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A Changing of the Guard at the SEC: Will Corporate America Get a More Sympathetic Ear?

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During his 28 months as chairman of the Securities and Exchange Commission, William Donaldson turned out to be something of a surprise. A longtime securities industry insider, Donaldson was appointed by President Bush to calm the waters after the controversial term of Harvey Pitt. But Donaldson, a Republican, repeatedly sided with the two Democratic commissioners to push through a series of post-Enron market reforms that irritated Wall Street and corporate America, but were applauded by investors' groups.

On June 1, Donaldson, 74, surprised the industry again, announcing he would step down June 30, saying he had accomplished most of his goals and wanted to return to his family in New York. Is the Donaldson legacy good or bad? And will the regulatory pendulum swing the other way under Christopher Cox, the conservative California Congressman Bush has nominated as the next SEC chairman?

"I have a positive impression of Donaldson," says Wharton legal studies and ethics professor Thomas W. Dunfee. "He was the right guy at the right time....There's perhaps a failure to appreciate the damage that all of the scandals have done to confidence in our financial services system. Donaldson was helping correct that by pushing the envelope."

But in certain areas, suggests Wharton finance professor Marshall E. Blume, Donaldson went too far. "Some of the regulations that he instituted were misguided. He implemented the Sarbanes-Oxley bill in a very heavy-handed way," Blume notes, referring to the reforms ordered by Congress in 2002.

Donaldson, founder of one of the best-known Wall Street firms, Donaldson, Lufkin & Jenrette, helped found the business school at Yale, was chairman of the New York Stock Exchange in the early 1990s and was chairman and CEO of Aetna Insurance. He took over the SEC in February 2003, becoming the third Republican on the five-member commission, which traditionally has no more than three members from a single party.

Among the key initiatives, many of which passed on 3-2 votes with Donaldson teaming with the Democrats, were requirements that companies count employee stock options as an expense, that mutual funds appoint independent chairmen, that corporations improve their accounting rules and that auditors stay at arm's length from their corporate clients.

Donaldson also pressured the New York Stock Exchange to reform in the wake of the pay scandal involving its former chairman Richard Grasso, and he helped make possible the NYSE merger with Archipelago Holdings Inc. This will modernize the exchange, turn it into a for-profit company and, Donaldson hopes, make it more attentive to investors' needs rather than those of the specialists who have controlled the NYSE for more than 200 years.

Further, he strongly advocated greater oversight of the booming hedge fund industry, and he pushed through a "trade-through" rule, Regulation NMS, requiring that investors trading on one exchange get the best price then available on any exchange, even at the sacrifice of trading speed that often is favored by many institutional investors.

Many of these positions have been unpopular with business groups, Wall Streeters and conservative lawmakers. "The SEC, in a sense, is at the fulcrum of an ongoing discussion, and sometimes a struggle, between big institutional investors and company executives," says Wharton management professor Michael Useem. "Arguably, Donaldson swung the pendulum toward investors."

More Transparency, Better Controls

Many of Donaldson's critics complain that the more stringent accounting reforms the SEC implemented under Sarbanes-Oxley will seriously increase corporate costs. "The biggest question is whether the improved standards of reporting and governance have been worth the enormous expense," saysThomas Donaldson, professor of legal studies and ethics at Wharton. "But I don't think there's any question that companies are more transparent and have better controls now than they did before Sarbanes-Oxley was put into place."

Adds Dunfee: "You know, you can't make every judgment just looking solely at costs. You have got to estimate the benefits, which are a bit more intangible." Investors are more confident in the integrity of the markets and of corporate management as a result of the Donaldson reforms. "The whole package was the key."

According to Useem, Sarbanes-Oxley, as implemented by the SEC, has given boards of directors far greater independence from corporate managers. "He and his staff have had to work very hard to convince us that what you see is what you get when you pick up a quarterly or annual report or proxy statement." More can be done, "but the SEC has gone a [long] way under Donaldson to achieve that."

Blume argues that the SEC under Donaldson made a serious error with Regulation NMS, requiring that investors get the best prices. In a sense, the regulation reduces the distinction between the various competing exchanges. At any moment each security will have just one price nationwide, and institutional investors will have less room to make their own choices when balancing price against trading speed. "It's a very technical type of rule, but it views the market in very simplistic terms," Blume says. "It is very likely to limit innovation. It puts the SEC in the position of being a price regulator, something that we eliminated in the 1975 [securities market reforms]. Government should facilitate competition, not thwart it."

Blume is also critical of rules implemented under Donaldson requiring greater independence of boards of directors' audit committees. Restrictions on who can serve as chairman of an audit committee, for example, will make it very difficult to find qualified people, especially with regards to small companies. "For a small business, it will increase the cost of doing business very substantially."

Donaldson pushed hard to get a rule requiring that hedge funds register with the SEC, arguing the industry has grown so big that regulators must have a better look at how it affects the markets. Blume approves of this move, after initially opposing it. He worries that hedge funds may not be accurately pricing some of their exotic, thinly traded holdings, and that their fee structures create conflicts between their managers and investors. Adds Dunfee: "At least he's causing some serious consideration of the nature of the hedge fund industry as it exists today, and the risks, if any, associated with that."

Donaldson's chief ally, Democratic Commissioner Harvey J. Goldschmid, plans to leave this summer to resume teaching at Columbia University Law School. The other Democrat, Roel Campos, may also be a short-timer. Though Bush will have to find Democrats for these posts, he may look for ones who are not as strong on investors' rights, many observers think. Since the two Republicans, Paul S. Atkins and Cynthia A. Glassman, will remain on the commission, there's a good chance it will turn more conservative with the Bush appointees.

A Sympathetic Ear to Corporate Needs?

A number of rules approved under Donaldson have yet to take effect, and the new chairman could let them languish. These include hedge fund registration, requirements that fund chairmen be independent of management, and option expensing, which Cox has opposed. Also hanging is a Donaldson initiative to make it easier for shareholders to elect directors not nominated by the boards themselves. After intense business lobbying, the proposal was watered down, and the softer version has yet to be adopted. Under Cox it could die.

"Some of these issues are really a struggle for the souls of the directors and officers of big companies, and particularly what they do when they close the doors and make decisions," says Useem, who thinks it should be easier for shareholders to nominate director candidates.

Under Donaldson, the SEC collected nearly $8 billion in penalties and disgorgements from its enforcement actions, a staggering figure. Some observers expect the agency will be less aggressive under Cox. The two Republican commissioners have argued that some corporate fines merely punish shareholders who have already suffered.

Cox, a former venture capitalist, was chief sponsor of the 1995 Private Securities Litigation Reform Act, which made shareholder lawsuits more difficult and helped shield accountants and corporate executives from liability for bad accounting. But he was a strong supporter of Sarbanes-Oxley. His confirmation hearings are expected in July.

"The perception is that he will be more sympathetic to corporate needs and to making Sarbanes-Oxley more compatible with the efficient running of a corporation," Blume says, predicting that some Donaldson reforms will be rescinded or modified. But Wharton's Donaldson suggests that "we may see a kindler, gentler Cox" once he takes office. To be confirmed, Cox may have to take more moderate positions than he did as a congressman from a district with a lot of high-tech companies that didn't like many of the recent market reforms, he notes.

Dunfee argues it is too soon to conclude that the Enron-era problems have been fixed and the pendulum can be allowed to swing back toward easing regulation. There has been a jump, for example, in the number of companies restating their earlier financial statements, indicating that many are still playing accounting games. "It seems to me it's kind of premature to say the confidence problem is solved."