REINVENTING THE SEC BY STARING INTO ITS PAST

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I. INTRODUCTION

As the Securities and Exchange Commission (SEC) turns seventy-five, it finds itself under the heaviest criticism of its history. The current credit crisis has prompted cries and proposals for wholesale review of the United States' financial regulatory quilt,[1] which renders the SEC particularly vulnerable. Will the SEC survive, and if so, will it have a more circumscribed role regulating U.S. capital markets than it has held in the past? Its vulnerability in the face of these questions is not because of the agency's actions, but rather its glaring inactions.

The financial frauds revealed in 2001 and 2002—the prior financial maelstrom—were not blamed on the SEC, but on gaps in the financial reporting process. Congress moved quickly to strengthen both the financial reporting process and the SEC's ability to monitor the truthfulness of financial reports. The Sarbanes-Oxley Act of 2002 (SOX)[2] was key to this effort. It strengthened the self-regulatory organizations that not only established the metrics of accounting standards[3] but also oversaw the auditing profession.[4] Numerous other provisions in SOX required the SEC to expand the scope of financial

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1. *See* U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (setting forth a wide range of proposals for augmenting and, to some extent, consolidating regulatory authority for various government agencies). Proposals of the preceding Administration are set forth in U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), http://www.treas.gov/press/releases/reports/Blueprint.pdf.

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat.745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

3. *See id.* § 108 (codified as amended at 15 U.S.C. § 77s (2006)) (amending Section 19 of the Securities Act of 1933, ch. 38, 48 Stat. 74, and requiring that authoritative accounting standards acceptable in SEC filings must, among other factors, be via a private entity funded through fees collected by the SEC from accountants and registrants).

4. *See id.* §§ 101–107 (codified as amended at 15 U.S.C. §§ 7211–17) (establishing the Public Company Accounting Oversight Board, a self-regulatory organization funded by fees collected by the SEC from accountants and registrants, charged with the responsibility of establishing and enforcing auditing standards for SEC registrants, and operating under the oversight of the SEC).

reporting[5] as well as improve the timeliness of public disclosures.[6] And, a cornerstone of SOX was the long-overdue deferred maintenance of internal controls for reporting companies, which now is addressed through the annual certifications by companies' senior officers[7] and accompanying attestation of their assessment by the outside auditors.[8]

New laws were not the only answer. Congress also invested in the SEC, nearly doubling its budget over two years. This gave the SEC the capacity to review public companies' filings more frequently, and increased the chances of avoiding the next Enron. Moreover, Congress dealt with the diaspora of senior SEC personnel[9] into the private sector by approving several hundred positions for above-grade compensation so the agency could retain its most senior and talented employees with compensation that rivaled the generous compensation long paid by the Federal Reserve Bank.[10]

The current crisis is not the product of financial reporting abuses. Much of the crisis is in sectors of the financial community well beyond the SEC's reach. The problems flow from the portfolios of insurance companies, commercial banks, and hedge funds—each of which are, at best, tangentially within the purview of the SEC's regulation. To be sure, these portfolios were infected with toxic securities, but this largely occurred in transactions that were exempted from securities laws when the portfolios were registered with the SEC. Indeed, the problem that continues to grip financial institutions is not the historical concern of disclosure, but their avaricious pursuit of gain through excessive

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5. *See, e.g.*, *id.* § 401(a) (codified as amended at 15 U.S.C. § 78m) (amending Section 13(j) of the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, and calling upon the SEC to require greater disclosure of material off-balance sheet transactions); *id.* § 401(b) (codified as amended at 15 U.S.C. § 7261(b)) (calling for the SEC to develop collateral disclosure requirements for "pro forma" financial information appearing in reports filed with the SEC).

6. *See, e.g.*, *id.* § 403(a) (codified as amended at 15 U.S.C. § 78p) (amending Section 16(a) of the Securities Exchange Act, accelerating the disclosures for trading by officers, directors, and certain beneficial owners of reporting companies); *id.* § 409 (codified as amended at 15 U.S.C. § 78m) (amending Section 13(l), enabling the SEC to compel disclosures of material items in plain English on a rapid and current basis); *see also* SEC Form 8-K, http://www.sec.gov/about/forms/form8-k.pdf (calling for prompt disclosure of entering into or terminating a "material definitive agreement," and disclosure related to the creation or acceleration of a material financial obligation).

7. *See* Sarbanes-Oxley Act of 2002 § 302 (codified as amended at 15 U.S.C. § 7241); Regulation S-K, 17 C.F.R. §§ 229.307–308 (2009) (requiring such disclosures in annual reports in SEC Form 10-K, Item 9A for large accelerated filers).

8. See Sarbanes-Oxley Act of 2002 § 404 (codified as amended at 15 U.S.C. § 7262).

9. *See generally* James D. Cox, Randal S. Thomas & Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L. J. 737, 751–53 (2002) (reviewing the resource constraints the SEC has faced while confronting a rapidly growing workload).

10. *See* Investor and Capital Markets Fee Relief Act, Pub. L. No. 107-123, § 8, 115 Stat. 2390 (2002) (codified as amended at 15 U.S.C. § 78d).

leverage. And it is on this point that the SEC is vulnerable—not because of errors of commission, but omission. The SEC did nothing to address excessive leveraging, except defer to the self-preservation instincts of financial holding companies not to excessively leverage.[11] Because its trust was misplaced, the SEC now stands before the audience of public opinion as an emperor without clothes.

This Article suggests the SEC's disrobing is from its failure to understand the true strengths and successes that have distinguished it through its seventy-five year history. As it survives its latest crisis and moves into the new era, it can draw guidance and strength from past successful strategies, reviewed below.

II. FRAMEWORK FOR SURVIVAL

It is worth asking how the SEC has survived while many other independent regulatory agencies have perished.[12] A key feature of the SEC, and its sister regulatory agencies, is the broad rulemaking authority Congress enshrined in its legislative mandate. Congress correctly anticipated that as times changed, so could the medium and content of financial disclosures. In 1996 Congress enhanced the SEC's broad rulemaking power when it conferred broad authority to the SEC to provide exemptions in each major act it administers.[13]

But broad, enabling powers are not the sole source of the SEC's longevity. An independent regulatory agency's durability is also largely determined by politics. The SEC has benefited terrifically from its structure, which balances politics by requiring that no more than three of its sitting commissioners be members of the same political party.[14] Even more important, historically the SEC's mission has been to protect investors and strengthen capital markets; this mission is not as politically loaded as those of rival administrative agencies.[15]

Emerging public issues threaten the SEC's politically neutral mission

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11. *See* Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. TIMES, Oct. 3, 2008, at A1, *available at* http://www.nytimes.com/2008/10/03/business/03sec.html.

12. *See* David E. Lewis, *The Politics of Agency Termination: Confronting the Myth of Agency Immortality*, 64 J. POL. 89, 92–93 (2002) (noting 62% of agencies created since 1946 were terminated by 1997).

13. *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, §§ 105, 209, 407, 110 Stat. 3416 (codified as amended at 15 U.S.C. §§ 77z-3, 78mm, 80b-5, 80a-6) (amending Securities Act of 1933, Securities Exchange Act of 1934, Investment Advisers Act of 1940, and Investment Company Act of 1940).

14. 15 U.S.C. § 78d(a) (2006).

15. *See* Donald C. Langevoort, Commentary, *Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 97 (1998) (attributing SEC's success and no doubt durability to having an apolitical agenda).

and, consequently, endanger its survival. Indeed, the SEC's present agenda invariably calls on the agency to take a position on issues that transcend disclosure and fairness in capital markets. One example reveals how the SEC's involvement in political issues can imperil its survival. A few years ago, the SEC's proposal that in extremely limited instances shareholders be permitted to nominate individuals for election to a company's board of directors provoked nearly 17,000 responses, mostly from company executives.[16] Related to this was the strongly partisan reaction to the Republican-controlled SEC's decision not to abide by the Second Circuit's narrow construction of SEC Rule 14a-8; the Second Circuit had rejected the SEC's position that a proposed bylaw authorizing shareholders to nominate directors was outside the scope of the SEC's shareholder proposal rule.[17] Though it lost that legal battle, the SEC proposed an amended rule that expressly excluded such a proposal.[18] Following a change in Administrations, the new Democratic chair proposed even broader authority for shareholder nominating proposals than the proposed regulation that had ignited the earlier firestorm among company executives.[19]

The growing institutionalization of stockholdings and increasing malaise in some financial institutions regarding management prerogatives—such as compensation, takeover defenses, or acquisition strategies—suggest that the SEC will be drawn into non-neutral political issues. This politicization seems inevitable and will necessarily jeopardize the bipartisan support the SEC has long enjoyed.

The SEC may find a recipe for addressing this problem in its approach to the 1970s revelations in connection with Watergate and massive bribery and illegal campaign contributions by public companies. Although the SEC threatened enforcement actions against companies that did not comply with its announced amnesty program, the issue shifted from the SEC to Congress via hearings leading to the

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16. *See* Security Holder Director Nominations, Exchange Act Release No. 48626, 81 SEC Docket 770 (Oct. 14, 2003) (among the triggering events was the failure of the board of directors to institute a proposal that had earlier garnered the support of a majority of the stockholders); JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM 90 (2005) (observing there were 17,000 responses to the shareholder nomination proposal).

17. *See* Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc., 462 F.3d 121, 123 (2d Cir. 2006) (holding that a proposal focused on amending the bylaws to empower stockholders meeting certain criteria to nominate directors does not pertain to the election of a director).

18. *See* Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc., 462 F.3d 121, 123 (2d Cir. 2006) (holding that a proposal focused on amending the bylaws to empower stockholders meeting certain criteria to nominate directors does not pertain to the election of a director).

19. *See* Facilitating Shareholder Director Nominations, Securities Act Release No. 9046, 2009 WL 1953653 (June 10, 2009).

Foreign Corrupt Practices Act of 1977.[20] Similarly, issues at the core of the public's concern regarding management prerogatives versus stockholder rights and protection are of sufficient significance to attract not just hearings, but possibly Congressional authority permitting the SEC to act.[21] Currently the SEC engages this battle through its shareholder proposal rule, but this provision lacks express Congressional approval and when initially adopted was never envisioned as the battleground between activist investors and management. Legitimizing the appropriateness of shareholder access to the proxy machinery, and even the nominating process, by legislation would not just clothe the SEC with authority to superintend national policy, but would establish a national position on shareholder rights in public companies. This likely would remove suggestions that the SEC has lost its virtue (not to mention, political necessity) as a neutral guardian of shared policies.

III. THE ORACLE OF THE INDUSTRY

The 1960 election of President John F. Kennedy ushered in a much needed rejuvenation of the SEC.[22] In the preceding decade the agency had slipped into disrepair, from the widely shared view that the SEC was the gem among President Franklin Roosevelt's New Deal independent regulatory agencies. A major part of the agency's reinvigoration was a special studies program carried out under its auspices.

The 1963 Special Study of the Securities Markets (Special Study) questioned the effectiveness of self-regulation and the various exchanges' commitment to protect investors. The study also took particular aim at the brokerage industry's unyielding support for fixed brokerage commissions and the prevalent practice of floor traders accentuating trends in securities prices.[23] The Special Study spawned numerous corrective steps, such as the first SEC regulations and later Congressional action abolishing fixed brokerage commissions,[24]

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20. Pub. L. No. 95-213, 91 Stat. 1494 (1977) (prohibiting registrant employees from bribing government officials as well as introducing adequate accounting records requirement).

21. *See* H.R. 1664, 111th Cong. (2009) (as passed by House, Apr. 1, 2009) (calling for nonbinding approval by stockholders of executive compensation); S. 1074, 111th Cong. (2009) (Sen. Charles Schumer's "Shareholder Bill of Rights Act of 2009").

22. JAMES BURK, VALUES IN THE MARKETPLACE: THE AMERICAN STOCK MARKET UNDER THE FEDERAL SECURITIES LAW 103–05 (1992) (recounting how the SEC's budget was drastically reduced during the Eisenhower Administration and the Kennedy Administration revived the agency with an infusion or resources).

23. *See generally* 2 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES 333 (2002) (discussing composition and findings of those carrying out the Special Study).

24. The SEC's action with respect to fixed commission rates occurred in stages via Exchange Act Rule 19b-3. *See* Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No.

restricting floor trading,[25] and amending the Securities Exchange Act to incorporate large over-the-counter traded companies in the periodic disclosure requirements.[26]

Equally significant was the so-called 1962 Wharton Report, which comprehensively reviewed the mutual fund industry.[27] The report cataloged the absence of arms-length dealings between fund managers and mutual funds, as well as numerous abuses flowing from this tight relationship. Most significantly, the Wharton Report found that mutual fund advisory fees were substantially higher than fees the same advisors charged their non-fund clients and that substantial portions of the difference in fees so charged could not be attributed to economies of scale posed by their non-fund clients or the additional services that advisors provided to their advised funds.[28] The Wharton Report, drawing from insights also provided by the Special Study, ultimately led to the Report of the Securities and Exchange Commission on the Public Policy Implications on Investment Company Growth.[29] Years later, the reports drove Congress to amend the Investment Company Act to introduce a fiduciary standard for the annual approval of fund's advisor's contract.[30]

The Special Study and Wharton Report reveal the important role thoughtful and thorough information gathering regarding discrete aspects of financial markets can play in the formulation of public policy.[31] This also argues that commissioning studies to assess the efficient and safe functioning of U.S. capital markets should be an important ongoing, not episodic, function of the SEC. While an agency may not be able to stay ahead of industry practices through timely regulatory developments, it is reasonable to assume that the SEC can

11,203, 6 SEC Docket 147 (Jan. 23, 1975), *rescinded by* Rescission of Rules Under the Securities Exchange Act of 1934, Exchange Act Release No. 26,180, 42 SEC Docket 4 (Oct. 14, 1988). Congress's actions occurred in connection with its 1975 amendments to the Securities Exchange Act. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified in scattered sections of 26 U.S.C.).

25. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 333 (2d ed. 1995).

26. Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565; *see also* SELIGMAN, *supra* note 25, at 321–22.

27. *See* IRWIN FRIEND ET AL., WHARTON SCH. OF FIN. AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274 (1962).

28. *See* SELIGMAN, *supra* note 25, at 366–71.

29. H.R. REP. NO. 89-2337 (1966).

30. *See* Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (codified in scattered sections of 15 and 26 U.S.C.).

31. For an interesting retrospective on the Special Study by some of those who participated in the report's preparation, see Transcript, The Roundtable of the 1963 SEC Special Study (Oct. 4, 2001), *available at* http://www.sechistorical.org/collection/programs/1963Transcript.PDF.

assess where industry practices and how they may impact the public interest. Thus, it is appropriate for significant agency resources to be deployed to an office tasked with proposing, designing, sponsoring, and carrying out comprehensive studies of industry and market practices and determining whether regulatory action is necessary.

While admittedly second-guessing, it would have likely have been revealing in the post Gramm-Leach-Bliley[32] era to have studied the operational changes of broker-dealers as many of them were engulfed within large financial conglomerates and shifted their profit centers from the provision of services to clients to their own trading desks. We likely would have learned a lot had this been among the SEC's foci. We now have a similar opportunity.

IV. FIRST, RID US OF THE LAWYERS

Four decades ago Professor Homer Kripke sharply criticized the SEC for its technocratic culture, which he largely attributed to being over-lawyered.[33] The SEC's staff, then and now, is in stark contrast to the individuals its first chairman recruited. Joseph Kennedy came from Wall Street and brought large numbers of individuals from Wall Street to the SEC. He and John Landis, the agency's third chairman, set much of Wall Street at ease by not only surrounding themselves with brokers, analysts, and accountants, but by overtly seeking the regulated's participation in the SEC's mission.[34] The symbiotic relationship persists in many quarters of the SEC's activities, despite the heavier presence of lawyers today than then. But, while the relationship is symbiotic, it is not likely to be as attuned to the public interest as it could be if the SEC's personnel had a wider set of skill packages.

Before the credit crisis in 2008, regulated parties insisted that SEC

32. *See* Graham-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 U.S.C.) (essentially repealing the Banking Act of 1933, ch. 89, 48 Stat. 162).

33. HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 4, 18–20 (1979).

34. *See* SELIGMAN, *supra* note 25, at 106–11 (describing the members of the Wall Street community that Joseph Kennedy recruited to the SEC); THOMAS K. MCCRAW, PROPHETS OF REGULATION 186–90 (1984) (describing Landis' belief that it was wiser to work through existing private structures and professionals rather than to confront them and his successful efforts of convincing the accounting profession that the SEC regulation was a benefit for them). These perspectives led naturally to the Maloney Act of 1938, which among other features, established the self-regulatory organization for broker-dealers that continues today. *See generally* JOHN O. MATHEWS, STRUGGLE AND SURVIVAL ON WALL STREET: THE ECONOMICS OF COMPETITION AMONG SECURITIES FIRMS 46 (1994) (detailing how early focus of self-regulation was on fraudulent and manipulative practices but not anti-competitive practices such as fixed commission rates).

regulations should be both principle-based and prudential.[35] In a sense, these each connote the same meaning: the SEC's role was to discretely nudge the regulated toward broadly shared goals rather than institute enforcement actions for violating announced directives. The paradigm of this new order was the United Kingdom's Financial Services Administrator, whose staff reflected the background and culture of the regulated and was distinctly not lawyer or enforcement oriented.

The SEC has attempted principles-based regulation. For example, its recent Compensation Disclosure and Analysis (CD&A) program contribution to the annual reports filed with the SEC is principles based.[36] In its first year, many companies adhered to the spirit of the CD&A, but significant numbers did not. The SEC's experience with CD&A rivals its ongoing problems with the analogous Management Discussion and Analysis (MD&A) portion of registrants' reports,[37] where the SEC's constant lament is that significant numbers of issuers do not comply with the required disclosure of existing conditions that pose a reasonable prospect for a favorable or adverse impact.[38] While there are rare enforcement actions brought for failure to comply with the MD&A's requirements,[39] the SEC's primary response is a few releases chiding companies for not complying with disclosure requirements. This may well be prudential regulation at its zenith.

A far wiser response would be to inquire into the backgrounds of those who review the filings or other compliance-related issues that confront the SEC. Advisors, broker-dealers, and others engaged in trading and advisory services are better monitored by individuals whose education, training, and experience are similar to the activities they review. We can only speculate whether the fraudster of the century, Bernard Madoff, whose $50 billion Ponzi scheme continues to shake investor confidence in regulators,[40] would have been uncovered earlier

35. *See, e.g.*, COMM. ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MARKETS REGULATION (2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

36. *See* Instructions to Item 402(b) of Regulation S-K, 17 CFR § 229.402(b) (2009); *see also* SEC, Div. of Corp. Fin., Staff Observations in the Review of Executive Compensation Disclosure (Oct. 9, 2007), http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm.

37. Item 303 of Regulation S-K, 17 CFR § 229.303.

38. *See, e.g.*, Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Exchange Act Release No. 8350, 81 SEC Docket 2905 (Dec. 19, 2003) (providing guidance regarding MD&A disclosure, and stating the SEC's belief and expectation that such disclosure will improve).

39. *See, e.g.*, *In re* Coca-Cola Co., Exchange Act Release No. 51565, 85 SEC Docket 601 (Apr. 18, 2005).

40. *See* Michael Lewis & David Einhorn, Op-Ed, *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 4, 2009, at WK 9.

had the SEC staff inspecting his operation had the toolkit similar to the whistle blower[41] that prompted the SEC's single visit to Madoff's advisory operations.

Staffing the SEC with individuals with the appropriate background would uncover problems earlier and be more effective than training and experience that better equip an individual for enforcement rather than inspection efforts. As the SEC moves forward, the Commission should mesh its staff's skill set with its regulatory mandate.

V. CONFRONTING GLOBALIZATION

Ultimately, the credit crisis will relent and no longer dominate, as it does now, regulators' agenda. Globalization of trading in, and offerings of, securities will persist and dominate regulators' agenda. U.S. investors are acquiring increasing amounts of foreign securities. U.S. holdings of foreign securities in 1990 was $197.6 billion, surged to $1.85 trillion in 2000, and stood at $2.97 trillion in 2005, when foreign holdings of U.S. companies was $2.3 trillion.[42] Stated differently, nearly two-thirds of all U.S. investors hold foreign securities in their portfolios.[43] U.S. acquisition of foreign securities occurs in foreign markets because the once-hardy trend of foreign issuers offering or listing their securities in the United States has slowed to a trickle. To be sure, foreign initial public offerings (IPOs) in 2006 accounted for 16% of the number (and 23% of the offering amount) of IPO's conducted in the United States, but the trend appears to be against the U.S. market, as foreign markets have become more trustworthy such that the U.S. listing premium has shrunk.[44]

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41. *See* Gregory Zuckerman & Kara Scannell, *Madoff Misled SEC in '06, Got Off*, WALL. ST. J., Dec. 18, 2008, at A1 (detailing the efforts of Mr. Markopolos to bring to the SEC his concerns that Mr. Madoff was engaged in defrauding investors).

42. SEC. INDUS. ASS'N, SECURITIES INDUSTRY FACTBOOK 2006, at 81 (2006). This figure does not capture the full story as it reflects only securities holdings. Including purchases and sales of securities, i.e., trading, U.S.-based investors racked up $7.5 trillion in transactions for 2005.

43. *See* Eric J. Pan, *Single Stock Futures and Cross-Border Access for U.S. Investors*, 14 STAN. J. L. BUS. & FIN. 221, 230 (2008) (stating that this figure rose from about 50% in 1999).

44. At least one group marshals statistics to support the claim that the U.S. markets have lost their competitive position. *See* COMM. ON CAPITAL MARKETS REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET 23 (2007), http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf (citing statistics of the slowing rate of growth in market capitalizations of U.S. markets in 2002–2007 versus 1990–2002, whereas worldwide market capitalizations have grown at twice the U.S. rate in 2002–2007). Certainly U.S. equity markets have shrunk in terms of the amount they make up of all equity markets. *See* Deepak Gopinath, *IPOs Shun U.S. Exchanges While Wall Street Collects Record Fees*, BLOOMBERG, Feb. 20, 2007, http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aFO7N_Ngeuzc (equities of

Historically, securities regulation was a much simpler activity. In a less globalized world, capital markets were balkanized so that each country's regulatory focus was local. This was particularly true in the United States, since the gap in quality between U.S. markets and its nearest rivals was so great that regulatory competition was not a concern; there was no competition among national markets. The above statistics document that this is no longer the case, and as such, the SEC understands that it is an important but no longer dominant regulator. Stated simply, for several years the SEC has been ensnared by the tsunami of globalization.

Several recent SEC initiatives can only be understood by considering how intimate the space has become within world capital markets. In this context, the overarching strategy has been that of mutual recognition. To the cynic, this reflects the regulator's perspective that "if you can't beat them, join them." A more supportive view of mutual recognition is that it is an efficient solution for coping with the reality that rival markets are converging toward American reporting and operational practices.[45] That is, differences between U.S. and foreign regimes are so slight that true convergence between them is not necessary to assure investor protection.

A dramatic embrace of mutual recognition occurred in late 2007 when the SEC lifted its seventy-five year requirement that foreign issuers reconcile their financial reports with generally accepted U.S. accounting principles (U.S. GAAP).[46] And, the SEC earlier announced it might permit domestic firms to prepare their financial statements in accordance with International Financial Reporting Standards (IFRS) rather than U.S. GAAP.[47] Additionally, in fall 2008 the SEC placed the death of U.S. GAAP, at least for securities disclosures, on the agenda by proposing

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U.S. companies in 2007 accounted for 37% of all global market capitalization versus 50% in 2001).

45. *See generally* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007) (reviewing numerous considerations that support mutual recognition among countries with high, albeit differing, regulatory standards).

46. Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP, Securities Act Release No. 8879, 92 SEC Docket 717 (Dec. 21, 2007). Not only did the SEC eliminate the reconciliation requirement for foreign issuers whose financial statements are prepared according to IFRS as issued by the IASB, but qualified this condition to permit issuers to depart from strict adherence to IFRS on their treatment of fair value and hedge fund accounting that had drawn the disapproval of EU authorities in response to heavy lobbying by public companies.

47. *See* Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards, Securities Act Release No. 8831, 2007 WL 2404264 (Aug. 14, 2007).

that all U.S. issuers be required to comply with IFRS.[48] Increasingly, the SEC's regulatory posture on financial reporting issues is one of accommodation to foreign issuers rather than its historical position of demanding obeisance to U.S. standards.[49] These developments, and others, bear testament that technology has made the world smaller and more integrated for investors and firms seeking capital through public offerings: U.S.-based investors and issuers invest and raise capital in foreign markets at an ever-increasing pace; foreign investors acquire securities in U.S. capital markets; and foreign issuers raise significant capital through public offerings in the United States. Indeed, the pace of such transnational investing and offerings is accelerating.[50]

The quest for convergence and mutual recognition go hand-in-hand. The SEC cannot, and should not, recognize that compliance with another nation's regulations is sufficient for entry into U.S. markets unless it is satisfied that the other nation's standards are comparable to U.S. standards. Mutual recognition therefore flows naturally from a convergence among regulators on proper standards.

Mutual recognition and fostering convergence is not a divergence from, but rather a continuation of, the SEC's history of interacting with regulators around the globe.[51] As the SEC has stated, the beginning point for the broad application of mutual recognition is a framework that sets forth the overriding principles by which individual regulatory items

48. *See* Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, Securities Act Release No. 8982, 94 SEC Docket 1703 (Nov. 14, 2008).

49. *See, e.g.*, Exemption of Certain Foreign Brokers or Dealers, Exchange Act Release No. 58047, 93 SEC Docket 1663 (June 27, 2008) (proposing a conditional exemption permitting foreign brokers to represent U.S.-based investors premised on the SEC being satisfied of relative comparability of regulation by the foreign regulator of the foreign broker or dealer).

50. For a thoughtful review of trends in cross-border offerings and trading, see Howell E. Jackson & Eric J. Pan, *Regulatory Competition In International Securities Markets: Evidence From Europe* (pt. 2), 3 VA. L. & BUS. REV. 207 (2008) (detailing waning interest in U.S. markets by European Issuers that predated the passage of Sarbanes-Oxley Act of 2002 that reflects growing maturity of European markets and has attracted the willingness of U.S. institutions to trade in a foreign market rather than ADRs in a U.S. market).

51. *See, e.g.*, Regulation of International Securities Markets, Exchange Act Release No. 6807, 42 SEC Docket 284, (Nov. 14, 1988) (extensive policy statement outlining objectives of securities regulators working together to develop coordinated international solutions through bilateral and multilateral relationships). Much of the SEC's interaction with its fellow regulators is through IOSCO. *See generally* James R. Doty, *The Role of the Securities and Exchange Commission in an Internationalized Marketplace*, 60 FORDHAM L. REV. S77, S83–84 (1992). The SEC, while envisioning that it has a leadership position, nevertheless humbles itself in carrying out this role by balancing the quest for investor protection by the need to be responsive to the realities within each marketplace. *See* SEC, The SEC's Cooperative Arrangements with Foreign Regulators, http://www.sec.gov/about/offices/oia/oia_coopfactsheet.htm (May 23, 2008) (summary of numerous cooperative arrangements with foreign regulators).

will be considered.[52] In setting forth these overriding principles, the SEC should, as it has in the past, remain true to its mandate of both protecting investors and strengthening U.S. capital markets. While some might see these as conflicting goals, the rich history of financial market regulation in the United States suggests that investor protection provides attractive venues for capital formation, which has greatly benefited the investment banking community. Indeed, the competition now faced by U.S. capital markets is largely due to the SEC's successful preaching of this message. Competition from other markets is a result of their becoming more efficient and investor friendly, and not due to dysfunctional regulation of U.S. markets.[53]

By continuing its practice of engaging foreign regulators, the SEC's rich experiences not only inform foreign regulatory efforts, but also improve global standards. The ultimate prize for all participants in such bilateral and multilateral engagements is, and should remain, mutual recognition on significant regulatory issues. The extent that the United States benefits from this process depends on the SEC's domestic regulatory efforts to remain on the forefront of being theoretically and empirically well-informed; this complements calls for expanded use of special studies on emerging regulatory issues. For mutual recognition to prevail as a practicable policy requires policies and practices that advance the historical objectives of securities regulation, which are balancing investor protection and assisting the efficient performance of capital markets.

VI. CONCLUSION

The SEC operates in a more complicated and international world than when it was formed seventy-five years ago. Its durability and contribution are the result of strategies outlined above, which were never envisioned when the agency was created: staffing the agency with experienced professionals from a broad range of disciplines, undertaking thoughtful studies of emerging issues, relying on congressional support on regulatory issues that are politically sensitive, and invoking mutual

52. *See* SEC, Statement of the European Commission and the U.S. Securities and Exchange Commission on Mutual Recognition in Securities Markets (Feb. 1, 2008), http://www.sec.gov/news/press/2008/2008-9.htm. Thus, leading up to the SEC's announcement that it would permit foreign issuers to use high-quality IFRS reporting without reconciliation to U.S. GAAP, the SEC set forth a template by which the SEC would work with the Committee of European Securities Regulators in implementing such convergence. *See* SEC, SEC and CESR Launch Work Plan Focused on Financial Reporting (Aug. 2, 2006), http://www.sec.gov/news/press/2006/2006-130.htm.

53. *See supra* notes 46–51 and accompanying text; *see also* COMM. ON CAPITAL MARKETS REGULATION, *supra* note 35, at 4–7.

recognition as an informed regulatory leader. These past strategies are as compelling today as they have been throughout the agency's history. Recognizing and committing to these strategies—not new laws—will ensure the SEC survives and thrives. The omissions that critics have laid at the SEC's feet are the result of the SEC's recent failure to steer closer to its historical methodology of addressing the ever-shifting forces of U.S. and global capital markets. Omissions become more significant when regulators lack the appropriate skills to understand the regulated. Often, policymakers look backwards, rather than inform themselves through comprehensive studies of emerging issues. They also defer to globalization forces rather than international diplomacy when formulating policy. Though the extent to which each of these have occurred in past years is debatable, this Article argues that the strategies suggested above were not applied as they should have been. By pursuing operational strategies that have distinguished it as a premier agency in the past, the SEC can avoid future charges that a crisis was partly due to its omissions.