



# U.S. CAPITAL MARKETS COMPETITIVENESS: THE UNFINISHED AGENDA

SUMMER 2011



CENTER FOR CAPITAL MARKETS  
COMPETITIVENESS

Compiled by Michael J. Ryan, Jr., Former Executive Director  
U.S. Chamber Commission on the Regulation of U.S. Capital Markets in the 21st Century



## CENTER FOR CAPITAL MARKETS

---

# COMPETITIVENESS

Since its inception, the U.S. Chamber's Center for Capital Markets Competitiveness (CCMC) has led a bipartisan effort to modernize and strengthen the outmoded regulatory systems that have governed our capital markets. Ensuring an effective and robust capital formation system is essential to every business from the smallest start-up to the largest enterprise.



# U.S. CAPITAL MARKETS COMPETITIVENESS: THE UNFINISHED AGENDA

## TABLE OF CONTENTS

---

Executive Summary.....	2
Introduction .....	8
Rationalizing the U.S. Regulatory Structure .....	10
Fundamentally Reforming Regulatory Agencies .....	15
Making Nongovernmental Policy Makers Accountable.....	21
Restoring Integrity to Litigation and Enforcement Practices.....	26
U.S. Competitiveness and Engagement.....	31
Conclusion.....	35



## EXECUTIVE SUMMARY

For the past year, more than a dozen U.S. financial regulators have scrambled to write hundreds of new rules to implement the hastily adopted Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the most sweeping financial regulatory legislation in nearly 75 years. Implementation of the Dodd-Frank Act has exposed unaddressed weaknesses in the U.S. financial regulatory system.

We still have the same old system—only more of it. We still have an inexplicable structure with multiple federal, state, and nongovernmental regulators, which often have overlapping jurisdictions and propose conflicting regulations on similar activities, products, and services. Regulators still do not have the technology, staff expertise, or operational capacity to regulate today's markets. Worse yet, there is no clear plan or strategy to address these fundamental problems.

In many key areas where markets operate globally, the United States has failed to reach agreement on a global approach to regulation. Further, and perhaps more troubling, foreign regulators have told us they will not follow our lead. And other significant barriers to entrepreneurial capital formation in the United States, including our litigation system, remain unaddressed. In short, the Dodd-Frank Act failed to solve many of the core problems that have eroded the stability, effectiveness, and global competitiveness of the U.S. capital markets.

For most of the 20th century, the U.S. capital markets were the envy of the world. Our financial services legal and regulatory system fostered the world's most favorable environment for investing and accessing entrepreneurial capital. Issuers and investors alike were attracted to the U.S. markets because they understood that they would be participating in markets that were transparent, efficient, and well-regulated.

But regulators and the basic regulatory structure have failed to keep pace with changing markets. Indeed, the current U.S. foundation was put in place at a time that was closer to the Civil War than it is to today. The failure to keep pace has led to huge gaps in regulation in some areas, duplicative and conflicting layers of regulation in others, and regulators who do not have the expertise or technology to regulate modern markets. Even before the financial crisis, the U.S. Chamber of Commerce and many other organizations warned of the need for fundamental regulatory reform to ensure the long-term vibrancy and competitiveness of our domestic capital markets and our economy.

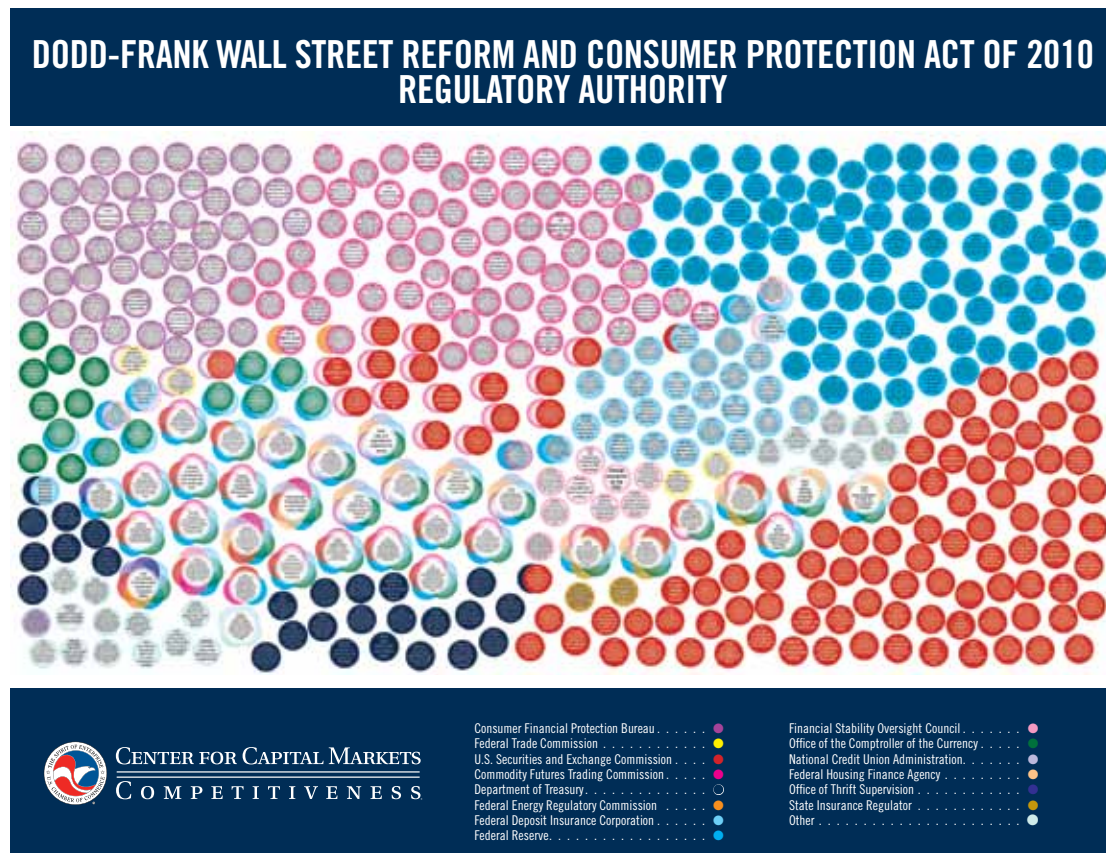
Despite all the activity in recent years, these concerns are only becoming more elevated. The problem with U.S. regulation is not its quantity, but its quality. Well-run businesses depend on well-regulated markets, and no legitimate business can compete in a marketplace that is not fair and transparent. The goal should never be less or more regulation, it should be better regulation. Our common goal must continue to be getting regulation right.


With the benefit of some reasoned and dispassionate reflection, the U.S. Chamber believes it is critically important to reevaluate the form and substance of U.S. financial services regulation. Unfortunately, our assessment is that we have made very little progress in recent years and, instead, are continuing to move along a troubling path.

Some characterize the Dodd-Frank Act as the largest and most sweeping financial regulatory reform since the Great Depression. Certainly, at 2,319 pages, the Dodd-Frank Act is the most far-reaching financial regulatory undertaking since the 1930s, authorizing or requiring agencies to enact 447 new rules and complete 63 reports and 59 studies (see Figure 1).

Certainly, at 2,319 pages, the Dodd-Frank Act is the most far-reaching financial regulatory undertaking since the 1930s, authorizing or requiring agencies to enact 447 new rules and complete 63 reports and 59 studies. However, the Dodd-Frank Act should never be confused with sweeping regulatory reform.

FIGURE 1





However, the Dodd-Frank Act should never be confused with sweeping regulatory reform. Rather, it layered more processes, people, and prohibitions on the cracked and crumbling 75-year-old regulatory foundation. It has failed to provide the modern financial services regulatory structure that is so crucial to ensuring that U.S. businesses have domestic access to deep and diverse sources of capital.

Rather than making the essential structural reforms desperately needed, the Dodd-Frank Act doubled down on a system conceived in the years following the Great Depression. Eliminating only one small regulatory agency from the vast array of federal, state, and nongovernmental financial regulatory authorities, the Dodd-Frank Act's legacy will be several new regulatory bodies with vague but far-reaching authority grafted onto the existing patchwork of financial regulators.

This paper highlights the five principal areas where our regulatory structure and processes are reducing the quality and efficiency of the U.S. capital markets. Unaddressed, these issues are undermining the long-term vitality of the U.S. economy. Regardless of its size or industry, every business depends on entrepreneurial capital to fund expansion and create jobs. Therefore, the concerns set forth below have direct and immediate implications for every business.

### **Rationalizing the U.S. Regulatory Structure**

The foundation of the U.S. financial services regulatory structure was laid more than 75 years ago, with only periodic, reactive changes since. The result is a patchwork of regulatory agencies

Regardless of its size or industry, every business depends on entrepreneurial capital to fund expansion and create jobs.

that have been cobbled together over time, with no comprehensible vision for the marketplace of the 21st century. Unfortunately, the Dodd-Frank Act did not overhaul this labyrinth of regulators but rather increased their numbers and overlapping mandates.

While the Dodd-Frank Act created a new umbrella, the Financial Services Oversight Council (FSOC), over the existing broken structure, there is no clear process to address conflicts and competition among regulators. The long-term goal for the regulatory system—which may yet be implemented through the FSOC—should be to fundamentally reorganize and simplify the regulatory structure. In the short term, the FSOC should undertake, or failing to do so on its own, be tasked by Congress to address the most egregious conflicts and duplication among the maze of existing regulators.

### **Fundamentally Reforming Regulatory Agencies**

The overhaul and modernization of outdated regulatory agencies is long overdue. The needed reform identified here applies to all financial regulators in varying degrees, with the U.S. Securities and Exchange Commission (SEC) at the epicenter of this problem. The fundamental weaknesses of the individual regulators parallel the need for systemic reform. Nearly all of these



agencies were established to oversee and regulate markets and market activity that are vastly different from those of today. While the markets have changed dramatically, these agencies have remained relatively static in their structure and operations, including their failure to implement major technology upgrades.

## The fundamental weaknesses of the individual regulators parallel the need for systemic reform.

Meanwhile, these agencies' mandates have expanded greatly. As a result, priority and resource allocations are skewed toward following the path of least resistance, rather than toward activities that are in the best long-term interests of the markets. Shifting significant resources to an immediate crisis is standard operating procedure. Meanwhile, the effort devoted to long-term, fundamental improvement of our regulators is gravely deficient.

### **Making Nongovernmental Policy Makers Accountable**

Nongovernmental policy makers should adopt regulatory due process standards that meet or exceed those of government agencies. The debate around financial services regulation and its impact on businesses and our economy focuses on the operations and activities of the multitude of government agencies responsible for regulatory policy and oversight. Several large nongovernmental agencies, however, also have a significant and growing influence on financial services public policy that warrants much closer scrutiny.

These organizations—most notably the Financial Industry Regulatory Authority (FINRA), the Self-Regulatory Organization (SRO) for securities firms, and Institutional Shareholder Services (ISS), the influential for-profit proxy advisory firm—fulfill many functions of government agencies and have either explicit or implicit delegated authority from government. Despite their tremendous influence over the workings of the capital markets, these organizations are generally subject to few or none of the traditional checks and balances that constrain government agencies. This means they are devoid of or substantially lack critical elements of governance and operational transparency, substantive and procedural standards for decision making, and meaningful due process mechanisms that allow market participants to object to their determinations. As government delegates regulatory authority, explicitly or implicitly, it should also impose Administrative





As government delegates regulatory authority, explicitly or implicitly, it should also impose Administrative Procedures Act or similar due process and transparency requirements on SROs and other nongovernmental organizations.

Procedures Act (APA) or similar due process and transparency requirements on SROs and other nongovernmental organizations.

### **Restoring Integrity to Litigation and Enforcement Practices**

Fair and consistent enforcement of the law and reasonable opportunities for private parties to seek redress for intentional or reckless violations of the law are fundamental parts of our financial regulatory system. Strong, reliable capital markets depend on the ability to identify and stop wrongdoers from undermining confidence in the financial system. We need to further strengthen the capacity of regulators to detect and deter fraud.

While aggressively pursuing efforts to stop fraud and punish wrongdoers to the maximum extent possible, regulators must avoid the temptation to use enforcement as an alternative to transparent and open rulemaking. Without the benefit of public input, regulations imposed through enforcement settlements often produce significant unintended consequences. In addition, the U.S. system

increasingly provides incentives to regulators, trial lawyers, and even corporate personnel to pursue narrow self-interests at the expense of the integrity of the capital markets. Foreign companies have cited unpredictability in litigation and enforcement as one of the primary reasons they now avoid accessing the U.S. public markets.

### **U.S. Competitiveness and Engagement**

The long-term interests of the U.S. economy require that U.S. policy makers have an influential role in establishing international financial regulatory standards. U.S. regulators should continue to seek common approaches to global challenges, without ceding control. Similarly, the United States should delay implementation and consider alternative approaches in areas where the rest of the world has already indicated it is unlikely to follow the U.S. approach, such as the Volcker Rule.

This does not mean waiting for the world to act or seeking global harmonization in every area. The United States can and should have different or even higher standards if the result is better and more effective regulation. However, when the United States unilaterally adopts regulations in an attempt to address global problems, it only serves to isolate the United States, weakening our capital markets and, in the end, failing to achieve the desired regulatory result.

For the better part of the 20th century, the depth, liquidity, and efficiency of the U.S. capital markets were unmatched. Businesses around the world accessed the U.S. capital markets at rates vastly greater than any other market. After decades of global leadership in capital markets regulatory





policy, regrettably, the United States appears to be conceding its place to increasingly more efficient global markets. This concession is not just in terms of business activity, but also in regulatory thought leadership.

Today, the United States is no longer the sole capital markets superpower. Markets are now global and interconnected, allowing businesses to select from several alternatives, including accessing capital in their home markets. Today, misguided and unilateral regulatory initiatives influence where firms take their capital markets business. For the United States to have a meaningful role influencing global regulatory policy in the future, U.S. policy makers must coordinate effectively with their counterparts. Continued failure will result in the erosion of our domestic capital markets base, shifting capital markets activity to more efficient markets abroad.

Today, misguided and unilateral regulatory initiatives influence where firms take their capital markets business. For the United States to have a meaningful role influencing global regulatory policy in the future, U.S. policy makers must coordinate effectively with their counterparts.



## INTRODUCTION

The engines that drive America's innovation economy are as diverse as our entrepreneurial spirit. Regardless of a business's size or the sector in which it competes, capital is the common and essential element that fuels these engines. It is the full range of entrepreneurial activities—from the seemingly small idea being supported by family, friends, and the local community bank, to the long-term research and development activities of multinational corporations—that create the quality jobs that sustain American families and provide a quality of life unmatched in the world. Private capital, in short, is a central component for a great deal of economic, cultural, and social activity.

Historically, America's supply of capital has grown more plentiful over time, thanks in no small part to an efficient and effective legal and regulatory framework for capital markets activity. In the past, policy makers recognized the central role capital plays in the lives of every American. In overseeing our markets, they made decisions by balancing three very important objectives: protecting investors; promoting fair and orderly markets; and facilitating capital formation.

Rapid changes over the past 25 years are challenging the traditional structures put in place more than 75 years ago to support our capital markets. Today, market participants have a presence in many regions around the globe. Complex financial transactions in multiple currencies are agreed to quickly and executed instantaneously. Never-ending technological advances are constantly changing the dynamics

Historically, America's supply of capital has grown more plentiful over time, thanks in no small part to an efficient and effective legal and regulatory framework for capital markets activity.

of business and regulation. Failure to keep pace with these changes is putting the U.S. legal and regulatory structure under significant strain and eroding the strength and quality of the U.S. capital markets relative to new, more modern regulatory structures.

In February 2006, the U.S. Chamber of Commerce launched the bipartisan, independent Commission on the Regulation of the U.S. Capital Markets in the 21st Century (the Commission) to evaluate the legal and regulatory framework of the U.S. capital markets. The U.S. Chamber "undertook this effort because of the concern that burdensome and duplicative regulatory schemes and an inefficient and unfair legal system were making U.S. capital markets increasingly less attractive to foreign and domestic companies alike."<sup>1</sup>

In March 2007, the Commission issued its report. The Commission found that "the competitive position of our capital markets is under strain—

<sup>1</sup> Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations (March 2007), p. 1, available at <http://www.centerforcapitalmarkets.com/resources/publications/>.



Further, these solutions have been adopted within or on top of the same regulatory framework that has been in place for more than 75 years.

The U.S. Chamber is deeply concerned that recent changes will have unintended consequences that will not be understood for years to come and that they have only exacerbated the fundamental problem. A year into the rollout of the Dodd-Frank Act, the Chamber believes that it is imperative that the continuing problems with the U.S. system be exposed and addressed.

from increasingly competitive international markets and the need to modernize our legal and regulatory frameworks.”<sup>2</sup> Also during this period, a number of other reports reflected similar concerns about the U.S. legal and regulatory structure for financial services.<sup>3</sup>

Since that period, we have experienced a massive global financial crisis. In response, regulators and Congress have scrambled to address the problem, often adopting “solutions” before completing objective and dispassionate analyses.

<sup>2</sup> Ibid, p.4.

<sup>3</sup> Committee on Capital Markets Regulations, Interim Report of the Committee on Capital Markets Regulation (November 2006), available at <http://www.capmktreg.org/>; Michael Bloomberg and Charles Schumer, Sustaining New York's and the US' Global Financial Services Leadership (January 2007), available at [http://www.nyc.gov/html/om/pdf/ny\\_report\\_final.pdf](http://www.nyc.gov/html/om/pdf/ny_report_final.pdf); Financial Services Roundtable, The Blueprint for U.S. Financial Services Competitiveness, available at <http://www.fsround.org/cec/blueprint.htm>; Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure (March 2008), available at <http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf>; United States Government Accountability Office, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (January 2009), Available at <http://www.gao.gov/new.items/d09216.pdf>.



## RATIONALIZING THE U.S. REGULATORY STRUCTURE

The past two decades saw marketplace changes substantially greater than those of the previous six decades. This accelerated rate of change reflects the increasing sophistication of the needs of businesses and investors. The markets and financial professionals kept pace with these changes by introducing new products and services and retooling their operations to remain competitive.

The aftermath of the financial crisis offered the opportunity to adopt true regulatory reform to modernize the U.S. regulatory infrastructure. Instead of seizing the moment, the Dodd-Frank Act simply layered—in historic proportions—more mandates and complexity onto the regulatory foundation that was established more than seven decades ago, a time that was closer to the Civil War than it is to today.

Although that system served investors and the U.S. economy well throughout most of its existence, it has not kept pace with the rapid evolution and needs of the U.S. capital markets. Markets and the businesses have built-in incentives to continually reinvent themselves and evolve to meet the changing demands of the marketplace.

Regulators, on the other hand, do not have built-in incentives to modernize and retool, leaving the U.S. regulatory systems largely static. While we tend to implement changes to account for the most recent crisis, these so-called reforms only put patches on the old, cracked foundation. The system was long

Instead of seizing the moment, the Dodd-Frank Act simply layered—in historic proportions—more mandates and complexity onto the regulatory foundation that was established more than seven decades ago, a time that was closer to the Civil War than it is to today.

past due for an overhaul before the passage of the Dodd-Frank Act, and it remains so.

Prior to the crisis, a growing chorus of investors, businesses, and policy makers were sounding alarms that the U.S. system for financial service regulation was becoming dangerously overcomplicated, due to the layering-on of new structures over the years in response to each new crisis. Unfortunately, the recent financial crisis created a chaotic legislative environment and the ideal opportunity to include many ill-conceived regulatory mandates in the so-called “reform” legislation instead of rationalizing the U.S. regulatory structure.

Little in the Dodd-Frank Act addresses this fundamental concern. In fact, most of the



legislation adds to the problem. The mandate that resulted in the Dodd-Frank Act could have gone another way. A year before its enactment, Treasury Secretary Timothy Geithner recognized in congressional testimony the dire need for reform: “And [the administration’s regulatory reform proposal] will streamline our out-of-date regulatory structure so that our regulatory system matches the size, shape and speed of our modern financial system.”<sup>4</sup>

Unfortunately, a deliberate approach to true financial reform was not taken. Lawmakers did not address the outdated financial regulatory system from the ground up. The Dodd-Frank Act failed to clarify regulators’ responsibilities. The Act does not ensure that firms, persons, products, or services, that require regulation, would be overseen by a coherent system that minimizes regulatory overlap or provides mechanisms for resolving conflicts between regulators. Such a system would have made great strides in eliminating the all-too-common problem that different regulators, each possessing some degree of authority over a particular segment of the financial industry, apply different and often conflicting criteria.

The hallmark of the Dodd-Frank Act has been the creation of two new regulatory bodies—the Financial Stability Oversight Council (FSOC) and the Consumer Financial Protection Bureau (CFPB). By any measure, the launch of these two bodies has been an early disappointment. A year after the enactment of the Dodd-Frank Act, the FSOC and CFPB have only added to the confusion by


<sup>4</sup> Testimony, Treasury Secretary Timothy F. Geithner, Before the Senate Committee on Appropriations, Subcommittee on Financial Services and General Government (June 9, 2009).

While disappointing to date, the FSOC does appear to be equipped with the tools that could resolve conflicts between regulators and reduce counterproductive regulatory duplication.

introducing more overlap into the mix of federal and state authorities. Interestingly, the prospects for these two new agencies are very different. While disappointing to date, the FSOC does appear to be equipped with the tools that could resolve conflicts between regulators and reduce counterproductive regulatory duplication. The CFPB’s approach to the regulation of consumer financial products, on the other hand, presents new overlap difficulties that threaten to overshadow its important mission.

### **Financial Stability Oversight Council**

The principal subject of Title I (“Financial Stability”), the Financial Stability Oversight Council, was conceived to be a collaborative body representing the expertise of the heads of the federal financial regulators, an insurance expert appointed by the President, and state regulators. It has ten voting members and five nonvoting members. In addition to chairing the FSOC, the secretary of the Treasury holds an effective veto over the body’s most critical decisions—major FSOC decisions are finalized by the affirmative vote of two-thirds of the voting members, with the chair in the majority. Among the FSOC’s



authorities is “to facilitate information sharing and coordination among the member agencies regarding domestic financial services policy development rulemaking, examinations, reporting requirements, and enforcement actions.”<sup>5</sup> If the first year of implementation is any indication, this authority will be given secondary consideration.

### **Additional Layering**

The FSOC has demonstrated that it will approach its mission with a strong propensity to regulate systemic risk by layering more regulators on perceived problems. For instance, the FSOC can designate nonbank financial companies as “systemically important” to the financial system, thus subjecting them to prudential regulation by the Federal Reserve. These companies, however, will continue to be regulated by their primary federal, state, and nongovernmental regulators, without any clear responsibility or mechanism for the FSOC or these other agencies to resolve or eliminate overlapping or inconsistent regulations (see Figure 2).

Rather than introduce a new, modern system, these changes layered additional regulatory agencies, mandates, prohibitions, and oversight mechanisms onto the old, broken system. Furthermore, the failure to develop a comprehensive oversight mechanism with meaningful authority to address conflict and overlap has made the implementation of these changes costly, confusing, and uncoordinated.

Rather than introduce a new, modern system, these changes layered additional regulatory agencies, mandates, prohibitions, and oversight mechanisms onto the old, broken system.

### **Lack of Coordination**

As a body made up of the heads of the financial regulators and industry representatives, the FSOC appears to possess the tools to streamline financial markets regulation and, crucially, to serve as a forum to resolve jurisdictional disputes. The FSOC’s primary focus, however, has been the worthy but narrower goal to “eliminate gaps and weaknesses within the regulatory structure.” This focus fails to give the serious attention needed to eliminate the redundant and often inconsistent regulation inherent in a system of multiple federal and state regulatory bodies.

Achieving coordination among the regulators must be an FSOC priority. While eliminating gaps is a worthy goal, equally important is achieving regulatory coordination to ensure that the regulations that are put in place protect investors and consumers, ensure fair and orderly markets, and promote capital formation and a healthy business environment.

A recent example of the need for a regulatory dispute resolution forum centers on the extent to which states are preempted by federal regulations

<sup>5</sup> U.S. Department of the Treasury, *Frequently Asked Questions on the Financial Stability Council*, available at <http://www.treasury.gov/initiatives/Documents/FAQ%20%20FinancialStabilityOversightCouncilOctober2010FINALv2.pdf>.





Compared with other financial services regulators, the CFPB is immensely and uniquely powerful. Rather than being led by an independent bipartisan commission, the CFPB will be headed by a single director. Rather than being subject to the checks and balances of congressional oversight through the appropriations process, the director of the CFPB has access to up to 10% of the Federal Reserve's total operating budget.

Equally concerning is a lack of clarity surrounding the limits of the CFPB's reach. The CFPB has a very broad mandate to enforce the prevention of "unfair, deceptive, or abusive acts or practices" in the consumer financial products markets. Exactly what constitutes "unfair, deceptive, or abusive acts or practices" remains undefined, forcing the market to speculate as to what established business lines may be construed as subject to enforcement.

In addition to being broad and vague, the CFPB's jurisdiction over consumer financial products raises more of the regulatory overlap issues discussed above. While billed as an overarching regulator of consumer financial products, the CFPB will often exercise that authority alongside—but not necessarily in coordination with—the Federal Trade Commission (FTC), the banking regulators, and state regulators. Another layer of dual regulation brings with it the likelihood that different regulators will take conflicting stances, leading to inefficient use of regulatory resources and uncertainty for businesses.

The overlap of CFPB and FTC enforcement authority is particularly significant. To mitigate confusing or conflicting enforcement activities, the CFPB and FTC should draw clear lines

dividing jurisdiction of the industry. The CFPB should be responsible for companies whose principal business is to provide consumer credit, and the FTC should be responsible for "Main Street" businesses that provide a consumer financial product as an adjunct to their otherwise nonfinancial business.

Many details of the CFPB's reach in the market and the standards it will enforce are not clearly defined. Therefore, close scrutiny of its implementation will be critical. This will mean ensuring that the promises of transparency, access, due process, and other procedural safeguards are honored in meaningful and substantive ways. Still, given the lack of structural safeguards, combined with the lack of transparency and an exceedingly broad mandate, the CFPB appears set to inject new uncertainty into the compliance process that may lead to fewer, more expensive credit options for consumers and small businesses.

...given the lack of structural safeguards, combined with the lack of transparency and an exceedingly broad mandate, the CFPB appears set to inject new uncertainty into the compliance process that may lead to fewer, more expensive credit options for consumers and small businesses.





# FUNDAMENTALLY REFORMING REGULATORY AGENCIES

The Dodd-Frank Act left nearly every pre-crisis regulator intact and failed to address long-standing, fundamental weaknesses in the system. While increasing the workloads of the existing agencies, the Act did not introduce the critical infrastructural and process changes within agencies needed to restore regulatory efficiency and effectiveness.

The Dodd-Frank Act left nearly every pre-crisis regulator intact and failed to address long-standing, fundamental weaknesses in the system.

America's investors and businesses need effective regulators that understand the markets and businesses they oversee. As noted earlier, the U.S. regulatory foundation was put in place in the 1930s and since then has been updated only through an uncoordinated series of changes. Similarly, the basic structure of the legacy regulators was designed to regulate the markets of the 1970s, with only modest and incremental changes since then.


The financial crisis was a global and system-wide wakeup call to modernize the regulatory agencies, but fundamental and long-overdue internal reform within the myriad regulators has not followed. These agencies need a serious commitment to technology upgrades and process enhancements, a commitment

that will receive sustained support by the highest levels of the executive branch and Congress. While the SEC is by no means the only financial services regulatory agency that requires an overhaul, its case illustrates the multitude of problems that persist throughout our regulatory system.

## Manually Operated

Every day, businesses compete by using advances in technology and operational practices to improve their efficiency. This allows today's products and services to be offered more quickly and at a lower cost than in the past, making room for the investment in new and innovative products and services that fuel a new wave of efficiency. Driven largely by this greater efficiency within the financial services community, the past several decades have seen a significant increase in financial products and services available to businesses to meet their often specialized needs and demands.

A modern, well-regulated market is one in which the regulators also use current technologies and techniques to keep pace with marketplace developments. Unfortunately, the U.S. regulatory strategy relies heavily on manual processing and forcing businesses to slow down to the pace of government. This comes in the form of delayed action on exemption requests, approval orders, and rulemaking, to name a few. Meanwhile, financial services providers are limited in their



ability to meet businesses' demands for innovative products and services.

Without the appropriate tools to analyze the vast amounts of market information, regulators cannot help moving slowly. Delayed regulatory decision making stifles efficient delivery of the financial products and services today's investors and businesses demand. The demand for these products and services is real, and this "slow down" strategy can have only two consequences for businesses—in the best case, it forces them to go overseas to fulfill their needs, and in the worst case, it results in the unavailability of the products they need to manage risk, fuel expansion, and create jobs.

Simply allocating more money to the problem is not the solution. Indeed, the SEC's budget has increased 300% since 2000, but serious operational challenges persist. With a coherent strategy and investment in technology, the agency could substantially leverage its already significant investment in human capital. A greater focus on micro- and macroeconomic data and analytical analysis could dramatically improve the identification of troubling trends and reduce response times. The benefits would be twofold. First, detecting and addressing a problem more quickly reduces the amount of damage the problem causes. Second, addressing problems quickly serves as a much better deterrent than a long, drawn-out process.

The Madoff case is particularly instructive on both these points. Had U.S. regulators deployed relatively simple analytical tools to compare Madoff's market activity to the broader market

activity, Madoff's activities would have raised serious red flags long ago. Rather than the tragedy that unfolded, an expedited result to terminate the fraud could have sent a much stronger deterrence signal to others—perhaps even Allen Stanford.

### **Inefficient Structure, Siloed Operations, and Staid Culture**

The old reality of relatively mundane business and financial activity long ago gave way to the modern world of global economic activity, complex financial arrangements, and instantaneous execution of transactions. When times were simpler, banking, securities, and insurance activities were easily distinguished, and the assignment of regulatory oversight responsibility was straightforward and much more easily allocated among and within the various state and federal regulators. Distinctions were clear, overlap was minimal, and conflicts were quickly resolved.

Today, however, the overlaps, complexity, and interactions are overwhelming. The regulatory silos that once made sense now often serve as safe havens for regulatory power and undermine desperately needed coordination. Meanwhile, market participants are demanding and developing new products and services to meet growing

The regulatory silos that once made sense now often serve as safe havens for regulatory power and undermine desperately needed coordination.

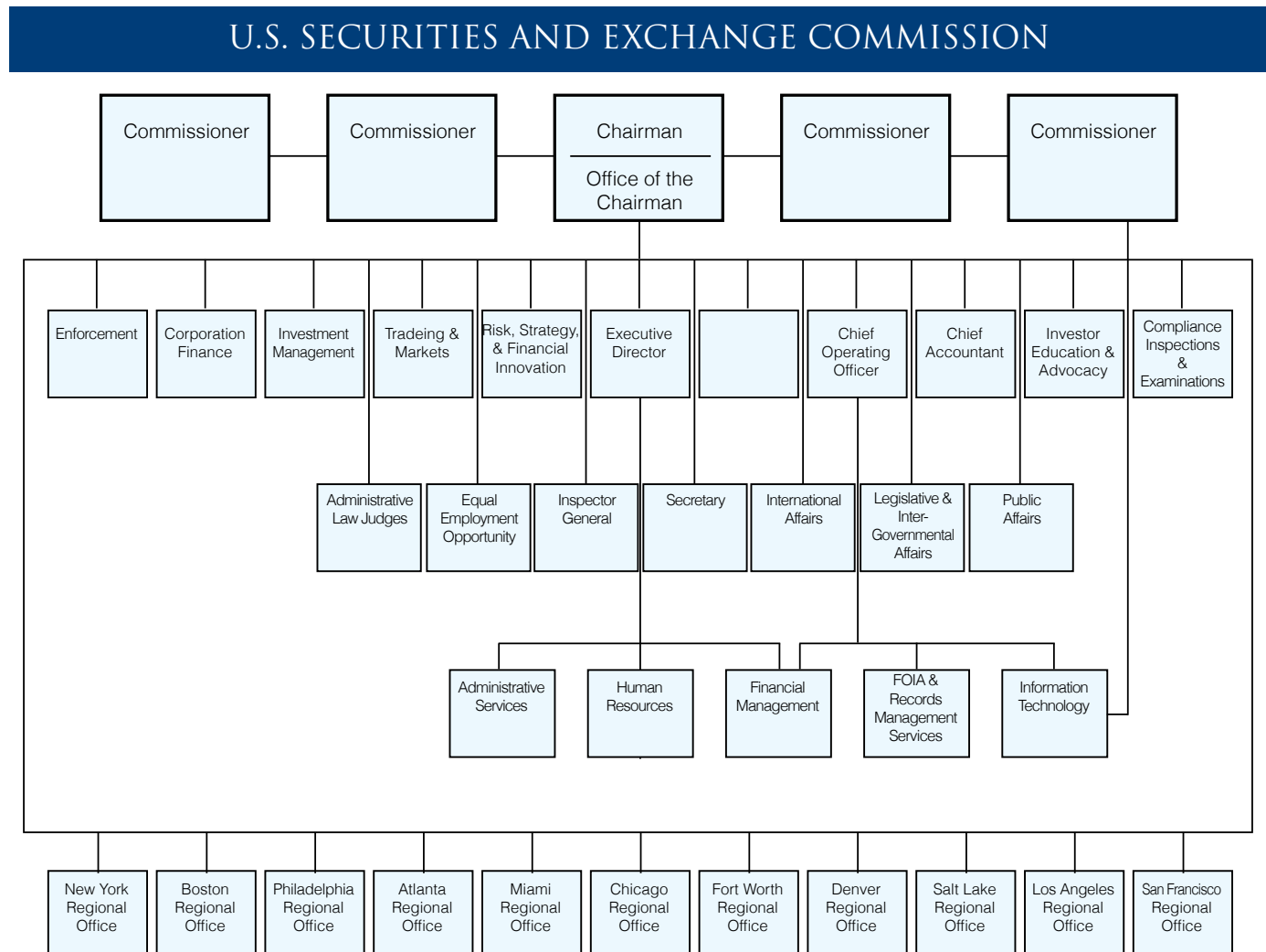
opportunities and challenges in the marketplace, and many of these new products and services—designed to fit a market need rather than a regulatory capacity—do not fit neatly within decades-old regulatory silos.

Organizational structures and reporting relationships play a vital role in the effectiveness of an organization. They send important internal and external messages about the organization’s priorities and inevitably influence the allocation of critical resources. The SEC organizational structure

Organizational structures and reporting relationships play a vital role in the effectiveness of an organization.

does not reflect a clear mission. The chairman of the SEC has 23 direct reports, which does not include the directors of the SEC’s 11 regional offices (see Figure 3).

FIGURE 3





## Streamlining Structures

U.S. financial services regulators need to give serious consideration to their organizational structures, focusing on their statutory mandates, organizational mission, and the grossly under-addressed need for regulatory coordination. This effort, however, needs to transcend lines and boxes on an organization chart and recognize that organization restructuring is just one step toward achieving a much greater objective.

For instance, although the SEC created the position of chief operating officer (COO) in 2010 with the purpose of “enhancing the agency’s efforts to refocus its resources and make the agency more efficient and effective,” the COO shares core operational responsibilities with the Office of the Executive Director. As noted by the Boston Consulting Group in its recent *Organizational Study and Reform* report for the SEC, “[t]his situation weakens the authority of both roles and limits them from providing relevant guidance to the operating divisions and adopting a broader approach to improving efficiency across the agency’s support functions.”<sup>7</sup>

## Reforming Culture

Effective reform also includes developing a culture that embraces and fosters change. Too often, entrenched regulatory staff become comfortable with their responsibilities and unwilling to accept—much less drive—the change that is needed to keep current with marketplace developments. Adding new divisions or realigning responsibilities to meet the changing marketplace dynamics requires

existing staff to adapt and, sometimes, accept a different or even lesser role.

Given today’s marketplace complexities, financial regulators need to develop much better communication and decision-making protocols to address overlapping responsibilities. For example, it is unacceptable that policy-making functions within an agency have one interpretation of a rule and the team of inspectors assigned to review for compliance has a completely different interpretation. The result is an incoherent regulatory environment in which market participants cannot rely on rules created through the established policy-making and interpretation process to inform and guide their compliance programs. This problem existed long before the financial crisis, and the layering-on of new agencies and increased responsibilities only exacerbates it.

## Confused Priorities

Successful regulation places a high priority on avoiding problems in the first place. Prosecuting fraud after the damage is done is important, but rarely do harmed investors receive a meaningful recovery. Likewise, hastily adopting new rules and restrictions in response to a market crisis only adds to the reactionary patchwork of regulation. The allocation of resources within an agency tends to indicate its priorities. For example, in 2010, the SEC devoted more than half of its budget to inspections and enforcement. The budget of the Office of Risk, Strategy and Financial Innovation, which is responsible for anticipating market problems before they occur, was less than half that of any of the policy-making divisions and

<sup>7</sup> U.S. Securities and Exchange Commission, *Organizational Study and Reform*, pp. 163–64, available at <http://www.sec.gov/news/studies/2011/967study.pdf>. (March 10, 2011)



approximately 3 percent of the inspections and enforcement budget (see Figure 4).

To head off problems, regulators must provide market participants with clear rules and guidance that spell out the regulators' expectations for market behavior, and diligently update these expectations to account for changes in the marketplace. These steps, however, must be in accordance with the requirements under the Administrative Procedure Act (APA).

Clear, up-to-date guidelines will provide the overwhelming majority of market participants who approach regulatory compliance diligently and in good faith the best opportunity to achieve compliance and identify bad actors early, before serious problems arise. In this environment, less

Successful regulation places a high priority on avoiding problems in the first place. Prosecuting fraud after the damage is done is important, but rarely do harmed investors receive a meaningful recovery.

reliance would be placed on enforcement actions, and the allocation of resources between policy-making and enforcement functions would favor proactive and informed engagement by regulators.

FIGURE 4

U.S. SECURITIES AND EXCHANGE COMMISSION: RESOURCE ALLOCATION				
	2010		2009	
<b>Enforcement Activities</b>				
Enforcement	\$355.5	33.6%	\$333.4	34.0%
Compliance Inspections and Examinations	\$229.4	21.7%	\$212.1	21.6%
	\$584.9	<b>55.3%</b>	\$545.5	55.6%
<b>Policy-Making Activities</b>				
Corporation Finance	\$131.2	12.4%	\$123.8	12.6%
Trading and Markets	\$54.1	5.1%	\$47.0	4.8%
Investment Management	\$47.9	4.5%	\$48.3	4.9%
	\$233.2	<b>22.0%</b>	\$219.1	22.3%
<b>Other Program Activities</b>				
Risk, Strategy and Financial Innovation	\$18.1	<b>1.7%</b>	\$14.4	1.5%
General Counsel	\$39.8	3.8%	\$36.9	3.8%
Other Program Offices	\$48.6	4.6%	\$45.1	4.6%
	\$106.5	10.1%	\$96.4	9.8%
<b>Overhead</b>				
Agency Direction and Administrative Support	\$128.5	12.1%	\$115.2	11.7%
Inspector General	\$5.4	0.5%	\$4.8	0.5%
	\$133.9	12.6%	\$120.0	12.2%
	\$1,058.5		\$981.0	



## Missed Opportunities

The private sector invests tens of billions annually in establishing, implementing, and monitoring governance, legal, and compliance programs to ensure that the capital markets are fair, safe, and liquid. Financial regulators must do more to leverage these commitments and efforts. The relationship between regulators and the compliance professionals they oversee must be extremely professional; that is, neither too comfortable nor adversarial.

Regulators and compliance professionals should have open lines of communication so that each is confident that they can seek and share information about emerging issues or challenges they are facing and work collaboratively to resolve the issues. Open two-way communication is critical so that regulators can learn more about changes in the marketplace and compliance professionals can better understand the perspectives and expectations of regulators.

A related issue concerns the impact of whistleblower bounty programs on the integrity of internal compliance programs. As discussed below, the increased reliance on these types of efforts ultimately undermines efforts to foster a corporate culture committed to legal and regulatory compliance.

## Balancing Regulatory Goals

Finally, when it comes to rulemaking, Congress and the regulators must take care to find a balance among important regulatory goals. The pursuit of one regulatory goal cannot be allowed to completely undermine another.

A glaring example of this problem emerged as Section 1502 in Title XV (“Miscellaneous Provisions”) of the Dodd-Frank Act, which requires companies registered in the United States to disclose and report to the SEC whether certain “conflict” minerals used in the conduct of their business originated in conflict zones in the Democratic Republic of Congo or an adjoining country. Under this requirement, companies will have to, among other things, describe the measures taken to exercise due diligence on the source and chain of custody of the minerals in their products. Even if they do not use conflict minerals, the process required to discover that fact is extremely costly. The SEC’s analysis of the economic impact of the rule claimed the cost of implementation would be approximately \$71 million, an amount calculated without reference to competitive burdens or compliance costs that would be borne by upstream companies not directly covered by the rule, but whose products are used by companies that would be subject to the rule.

Implementation difficulties have proven so great that the SEC delayed the final rule. The conflict minerals experience demonstrates the compliance difficulties that can result from regulators’ failure to appropriately balance priorities and take into account all consequences of a rule. By failing to provide a true estimate of the costs of implementing the conflict minerals rule, the SEC failed to find a reasonable balance in its threefold mission to protect investors, promote fair and orderly markets, and foster capital formation.



# MAKING NONGOVERNMENTAL POLICY MAKERS ACCOUNTABLE

Nongovernmental organizations' influence has grown dramatically over the past few decades, but their level of accountability to their constituents has not kept pace.

Nongovernmental organizations' influence has grown dramatically over the past few decades, but their level of accountability to their constituents has not kept pace. Rules established and enforced by nongovernmental organizations—principally the Financial Industry Regulatory Authority (FINRA), and Institutional Shareholder Services (ISS)—impact the capital markets much the same way as those of government agencies, yet they are not similarly bound by the APA, the congressional appropriations process, or other comparable checks on their power.


Marketplace changes over the previous decade—including the emergence of vibrant market centers outside the United States, stock exchange mergers, and initial public offerings—have fundamentally altered the nature and role of nongovernmental policy makers. The triggering events range from prescriptive legislative action, to exchange consolidation, to inertia and complacency by various market participants. In

all cases, these organizations have grown in size, power, and influence.

Unchallenged and largely unchecked, the influence of these organizations can be very detrimental to the development of vibrant capital markets. These organizations can, with few practical limitations, establish significant policies by arbitrary means and without any sound public policy or factual basis.

These nongovernmental organizations can, with few practical limitations, establish significant policies by arbitrary means and without any sound public policy or factual basis.

As these organizations grow and come to dominate the policy-making function, they can also have the dangerous effect of insulating—and isolating—congressional and government policy makers from the marketplace and changes in market activity and dynamics, thus undermining a central purpose for establishing independent expert agencies of the government. In most cases, the increased role of nongovernmental organizations in the U.S. capital markets is placing greater demands on the government regulators responsible for overseeing



these organizations. While this oversight is critical, it absorbs more time of government regulators, buffers them from the day-to-day activities of market participants, and exacerbates the growing problem of their being out of touch with the changing marketplace.

Despite the governing role these organizations play in U.S. capital markets, they are not subject to the traditional checks and balances associated with the American governmental structure. Certain core principles central to the operation and oversight of the U.S. capital markets should apply uniformly to government and nongovernmental policy makers alike, given their comparable roles and authorities over the marketplace. **Whether government or nongovernmental, all policy-setting organizations should have certain clearly articulated standards:**

- Substantive standards or principles upon which policy-making decisions are based;
- Procedural standards to be followed when engaging in policy-making activities; and
- Due process standards to allow private parties to challenge decisions.

For government agencies, these principles are generally found in their enabling statutes and in the APA. These laws set forth the substance and process for government decision making and the procedures for when an aggrieved third party seeks to challenge an agency's decision or determination. It is against these standards and procedures that the courts assess the activities of government agencies.

For nongovernmental policy makers, adherence to these principles is substantially reduced or, in some cases, nonexistent. In the past, for the most part, these organizations typically had governance structures and operational practices that were much more transparent to the public and policy-making influences that were far less significant and subject to greater control by the affected parties. Today, however, much of that has changed.

### **The Financial Industry Regulatory Authority and the Regulation of Broker-Dealers**

In the case of FINRA, the primary regulator of broker-dealers or securities firms, change began in the mid-1990s with an SEC-initiated organizational restructuring that substantially removed FINRA's members from involvement in the operations and policy-making functions of the organization. Prior to that time, FINRA—or the National Association of Securities Dealers, as it was then known—had been a member-run organization, whose officials gained their regulatory mandate from the members it regulated. Rather than a board comprised of experienced members from across the financial services industry, today's FINRA board consists of a majority of independent directors with limited or no experience working for a financial services firm.

More recently, FINRA's size, power, and influence grew tremendously when it combined with NYSE Regulation, the regulatory function previously affiliated with the New York Stock Exchange. Rather than having two independent regulators offering different perspectives, today's securities firms are overseen by one enormous nongovernmental regulator with substantial oversight by the SEC, but with substantially





reduced engagement with—and responsibility to—its own members.

As result of these changes, FINRA has moved away from the traditional notions of what it means to be a self-regulator. In the past, FINRA members exercised substantial influence and control over the organization’s operations, policy-making functions, and regulatory and enforcement priorities and determinations. Today, FINRA’s members no longer have a meaningful role in establishing policies and priorities.

While the trend for publicly traded companies and financial services firms has been toward greater transparency and accountability, FINRA has largely escaped these changes. Similarly, FINRA’s shift away from the traditional notions of a member-owned and controlled self-regulatory organization to a more governmental role has not brought with it the traditional checks and balances placed on government agencies. Transparency into FINRA’s governance, compensation, and budgeting practices is extremely limited and superficial. Furthermore, FINRA is not subject to the Freedom of Information Act or the APA, nor is it required to conduct a cost-benefit analysis when it engages in rulemaking or exercises its policy-making functions.


### **Institutional Shareholder Services and the Establishment of Corporate Governance Standards**

Of equal concern is the growing power and influence of Institutional Shareholder Services, the dominant provider of proxy voting advisory services to institutional shareholders, predominantly mutual funds and pension funds. ISS’s evolution into a de facto regulator has taken

Rather than having two independent regulators offering different perspectives, today’s securities firms are overseen by one enormous nongovernmental regulator with substantial oversight by the SEC, but with substantially reduced engagement with—and responsibility to—its own members.

a very different path than that of FINRA. ISS’s growing influence has been without any direct involvement with government regulators, but rather has emerged as a business response to government policies. Also unlike FINRA, ISS is a for-profit enterprise that is currently owned by a publicly traded company.

ISS’s business opportunity materialized when regulators of institutional investors—the Department of Labor with regard to pension plans and the SEC with regard to mutual funds—determined that voting corporate proxies was among the fiduciary duties of institutional investors. This, in effect, turned corporate governance and proxy voting into a compliance function within many institutional investors, and enabled ISS to develop one-size-fits-all governance policies and check-the-box voting practices to meet institutional shareholders’ compliance needs.



From the institutional investors' perspective, ISS's service allows them to outsource the function to a third party, whose purpose is to ensure that the institution votes all corporate governance matters consistently and that no votes are missed. From the perspective of a company about which ISS makes proxy voting recommendations, ISS represents a regulator whose policies must be complied with, because a negative vote recommendation from ISS can be outcome determinative in many corporate decisions that must be voted on by shareholders.<sup>8</sup> As a result, public company boards, under pressure to receive a favorable recommendation from ISS, are moving to a much more monolithic profile that is consistent with ISS's policy preferences.

FINRA and ISS are just two examples of nongovernmental agencies wielding substantial power. Others include the Financial Accounting Standards Board (FASB) and the Public Company Accounting Oversight Board (PCAOB). The FASB and PCAOB play central roles in establishing and interpreting accounting and auditing standards in the United States.

Regardless of the historical origin or the evolutionary path of these organizations, the need for them to abide by certain core principles becomes more critical as they grow in size and influence. When the authority to set policy standards and assess fees is delegated, in fact or in effect, then concomitant responsibilities must also be assumed, including the obligation to abide by certain minimum administrative procedures, to conduct and make decisions based on sound cost-benefit analysis,

ISS's growing influence has been without any direct involvement with government regulators, but rather has emerged as a business response to government policies.

to operate in a transparent manner, and to provide aggrieved parties due process.

### **Lack of Substantive Standards for Policy Making**

As noted above, the enabling statutes for government agencies generally establish the substantive standards by which the agency is to engage in decision making and rulemaking. These standards set forth the factors to be considered and the objectives to be sought. In many cases, multiple factors and objectives are to be considered, and the agency must balance competing interests and exercise informed judgment. Regardless, it is against these standards that the courts assess whether the agency met its statutory mandate.

Nongovernmental organizations engaged in similar rulemaking activities or influences, even if de facto, should be required to establish and adhere to substantially similar standards. Any nongovernmental organization engaged in activities that establish or substantially impact the policies and practices of a wide range of companies should be required to adhere to rigorous, substantive

<sup>8</sup> Stanford Graduate School of Business Corporate Governance Research Program, *Do ISS Vote Recommendations Create Shareholder Value?* available at <http://www.stanford.edu/group/knowledgebase/cgi-bin/2011/05/13/do-iss-voting-recommendations-create-shareholder-value/>.



policy-setting standards to go along with its delegated influence over the market.

Depending on the circumstances and role of the particular nongovernmental organization, these standards generally should be focused on achieving an appropriate balance among consumer protection, systemic integrity, and promoting economic growth. These standards should be carefully tailored to take into consideration the totality of the interests at stake and should not be set by arbitrary means or on a whim. Furthermore, these standards should be clearly articulated, and the nongovernmental organization should be held accountable for complying with them.

### **Lack of Procedural Standards for Policy Making**

Along with clearly articulated, substantive policy-setting standards, nongovernmental agencies should be required to adopt and follow procedural standards substantially in line with those set forth in the APA. This includes providing reasonable public notice and the opportunity for the public to comment in an open manner and with the input of the full range of market participants that will be impacted by the policies. It also means that the policy maker should be required to articulate its basis for the new policy and why it is consistent with the policy-setting standard, including how it addresses the concerns raised by commenters or why it chose not to do so.

All too often, these organizations hold out “standards” and “processes” that mimic the form of procedural standards but are entirely lacking in substance. It is unacceptable that these nongovernmental policy-making organizations

have governance, compensation, and disclosure practices that are less demanding and transparent than those they impose on third parties.

### **Inadequate Due Process**

Central to the U.S. legal and political system are notions of due process that include presumptions that people act in good faith, that the burden to demonstrate wrongdoing is on the government or accuser, and that aggrieved parties have a reasonable right to appeal unfavorable outcomes. Any nongovernmental organization taking on a regulatory role of policy making and standard setting should be required to adhere to the same due process obligations. A nongovernmental organization making determinations and judgments about the policies and practices of private enterprises should be required to provide meaningful and prompt opportunity to challenge or appeal.

Any nongovernmental organization engaged in activities that establish or substantially impact the policies and practices of a wide range of companies should be required to adhere to rigorous, substantive policy-setting standards to go along with its delegated influence over the market.



# RESTORING INTEGRITY TO LITIGATION AND ENFORCEMENT PRACTICES

Strong, vibrant capital markets depend on the fair and consistent enforcement of marketplace rules. Similarly, it is important to have reasonable mechanisms to provide redress to investors when they have been harmed by intentional violations or a reckless disregard for the rules. Restoring the integrity of the litigation and enforcement processes in the United States is as critical as reforming the regulatory structure and insisting that regulatory agencies—government and nongovernmental alike—be operated efficiently, effectively, and fairly.

All enforcement mechanisms—from private litigation to criminal prosecution—must be stripped of the multitude of perverse incentives that seriously undermine the value and integrity of the enforcement process. These long-standing problems continue to plague the competitiveness of the U.S. capital markets and were not addressed by the Dodd-Frank Act.

## **Rulemaking Through Enforcement**

Unlike the financial rewards available to the private bar to bring and settle class action lawsuits, the incentives for government regulators are more qualitative, but not necessarily less significant or troublesome. In too many cases, investigations are conducted by lawyers seeking to make a name for themselves in an agency that lacks sufficient internal oversight and self-restraint.

Rather than closing an investigation with no action and addressing an emerging concern through the rulemaking process, too often it is considered expedient to force a settlement with substantive undertakings.

To restore the integrity of the enforcement processes, it is critical to maintain a clear distinction between “regulation” and “enforcement.” Unfortunately, the terms are often confused and conflated. Put simply, regulation is the practice of adopting new rules to govern the future actions of market participants. Enforcement is the practice of holding market participants accountable for violating existing rules. While the distinction is well recognized in the law, it is too frequently blurred in practice.

To restore the integrity of the enforcement processes, it is critical to maintain a clear distinction between “regulation” and “enforcement.”

Regulations are adopted to achieve a broad public policy purpose. When proposing and adopting regulations, government agencies are generally required to follow certain procedures to ensure that their decision making is transparent and inclusive.



These procedures include providing advance public notice and a meaningful opportunity for comment, giving consideration to the comments received and the costs and benefits of the proposed regulation, and ultimately, providing a statutory basis for the new rule.

In contrast, an enforcement action is—or is supposed to be—focused on the application of an existing rule to a particular set of facts. This is not to say that enforcement does not play an important public policy function. Indeed it does, including serving as a deterrent. In an enforcement action, however, the burden is on the government to demonstrate that the defendant violated existing law. Unlike the regulatory process, where transparency plays a paramount role, enforcement actions are kept confidential to ensure the integrity of the investigative process.

The concern arises when regulators use their enforcement powers to engage in what amounts to rulemaking. This occurs when the government agency uses the pressure of an enforcement action to extract from a defendant or multiple defendants “undertakings” that go beyond any reasonable interpretation of the requirements or prohibitions in existing laws. The problem is amplified when the inspection authorities in these agencies then proceed to issue inspection reports to others, recommending that they adopt policies and practices in line with the undertakings. Over a relatively short time, these undertakings become imposed as part of the standard business practice without ever having gone through the rulemaking process.


## The concern arises when regulators use their enforcement powers to engage in what amounts to rulemaking.

In effect, these types of settlement agreements have all the force of rules, applicable to an entire industry. This approach negates the protections and benefits of the APA. Further, the negotiations around these settlements often take into consideration factors that are unique to the company under investigation, and its willingness to agree to certain terms is unlikely to be motivated by achieving a broad policy objective. As a result, the pros and cons of a regulatory requirement imposed in this manner are not fully considered. Further, less burdensome or more effective means of addressing the underlying concern do not receive full consideration.

### Political Grandstanding

In legitimate private litigation, the fundamental question comes down to, can the parties come to an arrangement that will resolve the dispute? When dealing with elected and politically motivated prosecutors, however, the steps necessary to resolve an investigation often are far less clear.

Though most prosecutors act in good faith and honor their ethical commitment to pursue cases in the best interests of the citizens they are sworn to protect, there can be strong incentives to engage in delay, political grandstanding, and other theatrics



designed to capture media attention, rather than take steps that would be in the best interests of the public and the markets.

In a world of 24-hour news cycles, there are increasing incentives to repeatedly get one's name into the headlines. Because, for all practical purposes, there are rarely negative consequences for crossing the ethical line, the growing rewards for grandstanding are causing more and more prosecutors to seek the benefits of publicity. Unfortunately, the only check on this type of behavior is self-restraint, and untoward motivations are too easily masked with insincere public displays of outrage.

### **Misguided Litigation Incentives**

The overall rise in the value of equity securities over the past several decades has brought with it plaintiffs' lawyers who use downturns in stock prices as opportunities to file shareholder class action lawsuits. Often with little or no evidence of any corporate wrongdoing, these "strike suits" serve as fishing expeditions where the plaintiff's lawyers use very aggressive—and often abusive—discovery tactics in the hope of finding some indication of wrongdoing and leveraging a settlement.

Unfortunately, the incentives to the plaintiffs' lawyers are so great—typically 30% of any award—and the burdens on the company so onerous—including the obligation to turn over vast amounts of corporate and business-sensitive documents—that many companies choose to settle rather than face the cost and distraction of litigation, much less risk potentially massive damage awards.

Frivolous securities litigation affects everyone—American businesses, investors, workers, retirees, and consumers. It transfers corporate assets from current shareholders to prior shareholders, depriving companies of valuable resources for business expansion and research and development. And all this occurs with the added privilege of paying a strike suit lawyer 30% for accomplishing the task.

Frivolous securities litigation  
affects everyone—American  
businesses, investors,  
workers, retirees,  
and consumers.

### **Whistleblowers**

Contributing to the excessive litigation issue are the increasing incentives being offered to corporate whistleblowers and their opportunistic lawyers. Section 922 of the Dodd-Frank Act directed the SEC to provide monetary incentives for, and protections to, corporate whistleblowers who provide information leading to successful SEC enforcement actions. In crafting this provision, Congress sought to ensure that the SEC takes whistleblower complaints seriously.

The rules adopted by the SEC, however, do more to benefit trial lawyers and, very regrettably, undermine effective corporate compliance and governance programs. The new rules entitle whistleblowers to an award valued between 10% and 30% of the amount collected by authorities

in federal securities law enforcement actions that result in amounts of at least \$1 million. The rules provide no incentive for whistleblowers to report allegations of wrongdoing internally and, in fact, provide incentives for them to bypass internal compliance programs altogether and reap the greatest reward possible. Moreover, legal, compliance, audit, and other fiduciaries can collect a whistleblower award despite the fact that they are the very people professionally obligated to detect and prevent wrongdoing.

The cumulative effect of the whistleblower rules is to undermine corporate compliance programs from the inside. Previously, whistleblowers were provided legal protections when reporting wrongdoing through internal compliance programs or similar reporting mechanisms. Now, they are offered serious financial incentives to keep companies in the dark by ignoring corporate compliance programs and going directly to the SEC with allegations of wrongdoing. This leaves expensive, robust compliance programs collecting


The whistleblower rules adopted by the SEC, however, do more to benefit trial lawyers and, very regrettably, undermine effective corporate compliance and governance programs.

dust, while violations continue, potentially increasing the value of the whistleblower's award, all to the detriment of shareholders and others who may be directly or indirectly harmed by the illegal activity.

Without a doubt, the SEC should have access to the information it needs to detect and deter fraud. Further, if a company is unwilling or unable to engage in effective self-policing, then establishing a balanced whistleblower program that allows individuals to bring actionable information to the attention of the SEC is reasonable.

FIGURE 5

The advertisement features a dark green background with a white scale of justice icon. On the left, a man in a white shirt and tie is smiling. The text on the right is in white and yellow. The headline reads: 'If you have information on corporate fraud, You may be entitled to MILLIONS in compensation.' Below this are three bullet points, each with a yellow square icon: 'Have information regarding corporate fraud and bribery? You may be able to file a SEC Whistleblower claim.', 'Millions have been won by people filing claims. Get compensation for helping stop corporate fraud.', and 'Do you have a claim? Fill out the form below to find out. Contact us for a FREE confidential consultation.'



However, not requiring immediate and simultaneous reporting to both the company and the SEC prevents quick action to investigate and solve problems. Companies rely on anonymous whistleblowers to provide information about malfeasance or fraud. With this information source cut off, companies must wait weeks, months, or years for the SEC to notify them about potential wrongdoing. The company is in the best position to immediately investigate and mitigate any violations, not the SEC, which will be inundated with thousands of tips it will not be able to handle.

The SEC's flawed rules will inevitably lead to trial lawyers urging whistleblowers to keep the company in the dark as long as possible to maximize any available bounty. Already, trial lawyers are running advertisements and training seminars on how to profit from bounty programs adopted under these rules (see Figure 5).

This is bad news for the shareholders and workers of any company victimized by a truly fraudulent actor. True long-term protection of investors will be achieved first and foremost by supporting the development and use of strong and effective internal compliance programs, not by offering bounties as encouragement to subvert

True long-term protection of investors will be achieved first and foremost by supporting the development and use of strong and effective internal compliance programs, not by offering bounties as encouragement to subvert compliance programs.

The recent shift toward reliance on whistleblowers is creating incentives that skew overwhelmingly in favor of direct reporting to the SEC, even when companies are willing and able to address reports through their internal compliance programs.

These results are directly contrary to the well-documented fact that companies and employees benefit, and scarce government enforcement dollars are preserved, when companies have the first chance to address corporate wrongdoing.





## U.S. COMPETITIVENESS AND ENGAGEMENT

By nearly any measure, U.S. competitiveness has been in consistent, if not rapid, decline for more than a decade. Whether this is cause for alarm depends, however, on the forces driving this decline and the steps U.S. policy makers take in response to these forces.

For most of the 20th century, the vibrancy of the U.S. capital markets was unmatched anywhere in the world, providing the capital to transform both the U.S. and the global economies. Entering the second decade of the 21st century presents a very different picture. At the same time the vibrancy of foreign capital markets is rapidly rising, many U.S. financial services policies are placing an unnecessary drag on—and, therefore, increasing the cost of—the domestic supply of capital.

In the past, the depth and liquidity of the U.S. capital markets was unmatched. Over the past 20 years, foreign market centers have developed regulatory policies, legal institutions, and other important structures that support the growth and development of domestic capital markets. This increased international competition, however, is not a negative factor for the U.S. economy. To the contrary, vibrant capital markets outside the United States offer many benefits for U.S. businesses and consumers. This increased competition brings with it a wider range of products and services and a lower cost of capital for U.S. and foreign enterprises alike.

Given these developments, the critical challenge for U.S. policy makers is to chart a new course.

Unfortunately, too often the U.S. financial services legal and regulatory structures and policies unnecessarily force capital markets activity out of the United States.

As noted above, this requires adopting modern legal and regulatory rules, systems, and structures to support today's financial services activity. It also requires a new era of engagement with the international community to ensure that the U.S. capital markets do not become isolated and fall behind their international counterparts. The recent financial crisis demonstrated clearly the interconnectedness of the U.S. capital markets with the rest of the global financial community and highlighted the need for a new era of international engagement and cooperation.

Unfortunately, too often the U.S. financial services legal and regulatory structures and policies unnecessarily force capital markets activity out of the United States. Not only does this increase the cost of capital for U.S. businesses, it undermines the U.S. competitive position and long-standing reputation for thoughtful and visionary leadership in this critically important area.

To ensure that U.S. capital markets remain competitive, policy makers need to develop



a new approach to U.S. engagement with the global financial services regulatory community. Going forward, U.S. policy makers must adopt a more cooperative and collaborative stance. The days of the United States dominating financial services regulatory policy are past, and the quality, credibility, and innovativeness of foreign capital markets centers has earned them a seat at the policy-making table.

### Financial Regulatory Cooperation

One of the failures leading to the implosion of the financial markets in September–October 2008 was the inability of financial regulators of various nations to cooperate with each other on cross-border issues. This was best illustrated by their failure to prevent the collapse of Lehman Brothers from almost triggering a shutdown of global capital markets.

Cooperation will make regulators more effective, offer certainty to investors and businesses, and provide mechanisms to prevent a meltdown of international capital markets.

While it needs to be recognized that major capital markets are dependent upon one another, global financial regulatory harmonization—as opposed to coordination—is unrealistic. The depth and breadth

of capital markets vary by nation, and domestic political interests play a role as well. The G-20 process has attempted to foster greater regulatory cooperation, and such efforts should continue. Cooperation will make regulators more effective, offer certainty to investors and businesses, and provide mechanisms to prevent a meltdown of international capital markets.

### The Volcker Rule

One of the most important steps in moving toward a more harmonized approach to global regulation is to ensure that significant new rules are adopted in a coordinated fashion. The United States' recent adoption of the Volcker Rule has been a failure in this regard.

Seeking to limit unnecessary risk taking is reasonable. Achieving this requires measured steps without impeding the entrepreneurial spirit that is so central to our economy and fuels business expansion, development, and job creation. Equally imperative is that any domestic measures adopted must be generally accepted outside the United States and fit comfortably into the overall fabric of global financial regulation.

The Volcker Rule should be repealed. It is neither a measured response nor consistent with the steps being taken by other jurisdictions in an area that is fundamentally a global issue. The Volcker Rule creates a system that is too rigid for vibrant capital markets and has significant implementation issues.

The Volcker Rule is proving to be unworkable and is harming the U.S. financial services sector by placing American firms at a competitive disadvantage. Through the Volcker Rule, the United



## The Volcker Rule creates a system that is too rigid for vibrant capital markets and has significant implementation issues.

States has instituted prohibitions on proprietary trading that other significant capital markets centers, including the European Union, have stated they will not adopt. Limiting the U.S. financial services sector in a manner that is incongruous with the international financial services sector will damage U.S. profitability and competitiveness. The majority of global financial regulators are taking a more measured approach, citing the inherent difficulty—if not impossibility—of defining proprietary trading as one of the many reasons to reject the Volcker Rule.

### Global Financial Reporting

Central to maintaining vibrant capital markets is having readable, reliable, and comparable financial statements and ensuring the fair and accurate presentation of financial information. In a global marketplace, this ultimately means achieving uniform accounting and auditing standards that are fairly and consistently applied and enforced.

Significant emphasis continues to be placed on the convergence projects of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Convergence is a critical step toward a single set of global accounting standards that will enable

investors, businesses, and other stakeholders to evaluate, compare, and use financial data through a common language. The convergence projects are important, and their proper implementation is vital to maintaining fair and orderly markets. The critical U.S. interest at stake is ensuring that global regulators—the IASB in this case—do not make unilateral decisions that could be imposed on U.S. businesses. The best way to avoid this situation is for the United States to provide leadership and become proactively engaged in developing these standards.

### Over-the-Counter Derivatives

Businesses from many industries across the United States benefit from the availability of over-the-counter (OTC) derivatives as a reliable and efficient way to hedge certain business risks by locking in otherwise volatile interest rates, currency exchange rates, or commodity prices. Over the past two decades, the U.S. OTC derivatives market has grown by offering these commercial hedgers, or end users, customization not available in exchange-traded derivatives.

End users enter into OTC derivatives customized to various unique underlying business risks. By matching a derivatives contract to its specific business exposures, a company can create an effective and cost-efficient economic hedge. These products, in turn, allow companies to deploy capital much more effectively than they could before. OTC derivatives have been a significant contributor to increased economic productivity and play an important part in job growth and shareholder return.



Imposing burdensome requirements on end users, such as the obligation to post margin, could quickly increase the cost of capital and harm U.S. competitiveness. U.S. businesses find these financial services and products invaluable and may seek to take their business outside the United States, and foreign markets will actively pursue this business.

By their very nature, OTC derivatives are often developed to meet the unique needs of a specific business transaction or series of transactions. As a result, many OTC derivatives cannot be standardized. This means that imposing central quote and trade reporting requirements, central trading and clearing requirements, and subjecting dealers to margin and capital requirements for OTC derivatives could decimate this valuable tool and undermine U.S. competitiveness in industries beyond financial services.

Yet, the rulemaking currently under way runs the very real risk of doing this. Imposing burdensome requirements on end users, such as the obligation to post margin, could quickly increase the cost of capital and harm U.S. competitiveness. U.S. businesses find these financial services and products invaluable and may seek to take their business outside the United States, and foreign markets will actively pursue this business.



## CONCLUSION

Significant risk looms over the U.S. economy—the illusion that the steps taken since the financial crisis have solved the problems that led to that crisis. The dramatic changes introduced by Congress and regulators must not be confused with progress. The gaps in the old system resulted from its complex matrix of overlapping and conflicting federal, state, and private regulators. Unfortunately, the response has been more of the same. The “new” regulatory system is the old system with more layers, regulatory mandates, and business prohibitions.

The response may have filled some of the gaps in the system, but this was accomplished with tremendous additional cost and reduced efficiency. Worse yet, some of the most significant changes undertaken by the United States were done unilaterally, creating an even greater gulf between the United States and other major financial centers around the world.

We have learned in stark terms that the health and vitality of our financial markets is closely linked to the health and vitality of our entire economy. Individuals and companies rely on the multitude of financial products and services available in the marketplace. The Dodd-Frank Act and other actions taken in response to the financial crisis are at best a giant step sideways, not forward. The U.S. Chamber of Commerce’s Center for Capital Markets Competitiveness is committed to exposing the weakness in our system and working to craft long-term solutions that restore U.S. leadership in the global capital markets.

The U.S. Chamber of Commerce’s Center for Capital Markets Competitiveness is committed to exposing the weakness in our system and working to craft long-term solutions that restore U.S. leadership in the global capital markets.



## ABOUT THE AUTHOR

### **Michael J. Ryan, Jr.**

This report is a compilation of the views of a wide range of financial services market participants—including investors, issuers, and financial services intermediaries—concerning many aspects of the U.S. financial services regulatory structure and the changes in that structure over the past five years. Michael J. Ryan, Jr. served as Executive Director to the U.S. Chamber’s Commission on the Regulation of U.S. Capital Markets in the 21st Century from February 2006 to March 2007 and then as Executive Director for the U.S. Chamber’s Center for Capital Markets Competitiveness from March 2007 to May 2008. Ryan has held a number of other capital markets-related positions, including president and chief operating officer of PROXY Governance, Inc., general counsel of the American Stock Exchange, counsel to the chairman of the NASD (nka FINRA), senior attorney at the U.S. Securities and Exchange Commission, and senior accountant with Price Waterhouse & Co.

## ACKNOWLEDGEMENTS

Special thanks to Kevin Wells, Senior Manager, Center for Capital Markets Competitiveness for his valuable and substantial contributions. Wells involvement was critical in ensuring successful completion of this project.





# U.S. CAPITAL MARKETS COMPETITIVENESS: THE UNFINISHED AGENDA

SUMMER 2011



CENTER FOR CAPITAL MARKETS  
COMPETITIVENESS

Compiled by Michael J. Ryan, Jr., Former Executive Director  
U.S. Chamber Commission on the Regulation of U.S. Capital Markets in the 21st Century