Volume 18 | Issue 1 Article 13

2013

Headwinds Confronting the SEC

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HEADWINDS CONFRONTING THE SEC

BY JAMES D. COX*

James D. Cox discusses his concerns for the future of the SEC in the wake of the financial crisis. He fears decreased resource allocation from the government to the SEC in the future, the development of a political climate that is averse to SEC regulation, and increased second-guessing by the judiciary of SEC regulation. He also notes how recent congressional deregulation has changed the landscape of SEC regulatory activities, and discusses the current state of SEC enforcement authority.

I will address a series of exogenous events that I fear will adversely affect the SEC. My fears are on several levels. Least important is the fear that without an SEC there likely would be little demand for our securities regulation casebook, so crass personal interest has only a minor role to play here. A larger and likely more legitimate concern is that the events I describe will cause the SEC to be much less vibrant, indeed even fundamentally marginalized.

There is no doubt in my mind that the SEC's importance has been diminished already by the financial crisis. Thus, I worry about the following series of exogenous events taking it over the cliff. Some of the forces that could overtake the SEC are beyond its control. Foremost is the nature of the risks that threaten our financial system. When the next financial blow-up happens it is not going to be because of something that fits within the realm of securities regulation. If you are a congressman, a policy maker, or president of the United States and you reflect on what threatens the U.S. and global financial systems, what you fear likely are not activities or phenomena neatly within the SEC's regulatory turf. It is something that falls within the jurisdiction of some other regulatory agency, most likely in the banking area. If this is correct, then we would expect greater resources to be allocated to those regulators than to the SEC. Thus, how the threat to the financial system is perceived implicates potential marginalization of the SEC.

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As we move into a new realm in which markets fold together and financial products do not fit into one agency's bailiwick or another, it is probably a good time to stand back—as occurred in the early 1960s when the SEC was also facing marginalization—and take a look at what really is happening in markets and look at the unique skill package that the SEC possesses or could develop that would address some of these concerns. The 1963 SEC Special Study[1] was based on a small appropriation ($5.3 million in 2013 dollars) by Congress that not only enabled the Commission to resuscitate itself, but also set the important agenda items for the next two decades. I think if we did that right now we would find that the SEC has certain core strengths and there are probably some areas where it probably does not have the strengths it needs to address the future challenges. For example, the SEC probably—and rightly so—does not have a good understanding regarding the appropriate capital requirements for broker-dealer firms, certainly ones that are a part of a global financial enterprise—the Federal Reserve or FDIC likely have a better command of this subject. To the extent this is correct, the SEC's optimal course may well be to partner with agencies that would be more experienced. In any case, a special study could examine such a regulatory design question as did the 1963 SEC Special Study.

This dovetails with another exogenous event—the *Business Roundtable* decision.[2] The *Business Roundtable* decision represents an issue that is larger than the case itself. Today's climate is hostile to regulation and *Business Roundtable* can be seen as a manifestation of that sentiment. A recently published article documents that the holding in *Business Roundtable* violated congressional intent as well as Supreme Court precedents regarding review of agency rulemaking.[3] The decision had nothing to do with the laws the SEC was interpreting. Instead it is a political decision reflecting what is going on in the nation as a whole.

There are some areas that are certainly more political than

1. *See generally* SEC. AND EXCH. COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess. (1963), *available at* http://www.sechistorical.org/museum/galleries/tbi/special_c.php (divided by chapter).

2. Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

3. *See* James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 Tex. L. Rev. 1811 (2012).

others and therefore more likely to attract the interest of those who want to slow down regulations that are outside the core competencies of the SEC. For example, what are we going to do about money market funds? What is the issue with money market funds? I do not think it is the one we are focusing on. I think the real issue is, do we want to have a regulated environment for money to be pooled to provide short-term funds for corporations that need overnight money? That is the regulatory issue and I do not think the SEC has any particularly unique insights about this question. So maybe this is an area where the Commission should cede the turf to the Federal Reserve Board ("Fed"), or if you want to have a regulator that is closer to business interests, the Office of the Comptroller of the Currency ("OCC"). The added benefit of ceding that territory to a different regulator is that you essentially make the *Business Roundtable* type decision go away because neither one of those agencies is subject to a requirement of cost-benefit analysis. Certainly those agencies are subject to due process concerns, which are mainly takings issues, but they would not get laughed out of court if they issued a regulation without performing a formal cost-benefit analysis. The Fed and the OCC are also not subject to Office of Information and Regulatory Affairs reviews.[4] But recall, when the SEC brings enforcement actions, it does not have to do cost-benefit analysis.

If the SEC sticks to its knitting and gets down to its core business, we move forward by focusing on the concerns that deserve regulation. I do not think we are concerned about credit default swaps primarily because widows and orphans are going to get defrauded in those deals. I think we are concerned about credit default swaps mainly because of what they might do to the national economy. If that is the case, regulation of credit default swaps ought to be performed by an agency that is more concerned with macroeconomic issues. This is especially true for issues surrounding money market funds.

The third exogenous event is the missteps in actions the SEC has taken on matters that are more clearly within its realm. In the

4. The OIRA may only review the regulations of entities which meet the definition of "agency" provided in Executive Order No. 12866. *See* Exec. Order No. 12,886 § 3(b), 3 C.F.R. 638, 641 (1993) (indicating that an "independent regulatory agency" is excluded from the definition of "agency"). Dodd-Frank amended the definition of "independent regulatory agency" in 44 U.S.C. § 3502(5) to include the OCC. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203 § 305, 124 Stat. 1376, 1524 (2010). The Federal Reserve is among the agencies defined as an "independent regulatory agency" in 44 U.S.C. § 3502(5).

decisions the SEC has lost before the D.C. Circuit, the court has gone out of its way to say if the SEC had just limited itself to disclosure then it would have been a lot better.[5] So instead of saying that a mutual fund, to be able to take advantage of some of the safe harbors, has to require at least three-fourths of its directors to be independent—which is a laughable proposition in the mutual fund industry by the way—that maybe what you should have done is require disclosure of the connections the directors have through the fund's sponsor. For example, listing the number of fund boards the individual director serves on within the same family of funds and the collective fees garnered by that director through such service.[6] This would have been at least as effective as the three-fourths independent directors' rule.

So one idea emerging from the D.C. Circuit's decisions is that the SEC should stick to its knitting. A further suggestion is that in adopting rules the SEC should stage their introduction and scale their requirements. The former allows information to be gathered to better assess whether the rule as initially adopted should be more broadly applied and the latter, would seek to reduce compliance costs for smaller entities. For example, when the SEC launched the repeal of its off-board trading bar,[7] and also when it considered eliminating the uptick rule for short selling,[8] it did so on a limited basis that permitted evidence of costs and benefits to be gathered. Not only did this make many an investigator delighted with the natural experiment but it also better informed the course of future regulatory action in these areas.

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5. *See generally* Chamber of Commerce v. Sec. and Exch. Comm'n (Chamber II), 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce v. Sec. and Exch. Comm'n (Chamber I), 412 F.3d 133 (D.C. Cir. 2005).

6. *See* Chamber of Commerce v. Sec. and Exch. Comm'n (Chamber I), 412 F.3d 133 (D.C. Cir. 2005).

7. Off-Board Trading Restrictions, Exchange Act Release No. 34-16888, 45 Fed. Reg. 41134 (June 18, 1980) (making it permissible for stocks which were previously confined to trading only on the New York Stock Exchange to be traded on other exchanges).

8. Former Exchange Act Rule 10a-1, the so-called "uptick rule," placed restrictions on short sales of stocks. *See* Rules for the Regulation of Short-Selling, Exchange Act Release No. 1548, 3 Fed. Reg. 213 (Jan. 26, 1938). The uptick rule was briefly waived for some stocks during a 2004 pilot program implemented by the SEC. *See* Rule 202T of Regulation SHO, Exchange Act Release No. 55245, 72 Fed. Reg. 6635 (Feb. 12, 2007). The uptick rule was removed completely in 2007 under the SEC's Rule 201 of Regulation SHO. *See* Regulation SHO and Rule 10a-1, Exchange Act Release No. 55970, 72 Fed. Reg. 36348 (July 3, 2007). In 2010, the SEC adopted a modified form of the uptick rule known as the "alternative uptick rule," which only applies to certain stocks. *See* Amendments to Regulation SHO, Exchange Act Release No. 34-61595, 75 Fed. Reg. 11232 (May 10, 2010).

These practices will place the SEC in a much better position before the D.C. Circuit or any other court that might consider a legal challenge to its regulations.

Another exogenous event is deregulation in the form of Dodd-Frank,[9] at least as to the securities laws, and most particularly the JOBS Act.[10] The combination of those two laws took away one of the most important innovations that has happened in financial market regulation from the very firms that needed it the most, the independent external assessment of internal controls in publicly traded firms. Dodd-Frank made permanent the SEC's timidity in not doing anything with respect to applying Sarbanes Oxley's Section 404(b)'s auditor's assessment of internal controls to non-accelerated filers (SEC registrants with a market cap under $75 million).[11] The JOBS Act confounded the problem by increasing the number of record holders required to make a non-reporting company become a reporting company from 500 up to 2000 record holders.[12] As a consequence, everything in Sarbanes-Oxley, from blackout periods to loans to officers, is keyed off the concept of an issuer; and because an issuer is defined as a public reporting company, the Sarbanes-Oxley requirements have been lifted for approximately eighty-three percent of the former number of reporting companies. So that is an exogenous event in which suddenly a vast number of companies are outside the requirements for reporting companies. This probably now approaches about eight or nine thousand publicly traded firms that are also going to be outside the realm of private litigation because their securities may well not be deemed to trade in a market that is deemed efficient. Therefore, the fraud on the market doctrine will no longer apply to them.

Many of these companies, that are not technically reporting companies, will choose nonetheless to go ahead and file an annual report with the SEC in order to continue trading on the over-the-counter bulletin board. Otherwise, they are just in a "Pink Sheet Market." The spreads in the Pink Sheet Market and the cost of capital are not

9. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

10. Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of the U.S. Code).

11. Dodd-Frank Act, 15 U.S.C. § 7262 (2012).

12. JOBS Act, 15 U.S.C. § 78l(g)(1)(A) (2012).

favorable so we might well expect many voluntary filers. What can the SEC do about the disappearance of the SOX 404(b) internal control requirements for so many companies? To be sure, the SEC cannot be so brazen as to implicitly reverse what Congress did in Dodd-Frank or the JOBS Act. As a former accountant, I can tell you that the *sine qua non* of doing an audit is to make some evaluation and some assessment of internal controls. You could have the SEC require some enhanced disclosure, likely collateral to the formal audit opinion letter, regarding the steps an auditor has taken to assure itself that the firm's records are sufficiently trustworthy in light of existing internal controls and other factors to permit the auditor's reliance on the firm's record keeping system. This would not be the same form of attestation as 404(b), but it would be better than nothing.

The final exogenous event that I will talk about is enforcement. There has been a lot of press about the SEC having nominated former prosecutor Mary Jo White as chairman, and whether this is going to change things or not change things.[13] I do not see any change in the SEC's willingness to start prosecuting individuals rather than entities. The problem with prosecuting entities and only entities is that the resulting sanction—a fine—is too easily internalized and simply becomes another cost of doing business. This means that through its enforcement efforts the SEC could be seen as merely operating a turnstile through which businesses may engage in lawless activities so long as they can pass the enforcement-related costs of those activities through their operations. To be sure, executives likely do not consciously contemplate how they are going to violate the law for maximum gain. But the ability to internalize the burdens of a legal violation into a firm's pricing structure may well impact the overall approach to compliance and funding for compliance efforts. Simply put, if violations can be priced we can expect this will seriously weaken compliance efforts.

If the SEC wants to start changing its culture and to begin taking meaningful enforcement actions against individuals then it has to assume the political risk. The SEC will need to focus its resources on

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13. Mary Jo White became the Chairman of the SEC on April 10, 2013. She was formerly the United States Attorney for the Southern District of New York from 1993 to 2002. Roger Runningen & Joshua Gallu, *Obama Names Former Prosecutor Mary Jo White as SEC Chairman*, BLOOMBERG, Jan. 24, 2013, http://www.bloomberg.com/news/2013-01-24/obama-set-to-name-white-to-sec-cordray-to-lead-consumer-bureau.html.

fewer cases. The SEC is likely to lose a lot more cases than they lose right now. And, the SEC will collect a lot less money. Indeed, Robert Khuzami, the outgoing enforcement chief, has justified the SEC's current enforcement practices by stating that the SEC brings a lot of cases and they've been going up. He argues that if the SEC brought fewer cases, it would collect less money for injured investors.[14] The SEC has a pretty good win-loss record, he would say. So, he says that unless you want to flip that around and bring fewer cases, recover less money, and lose some cases along the way, he doesn't think the SEC should want to change these results. This issue is a tough political issue for the new SEC Chairwoman. Note, the difficulty of changing course is that the perceived benefit—enhanced deterrence against executives and other key employees—is not nearly as tangible and hence observable as wins and losses or penalties recovered. In a society that assesses quantitatively the benefits of everything, this is a politically hazardous course. At the same time, there is a case to be made that it is corrosive to the SEC to perpetuate the status quo in which the individuals most responsible for legal violations are not held personally accountable for their actions. Eventually, this perception also taints the entire agency with the threat of leading to further marginalization.

There are multiple challenges that confront the SEC. But the largest of the challenges awaiting it are to define its mission, so that it is central to those challenges and not pushed to the margins by the exogenous events set forth here. Rather than counseling brave new initiatives, the discussion here suggests some stepping back and some following a new path. Most certainly continuing the past trajectory will only lead to continued decline and deprive America of a potentially effective and devoted agency.

The final point is that if you care about the SEC—and I think most of us in the room do care about having our markets be regulated and fair—and you want to have a good cop on the block, then you must try to stop the corrosion that is in the public eye right now, namely, that the big guys, the responsible people, never are held accountable. The worst outcome would be a continued public perception that paying corporate fines to the SEC for law breaking is just one more cost of

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14. *See* Robert S. Khuzami, Dir., Div. of Enforcement, Sec. and Exch. Comm'n, Testimony on "Examining the Settlement Practices of U.S. Financial Regulators" (May 17, 2012), http://www.sec.gov/news/testimony/2012/ts051712rk.htm.

doing business. Eventually, that is going to taint the whole agency and we will have further marginalization and the agency will not be able to redeem itself. The SEC needs to change.