which Cox calls by the less wonky term "interactive data"—makes financial statements and other reports machine-readable, so that in seconds a computer application can access the SEC files, select the income-before-taxes data for each company, and display it in a spreadsheet. The same would be true if an analyst or an investor has a model that projects a company's success through the use of a ratio between its sales numbers and its investment in research and development. Again, if the financial statements of the company have been filed in XBRL format, a computer application could, in seconds, access the SEC's files, select the correct numbers for all similar companies, compute the ratio, and display the results. Chairman Cox's insight was that a disclosure system that permitted this would be a vast improvement for investors—whether institutions or individuals—and since becoming chairman, he has been pressing for the adoption of XBRL by public companies.

In the absence of Cox's leadership on Sarbanes-Oxley, efforts in Congress to modify the act got no traction.

The United States is in fact well behind the rest of the world in implementing XBRL. Many of the developed countries that use IFRS have already completed the necessary definitional work (known as a taxonomy) so that financial statements prepared under IFRS will be machine-readable. In the competition for capital in the global capital markets, this will give companies that prepare their financial statements in IFRS an advantage over U.S. companies that file using GAAP. It will be far cheaper for analysts to assess the financial condition of companies that have filed in XBRL format, and this difference will be reflected in a higher cost of capital for GAAP filers. An XBRL taxonomy for GAAP had not been completed when Cox became chairman, and he has provided the funds necessary to bring the project to completion. Under the voluntary filing program Cox has established for GAAP filers, only somewhat more than thirty companies have filed. This is a painfully small number, but when the GAAP taxonomy is completed (as anticipated) in January 2008, the SEC will have the option of making filing in XBRL format mandatory over time.

The usefulness of XBRL is not limited to the numbers in a financial statement. A complete taxonomy would cover footnotes and the portion of a 10-K report known as management's discussion and analysis (MD&A). In other words, items that are not included in income statements or balance sheets, such as the proven or probable reserves of oil companies, could be compared by an investor or analyst in the same way that income before taxes could be compared—if the data in the MD&A are filed in XBRL format. Nevertheless, filing financial reports in XBRL will not address a bigger problem with the U.S. disclosure system—the fact that GAAP itself is of limited and declining use in assessing the true value of companies, especially the overwhelming majority of U.S. companies that now create value through the use of intangible assets.[7] On the horizon, therefore, are non-financial indicators of various kinds that would tell investors whether a company is adding value over the long term. These "key performance indicators" (KPIs), if established for all major industries, would allow investors to compare the prospects for long-term growth among all the companies in a given industry. The marriage of KPIs and XBRL will make these data instantly accessible to investors and analysts once the necessary KPIs are developed.

Chairman Cox has also been concerned that GAAP financial statements and the accounting standards on which they are based have become so complex that few professionals can understand them. Nonprofessional investors are completely lost. To address this issue, he recently appointed an Advisory Committee on Improvements to Financial Reporting to review the financial reporting process and recommend changes. This is not an area of the SEC's jurisdiction in which controversy is likely, and whether a replacement for Campos is appointed or not should not affect the implementation of the committee's conclusions. If so, Chairman Cox will have done a great deal to improve financial and nonfinancial disclosure for investors.

Financial Reporting in IFRS. On July 2, 2007, the SEC proposed a rule on the use of IFRS for financial reporting in the United States without reconciliation to GAAP.[8] Until this proposal, the SEC had required all companies with shares listed in the United States either to issue financial reports using GAAP or to reconcile their financial statements to GAAP. Reconciliation is an expensive process, and it has kept some foreign companies out of U.S. markets, limiting investment opportunities for U.S. investors. The first attempt to address this issue was to try to develop a single, internationally used system of financial reporting, a process known as convergence. But as this

process went forward—involving the U.S. standard setter, the Financial Accounting Standards Board, and the International Accounting Standards Board (IASB)—it became clear that convergence would be difficult and a long time in coming. In addition, a roundtable sponsored by the SEC showed a great deal of support for allowing IFRS—even before convergence with GAAP—to be used for financial reporting by companies that have securities listed in the United States. Accordingly, the most important sentence in the SEC's release was this: "We do not believe that a particular degree of convergence should be a prerequisite for our acceptance of financial statements prepared under IFRS as published by the IASB without reconciliation."[9]

If the proposal is ultimately adopted, it will be a landmark event for the SEC, since it admits for the first time that foreign financial statements and reports can adequately meet the SEC's standards for the protection of U.S. investors. The proposal is also the first and most important step toward integrating the U.S. securities market with the rapidly developing global market. This initiative was not without its political dangers, since Congress tends to have a naïve view of the quality of GAAP in itself and in relation to other financial reporting systems, so Chairman Cox deserves credit for sponsoring the idea that IFRS should be accepted in the United States. It also suggests that if he had taken more risks in other areas, as outlined below, he might have overseen a truly significant period of growth and reform for the SEC.

Missed Opportunities

The Cox legacy—not an inconsiderable one—is likely to revolve around improved disclosure for investors, but one wonders what his legacy might have been had he worked with the Republican members of the SEC instead of adopting Donaldson's initiatives and ignoring calls for deregulation or relief from regulatory costs. The implementation of Regulation NMS was one example of imposing unnecessary costs. Shortly after the regulation was adopted, the combination of the NYSE and ArcaEX profoundly changed the structure of the industry. But Chairman Cox gave no indication that he was willing to reconsider whether there was still any remaining rationale for the regulation. The result was the imposition of substantial compliance costs on the securities industry, which has inevitably had a chilling effect on the growth of U.S. securities markets relative to those in the rest of the world.

In 2006 and early 2007, three key reports suggested that excessive regulation and litigation risk in the United States were reducing the attractiveness of U.S. public securities markets for foreign issuers.[10] There is indeed considerable evidence that foreign companies were willing to access our capital markets to raise needed funds, but preferred to do it through private transactions that would not subject them to the regulatory costs and litigation risks associated with a listing of their securities in the United States. There is also evidence that smaller companies were privatizing at a higher rate than normal, and that the process by which venture capital firms were financing new tech companies and taking them public was being impeded by excessive regulatory costs.[11] If Chairman Cox had moved the SEC to address regulatory costs and litigation risk, he would likely have had the support of the Republican commissioners and might have averted or limited many of these problems. There are two areas where his intervention might have been particularly helpful: the Sarbanes-Oxley Act (SOX) and the SEC's own enforcement activities.

SOX is one of the principal sources of regulatory costs especially resented and feared by foreign companies. Although he was not chairman when the SEC adopted its original SOX regulations and approved the implementing regulations of the Public Company Accounting Oversight Board (PCAOB), Cox did little for a year to address the costs of these regulations, which were far higher than what the SEC anticipated when the regulations were adopted and fell most heavily on smaller companies. Throughout the controversy over these costs, Chairman Cox refused to acknowledge that SOX was more costly to public companies than anyone in Congress or on the SEC had anticipated and should be cut back by Congress. In the absence of his leadership on this issue, efforts in Congress to modify the act got no traction.

The most significant cost was imposed by the notorious Section 404 of the act, which required that management create internal controls and certify their adequacy, and that auditors certify the accuracy of management's view. When the SEC and the PCAOB finally addressed the issue in 2007, they adopted amended rules that directed companies and auditors to focus only on matters that could entail material risk. Given that private class actions create substantial "hindsight risk" for auditors and companies, it is unlikely that this fix will be effective in substantially reducing the costs of Section 404; there are still strong incentives to impose the most detailed internal controls possible. Despite requests from some members of Congress and the findings of an SEC advisory committee about the costs of SOX compliance for small companies, the Commission has not recommended to Congress any reforms of SOX that would

alleviate the act's burden on small companies. Instead, the agency has simply deferred the application of Section 404 to these companies, but kicking the can down the road just leaves the problem for someone else.

SEC enforcement policy itself was frequently criticized in the reports about the decline of the U.S securities markets. The SEC was seen as excessively adversarial and arbitrary in its enforcement actions—more interested in scoring publicity points than protecting investors. Foreign companies are concerned about subjecting themselves to the risk of SEC enforcement as well as uncontrolled private class actions that flow from and free ride on SEC enforcement actions. During the Cox chairmanship, the aggressive approach of the SEC's enforcement division remained largely unchanged—although there was an effort to avoid penalizing innocent shareholders of companies charged with wrongdoing—and no effort was made by the SEC to persuade Congress to control private securities class actions. Indeed, when the Department of Justice (DOJ) asked the SEC what position DOJ should take before the Supreme Court in *Stoneridge v. Scientific-Atlanta*—a case which, if decided in favor of the plaintiffs, would substantially expand the scope of securities class actions—the SEC recommended that DOJ back the plaintiffs. Fortunately, DOJ eventually weighed in on the defendants' side. Had Cox led the SEC to cut back on regulatory costs, and had he brought the SEC's enforcement division under stricter control, he might have averted some of the continuing losses to the U.S. securities markets, the increasing number of privatizations that have occurred, and the slowdown in venture capital activity.

Perhaps Cox's most significant missed opportunity, however, was his failure to recognize the significance of—and act upon—the D.C. Circuit's decisions in the two independent chair cases.[12] Two panels of that court, in two separate cases, endorsed the idea that the NSMIA language concerning "efficiency, competition, and capital formation" was more than a requirement that the SEC engage in better economic or cost analysis. Instead, the court made clear that the statute was intended to broaden the agency's focus, adding attention to matters of market structure and promotion of capital formation to its traditional concern for investor protection. Recognizing the significance of this change would have enabled the Cox SEC to refashion itself into the world's leading agency for protecting and promoting healthy capital markets. Instead, the SEC remains today—and is likely to continue through the end of the Bush administration—an agency with solely a consumer protection focus.

Perhaps the next chairman—Democrat or Republican—will seize the opportunity presented by NSMIA and the D.C. Circuit Court of Appeals to enhance the SEC's role.

AEI research assistant Karen Dubas and editorial assistant Evan Sparks worked with Mr. Wallison to edit and produce this Financial Services Outlook.

Notes

1. *Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133 (D.C. Cir. 2005); and *Chamber of Commerce v. Securities and Exchange Commission*, 443 F.3d 890, (D.C. Cir. 2006).

2. Peter J. Wallison, "It's Not the Principle; It's the Money: The SEC and Proxy Access," *Financial Services Outlook* (August 2007), available at www.aei.org/publication26611/.

3. Ibid.

4. Peter J. Wallison, "Buried Treasure: A Court Rediscovers a Congressional Mandate the SEC Has Ignored," *Financial Services Outlook* (October 2005), available at www.aei.org/publication23310/; and Peter J. Wallison, "Landmark Ruling: Could the Court's Decision in *Chamber v. SEC* Be a Turning Point in Securities Regulation?" *Financial Services Outlook* (May 2006), available at www.aei.org/publication24303/.

5. 412 F.3d 133; and 443 F.3d 890.

6. *U.S. Code* 15, § 80a-2(c). Emphasis added.

7. Robert E. Litan and Peter J. Wallison, *The GAAP Gap: Corporate Disclosure in the Internet Age* (Washington, DC: AEI-Brookings Joint Center for Regulatory Studies, 2000), available at www.aei.org/book98/.

8. Securities and Exchange Commission, *Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP*, release no. 33-8818, file no. S7-13-07 (July 2, 2007).

9. Ibid., 26.

10. U.S. Chamber of Commerce, Committee on the Regulation of the U.S. Capital Markets in the 21st Century, *Report and Recommendations*, March 2007, available at www.uschamber.com/publications/reports/0703capmarketscomm.htm (accessed April 2, 2007); Committee on Capital Markets Regulation, *Interim Report*, November 30, 2006, available at www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (accessed March 5, 2007); and Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Services Leadership*, January 22, 2007, available at www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (accessed March 5, 2007).

11. Robert E. Grady, "The Sarbox Monster," *Wall Street Journal*, April 26, 2007.

12. 412 F.3d 133; and 443 F.3d 890.