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Evaluating the boundaries of SEC regulation

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Abstract

Ostensibly, the SEC's new round of regulatory activity is motivated by a bout of well-publicized business scandals and an explosive increase in financial innovations and instruments. Many critics of the "new" SEC question the proportionality and usefulness of the responses, which move the SEC well beyond reliance on disclosure and promotion of transparency. Others argue that more heavy-handed and far-reaching regulation is necessary given the vast changes in financial markets, the increasing importance of (largely unregulated) hedge funds and private equity, and corporate scandals that allege fraud and deception. This paper provides a rationale for studying recent regulatory changes and for addressing the overarching question of how to define the boundaries of SEC intervention in financial markets. The study provides an overview of papers in this special issue and concludes with suggestions for how policymakers can use research to better evaluate the costs and benefits of regulation.

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1. Introduction

The papers in this special issue of the *Journal of Corporate Finance* consider aspects of defining the optimal boundaries of financial market regulation. The topic is timely given recent efforts of policymakers to go beyond their traditional domain of securities regulation and to expand oversight to the broader financial services industry and even corporate governance. Examples include the Sarbanes Oxley Act, passed by Congress and enforced by the U.S. Securities and Exchange Commission (SEC); federal mandates on board independence for mutual

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funds; Regulation Fair Disclosure (Reg FD); proposed regulation of hedge funds, and more. Ostensibly, the motivations behind this new round of regulatory activity have been a bout of well-publicized business scandals and an explosive increase in financial innovations and instruments.

Many critics of the "new" SEC question the proportionality and usefulness of the responses, which move the SEC well beyond reliance on disclosure and promotion of transparency, and into such murky debates as the appropriate composition of mutual fund boards of directors. Others argue that more heavy-handed and far-reaching regulation is necessary given the vast changes in financial markets, the increasing importance of (largely unregulated) hedge funds and private equity, and corporate scandals that allege fraud and deception, which may increase uncertainty and undermine investor confidence in the US capital markets.

Finding the right balance of fostering financial innovation, while imposing financial discipline, is not an easy assignment. Presumably, rules are desirable if they create value for investors in the capital markets and attract firms and capital to those markets. But even this simple test is not without its problems. Many of those harmed by the failure of Enron, for example, were not stockholders, but rather employees, customers and trading partners, so the impact of the collapse on these groups is not likely to be fully reflected in stock prices. And given the propensity of the U.S. government to intervene in major failures such as Long-Term Capital Management, and the collapse of the Savings and Loan industry, taxpayers have a stake in determining the rules of the game. The issue, of course, is not exclusively domestic. See Faccio, Masulis, and McConnell (2006) for international evidence regarding political connections and bailouts of publicly-traded companies by home countries. Clearly, multiple stakeholders affect regulatory outcomes, as contemplated by the economic theory of regulation (see Mulherin's review of the literature, this issue).

On the other hand, the U.S. does not have a monopoly on the provision of venues for raising and investing capital. This raises the question of how much of the capital flows into private equity and into other exchange venues is the result of innovation and the rise of competition among professional money managers and how much is attributable to the desire of firms and investors to avoid the increased regulatory compliance costs arising from such initiatives as Sarbanes-Oxley and Reg FD.

2. Motivation for the special issue

These issues and others were addressed at a conference held at Claremont McKenna College in February 2006. The conference brought together economists, lawyers and policymakers to discuss and analyze regulatory responses to innovations and practices in financial markets. The conference was intended to add perspective to the questions raised above by: reconsidering the underlying economic rationale for financial market regulation; presenting new evidence; and debating and analyzing whether, on net, current and prospective regulations encourage competition in financial markets or create anticompetitive impacts relative to alternative types of oversight, including self-regulation (SROs, trade organizations), market oversight (caveat emptor), and private litigation. The papers published here were presented as part of the conference. The papers reflect the range of topics that come under the rubric of "Boundaries of SEC Regulation".

3. Overview of papers

Litvak (2007-this issue), the winner of the *Best Paper Award* for this special issue, provides a unique perspective on the potential cost of Sarbanes-Oxley. While a number of papers have examined the effects of "SOX" (by examining stock returns, changes in accounting and registration behavior, etc.) the results have been difficult to interpret because of confounding effects of contemporaneous events. Litvak examines the law's impact on foreign companies that are listed in their home country and cross listed in the U.S. Each firm in her sample is matched with a company in the same country that is not cross listed. Her sample includes firms in 46 countries, representing five continents and all major legal systems. By comparing two sets of firms, one subject to the Act and one not, Litvak controls for broader economic and political trends. She examines stock returns over the period when SOX was being developed and put into law, and finds that investors expected the Act to have negative effects, with the biggest losers being companies from countries that have good overall levels of disclosure (most of Europe and Canada). The findings support the view that other countries find it costly to follow the U.S. regulatory model as embodied in SOX. Another implication is that other capital markets may gain at the expense of the U.S. market and that companies in developed markets are less likely to cross-list in the U.S.

The Litvak study is complemented by another paper in this issue. Wintoki (2007-this issue) studies the cross-sectional variation in wealth effects of SOX and the 2002 exchange listing requirements that the SEC and the major stock exchanges jointly developed for publicly traded firms. Both regulations impose a higher level of outside director monitoring on firms. In this study, the firms that have less beneficial (or more adverse) wealth effects from the regulations are those that, *a priori*, can be expected to benefit less from outside monitoring and have higher costs of monitoring: i.e., smaller and younger firms, firms with narrower industry focus, uncertain operating environments, and higher growth opportunities. The results are consistent with the concern that a "one size fits all" approach to regulation may be particularly costly for certain types of firms.

The SEC's main charge is to enforce the disclosure of material information. Four papers in this issue, along with a commentary by Bethel (2007-this issue), examine aspects of disclosure regulation. Rodrigues and Stegemoller (2007-this issue) evaluate the success of the SEC in applying consistent standards regarding disclosure rules. By examining acquisitions of privately-held targets, they find evidence of a regulatory "disconnect" between the SEC rules that define a "significant" transaction (i.e., targets that are 20% or more of the acquirer's assets) and what investors demonstrate is an economically important one. The disconnect arises because the SEC's disclosure rule is based on relative size of the transaction, so that acquisitions of targets that are large in absolute size may not be disclosed because they are small relative to the acquirer's size. As the authors show, such transactions can reveal important information about the acquiring firm, as evidenced by abnormal returns surrounding releases of financial statements that disclose the acquisitions. Moreover, changes in disclosure rules in 1996 and 2000 reduced the level of required financial statement reporting about private targets. These reductions are associated with an increase in the magnitude of absolute abnormal returns around the acquisition announcement, although the average return is small. The evidence suggests that changes in disclosure rules are associated with a reduced flow of important information to investors at the time of the acquisition, indicating that the changes have reduced the level of information in the market, potentially contributing to an unlevel playing field that favors those who happen to know of the transactions.

The other three papers on disclosure consider specific impacts of the Reg FD, regulation aimed at stopping the practice of companies making "selective disclosure" in favor of particular analysts and investors. One way for a company to avoid sanctions under Reg FD is to *not* disclose information to any analyst or investor, causing the *Wall Street Journal* and others to claim it is the regulation that "shuts firms up."

Evaluations of Reg FD have diverged, some researchers finding that the regulation has reduced information flow, and others finding that it levels the information-playing field for investors. These are not mutually exclusive effects. It is possible that the field is made more level by making less information available to everyone. If so, the expectation is that the market will exhibit larger reactions to the information when it does formally arrive. Along the lines of Manne's defense of insider trading (1966), an effective ban on selective disclosure may reduce the speed at which securities prices fully reflect relevant information.

Collver (2007-this issue) points out the difficulty of treating Reg FD as a natural experiment because decimalization of trades on US exchanges occurred at about the same time as Reg FD. He adopts a summary "informativeness" measure to assess the impact of Reg FD, and finds a significant decrease in informed trading after earnings announcements of NYSE firms. However, he finds that the switch to decimalization, which occurred at about the same time, had a much larger impact on the informativeness measure.

Two other papers in this issue take a different approach to evaluating the impact of Reg FD. These papers emphasize the use of cross-sectional data to investigate differential effects. Ahmed and Schnieble (2007-this issue) document a reduction in selective disclosure after Reg FD, but find that the market is less informed generally, especially about small, high-tech firms. Thus, it appears that to avoid selective disclosure, companies refrain from some voluntary disclosure. Their findings complement those of Gomes, Gorton, and Madureira (2007-this issue), recipients of the *Distinguished Paper Award* for this special issue. Gomes et al. find that Reg FD raised the cost of disseminating information to investors for small firms and for firms that must convey technical information. Following Reg FD, small firms lost analyst coverage while large firms gained coverage, and the authors document an apparent increase in the cost of capital for small firms. Their evidence suggests that prior to Reg FD, small firms could "buy" coverage by selectively disclosing information to analysts and that even though the allocation was selective, it may have increased the overall level of information in the market and the speed at which information was impounded in prices.

Another way to examine boundaries of SEC regulation is to consider the efficiency of disclosure requirements as they apply to innovations in the capital markets. Hu and Black (2007-this issue) evaluate the potential for both insiders and hedge funds and other outside investors to use share borrowing and equity derivatives to "decouple" voting rights from economic ownership shares, and whether SEC disclosure regulations cover these decoupling strategies. While various types of decoupling opportunities have been available for some time, what is new is the ability to engage in decoupling on a large scale with low transactions costs. The authors advocate that the current SEC approach to dealing with the disclosure of ownership could be both simplified and extended to address both voting and cash flow rights. They propose that enhanced disclosure of such positions may be desirable as it would allow market participants to assess and monitor how much of this type of activity occurs, and how it affects shareholder vote outcomes. They offer a theme for disclosure policy: that disclosure be simple, cheap and internally consistent; that the disclosure produces enough information to allow regulators and shareholders to assess the magnitude of decoupling activity; and that long and short positions be treated symmetrically.

Shareholder activism is another approach to dealing with perceived problems with board and managerial behavior. The SEC's rule 4a-8 is aimed at enhancing the role of shareholders in corporate affairs by allowing them to place proposals on annual proxy statements and to vote on them. To assess the impact of the rule in the post-Enron era, Thomas and Cotter (2007) contrast earlier periods with the 2002–2004 proxy season and find an increase in the number of such proposals that received majority shareholder support. They also document increased board responsiveness to the proposals, especially those associated with removal of anti-takeover defenses. However, stock market reactions to these proposals generally are not significant, suggesting that their impact may be mainly cosmetic. While more research is needed to determine if the lack of significance is explained by measurement problems in detecting wealth changes, the authors advocate keeping rule 14a-8 in tact as boards appear to be implementing a greater percentage of actions that shareholders propose.

Finally, Ferris and Yan (2007-this issue) examine the SEC's new involvement in the governance of mutual funds. In 2004, the SEC adopted reforms aimed at increasing board independence among mutual funds. The controversial move has been widely debated and is subject to ongoing litigation. Among the reforms is a mandate that at least 75% of a mutual fund's board consist of independent directors and that board chairmen be independent. The study questions the usefulness of these rules, as the authors find no evidence that "more independent" funds have lower fees, better performance, lower turnover rates, or lower likelihood of scandal. As with other studies published here, this study points to the need to adopt a more systematic approach to adopting regulation, an approach that takes into account cost effectiveness and that considers possible unintended consequences of regulation.

4. Conclusion

A common theme of the papers presented here, and one that comports with the tenor of discussion at the conference, is the need for a more thorough approach to evaluating costs and benefits of regulation, including "unintended" costs and benefits, along with a recognition that special-interest groups can and do play a role in the regulatory process. Re-examining the underlying rationale for regulation is a sensible first step, as it puts the burden on regulators (1) to be clear about objectives and expected results and consequences, and (2) to explain why the proposed regulation is superior (in terms of outcomes, costs, incentives, etc.) to either no regulation or to alternative types of regulation. While lip service is paid to the need for cost/benefit analysis, there is little consensus on the optimal way to structure or implement such analysis. One approach may be to expect regulators to set forth testable predictions associated with the regulations — that is, setting out what investors and voters should expect in terms of effects and the timing of those effects. For example, some of the Reg FD studies in this issue examine hypotheses that could have been formulated in advance of imposition of the rule. The evidence on how observed impact departs (or not) from expectations could be used as part of a systematic cost/benefit evaluation of whether to modify or eliminate the regulation. As many of the papers in this volume indicate, the effects of SEC regulation are economically important and are sometimes not the effects that were articulated by policymakers, or perhaps even contemplated.

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