

Remarks of Alan L. Beller: Some Thoughts Regarding Capital Markets Regulatory Reform

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Thank you for that kind introduction. It is a pleasure for me to be here today at New York Law School to speak with you. Venues of this sort provide all of us with an opportunity to learn, and I am hoping that my remarks here today, which address potential capital markets regulatory reform, will provoke both discussion at today's program and further thinking on the subject.

The competitiveness of the U.S. capital markets has become a major subject of attention in recent months. Senator Charles Schumer and New York City Mayor Michael Bloomberg have released a report on the subject prepared by McKinsey. The Committee on Capital Markets Regulation, endorsed by Treasury Secretary Henry Paulson, has also released its interim report. The subject has also been addressed in numerous editorials and speeches, including briefly by President Bush in his State of the Economy Address at Federal Hall in New York on January 31, 2007 and at more length by SEC Chairman Christopher Cox in San Diego on January 24.

The Schumer-Bloomberg report stands out so far for the breadth of its analysis. It considers a broad range of issues of securities law and regulation, as well as additional issues, such as immigration. The Schumer-Bloomberg report conducts an empirical analysis that suggests that the United States, and New York City in particular, is today the world's leading capital markets center, but that the leadership position is eroding, arguably to the point that in a few years it will disappear. While I might look at different data, I do not quarrel with either conclusion.

The reasons are much harder to agree on. Almost all the evidence suggests that a large part of current and probably future developments is caused by the combination of advances in information technology and communications, which now after years of prediction really have resulted in global markets, and the increasing quality (including regulatory quality) and liquidity of non-U.S. markets. Institutional investors the world over (including from the United States) are prepared to entrust billions of dollars in investments in companies listed only in Hong Kong, or only in Brazil, and certainly only in Western Europe. That will not change significantly even if modifications in U.S. regulation occur.

Nonetheless, both the Schumer-Bloomberg study and interim capital markets regulation committee report call for liberalization of U.S. legal and regulatory requirements in order to capture whatever partial benefits might be achievable. While I agree that regulatory modification can strengthen the position of U.S. capital markets, I also believe that the activities and metrics on which the competitiveness debate has been focused are somewhat off-the-mark. I would focus the debate on two fundamental points of competitiveness that have received only limited attention. I further believe that considering those points lead to particular areas of securities regulation in which to seek approaches to maintain the leadership positions of U.S. markets. (I leave other subjects, such as immigration and even litigation and auditor and auditor liability reform, to others or at least to another day.)

My first fundamental point is that the competitive leadership position of the United States or any other market center depends on transactions being executed there. Transactions, not listings or issuances or ownership of financial instruments. Companies from essentially anywhere can list in any major market in the world. Investors from essentially anywhere can invest in any major market in the world. And a listing in Hong Kong does not mean that capital is being raised in Hong Kong. And a company's listing in Hong Kong, or in New York for that matter, does not mean that future capital raising activities by that company will be in the listed market. The talismanic importance attributed to listing in the reports and debate to date is unjustified. Rather, where are the deals being done? Is the salesman or trader or computer terminal located in, and bringing business to, New York or London?

The second fundamental point is that the leading international financial institutions, whether they are based in the United States or Europe or elsewhere, have become essentially agnostic with respect to the location of their business transactions. They are global in their span of activity and well established in all of the plausible leading financial centers. Those centers are all places where in their view the regulatory system is sufficiently developed and robust to protect the institution's interests and to foster adequate investor confidence. There is no longer any built-in preference for New York or Zurich or Frankfurt or London. Where is it easiest, most convenient, cheapest or most remunerative to execute a transaction? London's growing attractiveness has nothing to do with the success of London-based institutions. (There is only one left among the leading international financial institutions.) Rather, if it is preferable to securitize English mortgages in the United States, the transaction will be executed there. If London is the better place to execute a complex over-the-counter derivative transaction with a U.S. counterparty, the transaction will be executed there.

Where do these points suggest we look to maintain the leadership of U.S. markets? Surely not to weakening the reforms contained in the Sarbanes-Oxley Act. That the decline in competitiveness of U.S. markets is attributable to SOX is an old saw that has now been repeated enough times that it has taken on a life of its own. And perception is reality to some extent. But it is instructive that both the Schumer-Bloomberg and the interim capital markets regulation committee reports focus their recommendations for reform efforts

regarding SOX on the burdens of application of Section 404 regarding management assessments and auditor attestations of the effectiveness of internal control over financial reporting. They are correct, and the SEC and the Public Company Accounting Oversight Board are in the process of trying to do just that. I believe over time they will succeed.

As to the rest of SOX, some of it has been very beneficial and has improved our markets. I would cite in particular the provisions calling for increased responsibility, more properly aligned incentives and better tone at the top (including the requirements of CEO and CFO certifications) those fundamentally changing the mode of regulation of the auditing profession and those calling for greater attention to the independence of auditors and audit committees and to financial reporting generally. Importantly, it is clear that a number of other jurisdictions are addressing many of the same subjects as SOX does, though not necessarily using the same approaches. In any event what I now want to address is more important than reforming SOX.

My transactional view of competitiveness suggests that among the principal areas considered for securities offering reform should be the following:

- Direct regulation of the activities of financial institutions;
- Provisions of the securities laws that prohibit certain products or transactions for reasons other than fraud; and
- Better-coordinated and even unified oversight of financial markets by the various U.S. regulators.

First, the quality of securities regulation of financial institutions, which are after all the entities operating in those financial centers, has a direct and substantial bearing on competitiveness. The situation in the United States, with detailed and prescriptive regulation, including of institutional business, and duplicative and overlapping regulations, inspections and examinations, imposes management and financial burdens that do not exist in overseas financial centers. And because they can execute from anywhere, large global financial institutions have shifted and will continue to shift business and transactions outside the United States in response to those burdens. Regulators should therefore be very careful and granular in weighing the investor protection advantages of regulations against their burdens, especially where institutional customers are concerned. Unnecessary and unnecessarily prescriptive rules should be eliminated.

This is very definitely not a plea for “light touch” regulation or for the abandonment of investor protection. And continual disclosures about banks’ and dealers’ fraud, over-reaching, conflicts and other unlawful or unethical conduct do not make it easy to argue for less regulation. But effective regulation that continues to attack vigorously all of the

actionable or objectionable conduct we have seen does not also have to mean unnecessary regulation.

The rulebooks of the SEC, the National Association of Securities Dealers and the New York Stock Exchange and other exchanges each have many examples of rules that cost broker-dealers time and money and that do not serve an adequate investor protection purpose. Do boilerplate legends on institutional research advising institutional customers that a broker-dealer may hold positions in or engage in transactions in or advise issuers of securities discussed in the report really serve an investor protection purpose? Do regulators and self-regulators spend their time and their subjects' money wisely trying to devise and then impose a methodology for treating the London subsidiary of a U.S. financial institution as a branch office? What kind of information should be required to be disclosed regarding mark-ups on trades for institutional customers? How much detailed prescription is required? How many inspections and examinations of one broker-dealer or one business unit are appropriate?

Fortunately, an opportunity now presents itself that could be used to determine whether effective regulation and regulatory reform can co-exist. The National Association of Securities Dealers and the regulatory arm of the New York Stock Exchange, known as NYSE Regulation, have agreed to combine. The combination, which has been praised as an important regulatory reform effort by SEC Chairman Christopher Cox and others, should merely by its consummation provide more effective, more efficient and less duplicative regulation. However, more is possible and should be achieved. This is a "once-in-a-lifetime" opportunity to start afresh from first principles in devising a better regulatory approach and writing a better regulatory rulebook. The new organization should attempt to embark on at least the following:

- They should undertake a far-reaching and serious effort to create separate regulatory regimes for institutional and retail business. I don't mean just bolting on some different rules for conduct of institutional business. I mean two completely different starting points, including an approach for institutional business that eschews both paternalism and boilerplate for a sensible relationship that takes the knowledge, background, sophistication and wherewithal of the customer and the different characteristics of markets that are essentially institutional (such as structured finance, over-the-counter derivatives and many parts of the fixed income market) into account. Much of the basic protections for investors would be common to the two markets, but much would also be different. In most cases the regulation of retail business would be more detailed and prescriptive. But in some areas institutional customers might deserve protection where retail investors do not need it as much. For example, front-running large block trades is less of a concern to retail customers than to large institutional ones.

- The new combined entity should try to create a rulebook that starts with an articulation of the objectives of regulation. I am confident of the advantages of approaching regulation in a principles-based manner—witness the asset-backed regulatory regime and the executive compensation disclosure rules that the SEC worked on while I was the Director of the Division of Corporation Finance. I am also wary of over-use of the term and over-promising its benefits. And I am absolutely certain that this is one of those areas where it is clearest that “the devil is in the details.” So I know how challenging such an approach will be. But the NASD starts from a history of perhaps the most principles-based regulatory scheme in the securities field, since a non-trivial portion of its rules follow from its requirement that members must embrace “just and equitable principles of trade.”

I believe the key to a principles-based system of regulation is first to articulate the objective of a particular area of regulatory interest. For example, an objective can involve the management in a customer’s interest of conflicts that arise within a multi-faceted financial institution. That provides the basis for further implementing rules. For example, are there guidelines for conflicts that should be prohibited rather than disclosed? Are there ways to provide for mandated meaningful disclosure and not mere meaningless boilerplate legends? In what areas if any are detailed prescriptive rules the best approach, as opposed to rules that articulate an objective and leave implementation to members? As noted above, one point to keep in mind in trying to adopt a principles or objectives-based approach is to proceed separately for institutional and retail businesses. The results could be strikingly different I believe.

One of the objections of regulated entities and legal practitioners to more general rules requiring judgment to implement is that the lack of certainty opens them and their clients to enforcement risk. For an objectives-based regime to work, compliance departments must avoid the customary clamor for bright lines (because they too often become the overly prescriptive rules that later raise objections) and regulators have to let institutions exercise reasonable judgment without fear of “gotcha” enforcement.

- Finally, and this is more an issue of enforcement philosophy than the form of a new rulebook, the new organization should develop a range of compliance and enforcement approaches and use them as appropriate. Enforcement investigations and proceedings clearly have an important place. But the absence of more prudential complements leaves both regulators and market participants in a position where early intervention to foster compliance initiatives or even best practices is often difficult or impossible to achieve. Simply put, not every information gathering exercise should be with a view, or solely a view, to enforcement activity. Sometimes investors and

markets will be better served by personnel from the new organization and its members consulting and working out approaches to newly emerging issues. The NASD's recent approach to a gifts policy is an example of such an approach. It is not a plea for weaker enforcement to suggest this should happen more in the future.

Second, while the U.S. securities law regime is often referred to as disclosure-based, it too often prohibits the offering of particular products or the execution of particular transactions. These prohibitions are not fraud-based. Many of them derive from the substantive prohibitions of the Investment Company Act or the treatment of different categories of financial instruments under the U.S. securities and commodities laws. In most cases the prohibited products or transactions are accommodated in other jurisdictions. These prohibitions should be eliminated where they can be consistent with investor protection. And I believe that in most cases investor protection will best be served by proper disclosure and suitability or "know-your-customer" standards.

Regarding the Investment Company Act, for example, so-called "permanent capital" vehicles generally cannot be publicly offered or listed in the United States. These vehicles are essentially investment funds where the investor achieves liquidity not from a payout by the fund but by a sale in the market—hence they constitute "permanent capital" for the managers operating in the private equity or other areas. Offerings of these funds are being carried out, and their shares listed, outside the United States. U.S. investors, including U.S. investors operating from offshore, are investing. A business is being developed in London and not in New York solely for regulatory reasons. Is there really no regulatory regime under which transactions involving these products cannot be responsibly carried out in the United States? There is a statement in the Schumer-Bloomberg report that suggests these products are being developed in London to "avoid regulatory requirements associated with a U.S. listing" under the Investment Company Act. It is in fact worse than that—these transactions cannot be executed in the United States under the Act's prohibitions.

The SEC has never attempted a broad modernization of its rules under or its administration of the Investment Company Act. The SEC succeeded in using its broad exemptive authority in 2005 to achieve far-reaching modernization of the rules for capital formation under a different regulatory scheme, the Securities Act of 1933. Some of the changes implemented under Securities Offering Reform, for example the enabling of written offers outside the statutory prospectus, reversed more than seven decades of restrictions because intervening market and technological developments left those restrictions without a public policy purpose. It may be time to consider an equally far-reaching step under the Investment Company Act. The SEC has similar broad exemptive authority and could use it to eliminate some restrictions, which amount to prohibitions on offering certain products and have outlived their public policy purpose. Examples of restrictions that might be examined include those on performance fees and fund leverage.

The Schumer-Bloomberg report identified another product area where transactions are being broadly executed in London and not the United States—namely derivatives. Here too a significant problem is a U.S. regulatory regime that prohibits transactions or substantially restricts them where they can be executed outside the United States, including in some cases with U.S. investors. Other U.S. investors can execute them by transacting business offshore.

In this case one culprit is a U.S. regulatory regime that does not provide for uniform regulation of financial products. The Commodities Futures Modernization Act addressed some of the anomalies. However, there is still different or overlapping regulatory treatment of securities and securities options products, futures products and securities futures products, and different treatment still of at least some over-the-counter swap transactions implicating securities or securities futures. The consequence of this crazy quilt is that some transactions cannot be executed at all, or only with difficulty, by financial intermediaries in the United States. Yet there is demand for these products, and in some cases strong demand, so the market for executing these products has moved outside the United States. Innovation and technology for the most part developed in the United States is now being used to transact business elsewhere. Again, I believe there is a policy approach that would permit a single, or at least a coordinated, regulatory approach that relies more on disclosure and suitability or “know-your-customer” rules and less on intentional or inadvertent prohibitions to regulate such an important market.

And this point actually segues nicely into my last suggestion, which is to seek to have better coordination of regulation, or even unified regulation, of financial institutions and financial markets that would eliminate overlapping and duplicative regulation. On the derivatives side, this would involve a significant change towards combination of, or at least joint oversight by, the SEC and the CFTC. Under SEC Chairman Cox and CFTC Chairman Reuben Jeffrey there has already been closer cooperation between those agencies than previously, for example in setting margin requirements for securities futures products. But what I am calling for is much more far-reaching—ideally a unified regulatory system that would to the extent possible under current law subject financial instruments generally to a single unified regulatory regime. Only an aggressive effort in this area will reverse or even slow the offshore march of derivatives business, including such business with some U.S. counterparties, that has no proportionate investor protection benefits.

Another inter-agency effort would be appropriate for regulation of financial institutions. Broker-dealers that are subsidiaries of banks are subject to both banking and securities law and often commodities law regulation. There, too, better coordination could increase efficiency and reduce burdens with no cost in investor protection. The so-called Paulson committee report calls for the President’s Working Group to address regulatory reform. An early agenda item could include inter-agency cooperation, since the four members of the

Working Group—the Department of the Treasury, the Federal Reserve Board, the SEC and the CFTC—are the agencies that need to coordinate and cooperate in this area.

I will stop at this point. I appreciate both your time and attentiveness. Potential capital markets regulatory reform is a timely subject, and one worthy of ongoing consideration and continuing development of possible approaches and solutions. I hope that my remarks today will stimulate both discussion and additional thinking. To start off that discussion, I would be pleased to take your questions.

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