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The Cox Revolution

BY CHRISTOPHER WHALEN

How the former U.S. lawmaker is changing the SEC.

With the selection of Rep. Christopher Cox (R-CA) to succeed William Donaldson at the Securities and Exchange Commission, the focus of the agency has changed from punishing the corporate guilty to seeking to improve protection for investors. Some cynics thought Cox's appointment represented the business community retaking control over the SEC from a relative moderate like Donaldson, but Cox is showing himself to be an activist in many respects, imposing new disclosure requirements on C-suite compensation and continuing a number of other initiatives begun under Donaldson, in particular the agency's push to improve the quality of disclosure by companies and mutual funds.

When Donaldson was appointed to head the nation's securities regulator in 2003, his mission was to restore confidence in the wake of the cascade of financial fraud scandals that swirled around corporations such as WorldCom and Enron. After the Bush Administration stampeded Congress into enactment of the Sarbanes-Oxley Act in the fall of 2002, Donaldson worked hard to protect the industry he helped to build even as he levied some of the largest fines and stiffest civil and criminal penalties ever on the Street's former clients.

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In many respects, the reformer reputation of Donaldson was undeserved. The former head of broker Donaldson, Lufkin & Jenrette was highly accommodative to the New York Stock Exchange and to corporate issuers alike. Seen through cynical eyes, the Sarbanes-Oxley legislation and Donaldson's subsequent "reform" efforts at the SEC were simply a means of distracting attention from the enabling role that the NYSE, NASDAQ, and SEC too played in the fleecing of American investors with the New Economy bubble, a role abetted by an assortment of well-compensated investment bankers, lawyers, auditors and other supposed gatekeepers. Just ask New York Attorney General Eliot Spitzer.

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As Wall Street focuses on future earnings rather than the current performance of a company or bank, policymakers in Washington are tasked to maintain the perception of solidity rather than solve intractable problems such as proactively detecting corporate behavior, and Donaldson did the job. Under the former investment banker, executives were fined, hedge funds spanked, and mutual funds investigated, but issues like soft dollar payments to brokers and the use of arbitration to conceal the bad acts of Wall Street were left off the table. Indeed, during Donaldson's tenure and apparently with his approval, Congress passed "bankruptcy reform" legislation that allowed investment bankers to "advise" the very same companies they previously helped into insolvency.

Yet even with Donaldson's careful custodianship of the Wall Street status quo, members of

The Handoff

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—*C. Whalen*

Current SEC Chairman
Christopher Cox

Former SEC Chairman
William Donaldson

Congress, the Bush Administration, and organizations such as the U.S. Chamber of Commerce became uncomfortable with Donaldson. His seeming penchant for new regulations and for the magnitude of fines levied on corporate wrongdoers, part of the public façade behind which he protected the Street, caused outright distress in some quarters, but then only feigned.

An important part of the political kabuki show came when Donaldson repeatedly split the SEC by passing many contentious proposals without the support of the SEC's two Republican appointees. Another dramatic moment came when the U.S. Chamber of Commerce sued the SEC to block Donaldson's regulation to compel hedge funds to register. On the eve of his resignation, with rumors abroad that he had been fired by the White House, Donaldson forced through new regulations for mutual funds that likewise were not supported by the SEC's two Republican commissioners.

Loud harrumphs were audible all over Washington as Donaldson departed, but the basic relationship between Wall Street and its victims remained unmolested by the SEC. While the Commission and the various self-regulatory organizations in its orbit made a great show of increasing regulation in the post–Sarbanes-Oxley period, it has been the onset of technology that has caused greater discomfort to the Street than any new edict emanating from Washington. The adoption of decimalization and improvements in electronic trading and other technologies are combining to destroy the human markets Bill Donaldson worked so hard to protect.

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Two intriguing policy issues have surfaced early in Cox's tenure, both arising from the former prosecutor's Silicon Valley background. First, it is said that he believes that the Internet and other electronic means should be relied on more to make documents available to investors. This is fine, but it means little if the documents themselves are flawed because companies in Silicon Valley and the financial community, to cite two leading examples, choose not to accept Generally Accepted Accounting Principles (GAAP). Yet Cox seems very well-versed in the issue, even to the point to uttering the word "taxonomy"—meaning the vocabulary for describing each entry in a financial report—in public statements.

Second, whereas the world according to Donaldson was one that did not threaten the dominance of the New York Stock Exchange in the U.S. equity markets, Cox seems intent upon introducing new technology throughout the marketplace that will eviscerate the number of people employed by the major exchanges and many vendors as well. Even as Cox supports new regulations that, for example, require corporations to better disclose the full scope of compensation paid to executives, the significance of the technology revolution being lead by Cox is not well understood by either side of Wall Street.

One of the more significant initiatives is the SEC's embrace of "interactive data" for use in all filings with the Commission. In remarks delivered to a January 2006 meeting of scientists and software vendors pushing for adoption of eXtensible Business Reporting Language or XBRL for SEC reports, Cox noted that one reason the SEC is interested in interactive data is that "obtaining and crunching financial information faster and more easily will strengthen our ability to police wrongdoers, and prevent fraud. But that isn't the whole story by a long shot."

Cox continued: "No, the real basis of our interest in interactive data at the SEC is our fundamental mission: to protect investors. As Fed Chairman Alan Greenspan recently told me, the best investor protection is a growing economy and a rising market. The SEC performs its highest and best function when we contribute to general prosperity by ensuring that markets function the way they should."

It is worth noting that the Fed under Alan Greenspan has never admitted to targeting the per-

formance of the private financial markets as an explicit component of monetary policy, but Cox's statement certainly squares with the Fed's de facto policy of bailing out insolvent banks and hedge funds which threaten market stability. Long Term Capital Management and Bankers Trust Co. are just two examples where the Fed suspended "market forces" to ensure that Wall Street's virtual casino remained open.

In April 2005, the Commission began a voluntary program for receiving financial information using XBRL, a computer language which is essentially a marriage between the ubiquitous transport capabilities of XML and an accounting taxonomy, hopefully one that is consistent with GAAP. The SEC calls languages like XBRL "interactive," but more specifically the numeric data and text is structured so that as to be machine readable. It is the complex library of analytical rules applied by the computer, not the data itself, which make the entire product appear "interactive."

The SEC program allows for the voluntary submission of XBRL documents as exhibits to periodic reports from corporate issuers and Investment Company Act reports. Companies that participate in the voluntary program's new test group will furnish to the SEC financial data contained in their periodic and investment company reports in XBRL format for at least one year and provide feedback on their experiences, including the costs and benefits associated with reporting in the interactive data format. Among the companies that have taken the dive to "tag" their SEC filings in XBRL so far are Microsoft, Morgan Stanley, and United Technologies, but more will follow as the SEC encourages participation with a variety of incentives, another characteristic of Cox's free market approach to regulation.

With the adoption of an XML-based data format, the SEC hopes to improve the ability of investors to analyze company behavior. Says Cox: "We'd like to see the democratization of financial information and analysis, and the empowerment of individual investors. Software that consumers can use to help make wise investment choices, designed either for their personal use or integrated into websites, will run the gamut from RSS feeds about companies and funds to analysis tools built into personal financial software."

It remains to be seen whether the SEC's initiative to empower investors will, in fact, use interactive data to perform more extensive financial analysis or simply do more or less the same work in a reduced amount of time. But the advent of fully structured SEC reports does suggest an intriguing scenario, a future where the U.S. marketplace is governed by a far more efficient, even dangerous, securities agency that has real-time access to all data filed by mutual funds, public companies, and significant investors.

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As the SEC arms its personnel with surveillance tools enabled by interactive data, the possibility exists that it will make a quantum leap in terms of the "visibility" of corporate deviation, to pilfer the Sell Side analyst term for clarity in earnings guidance. By the time Chairman Cox is finished with his campaign to modernize the SEC's technical capabilities, he may have begun a process that will inevitably lead to the creation of an agency that far outstrips the bank regulatory community in potential to identify anomalies and correct them, either through civil penalties or other sanctions on managers, and their lawyers, auditors, and banksters.

Whereas Sarbanes-Oxley entails a great deal of expense for public companies, the prospect of a regulator that can actually discern when a company's financial behavior is out of line with historical patterns and its peers holds out the possibility of catching events such as HealthSouth or Parmalat. Both for the managers of fraudulent companies and funds, and the professionals who advise them in committing such transgressions, the prospect of a technologically empowered SEC could very well make dealing with the requirements of Sarbanes-Oxley seem sublime by comparison. ◆