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TESTIMONY

FIXING THE WATCHDOG: LEGISLATIVE PROPOSALS TO IMPROVE AND ENHANCE THE SECURITIES AND EXCHANGE COMMISSION
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United States House of Representatives
Committee on Financial Services

Chairman Bachus, Ranking Member Frank, and distinguished members of the Committee, it is a privilege to testify today. My name is J.W. Verret. I am an Assistant Professor of Law at Stanford Law School where I teach corporate and securities law. I also serve as a Fellow at the Hoover Institution and as a Senior Scholar at the Mercatus Center at George Mason University. I am currently on leave from the George Mason Law School.

My testimony today will focus on two important and necessary reforms.

First, I will argue that clarifying the SEC's legislative mandate to conduct economic analysis and a commitment of authority to economists on staff at the SEC are both vital to ensure that new rules work for investors rather than against them. Second, I will urge that the SEC be required to consider the impact of new rules on the state-based system of business incorporation.

Every President since Ronald Reagan has requested that independent agencies like the SEC commit to sincere economic cost-benefit analysis of new rules. Further, unlike many other independent agencies the SEC is subject to a legislative mandate that it consider the effect of most new rules on investor protection, efficiency, competition and capital formation.

The latter three principles have been interpreted as requiring a form of cost-benefit economic analysis using empirical evidence, economic theory, and compliance cost data. These tools help to determine rule impact on stock prices and stock exchange competitiveness and measure compliance costs that are passed on to investors.

Three times in the last ten years private parties have successfully challenged SEC rules for failure to meet these requirements. Over the three cases, no less than five distinguished jurists on the DC Circuit, appointed during administrations of both Republican and Democratic Presidents, found the SEC's economic analysis wanting. One failure might have been an aberration, three failures out of three total challenges is a dangerous pattern.

Many SEC rules have treated the economic analysis requirements as an afterthought. This is in part a consequence of the low priority the Commission places on economic analysis, evidenced by the fact that economists have no significant authority in the rule-making process or the enforcement process.

As an example of the level of analysis typically given to significant rule-making, consider the SEC's final release of its implementation of Section 404(b) of the Sarbanes-Oxley Act. The SEC estimated that the rule would impose an annual cost of $91,000 per publicly traded company. In fact a subsequent SEC study five years later found average implementation costs for 404(b) of $2.87 million per company.

That error in judgment only applies to estimates of direct costs. The SEC gave no consideration whatsoever to the more important category of indirect costs, like the impact of the rule on the volume of new offerings or IPOs on US exchanges.

In Business Roundtable v. SEC alone the SEC estimates it dedicated over $2.5 million in staff hours to a rule that was struck down. An honest commitment by the SEC to empower economists in the rule-making process will be a vital first step to ensure the mistakes of the proxy access rule are not replicated in future rules.

I also support the goal in H.R. 2308 to further elaborate on the economic analysis requirements. I would suggest, in light of the importance and pervasiveness of the state-based system of corporate governance, that the bill include a provision requiring the SEC to consider the impact of new rules on the states when rule-making touches on issues of corporate governance.

The U.S. Supreme Court has noted that "No principle of corporation law and practice is more firmly established than a state's authority to regulate domestic corporations."

Delaware is one prominent example, serving as the state of incorporation for half of all publicly traded companies. Its corporate code is so highly valued among shareholders that the mere fact of Delaware incorporation typically earns a publicly traded company a 2-8 percent increase in value. Many other states also compete for incorporations, particularly New York, Massachusetts, California and Texas.

In order to fully appreciate this fundamental characteristic of our system, I would urge adding the following language to H.R. 2308:

"The Commission shall consider the impact of new rules on the traditional role of states in governing the internal affairs of business entities and whether it can achieve its stated objective without preempting state law."

The SEC can comply by taking into account commentary from state governors and state secretaries of state during the open comment period. It can minimize the preemptive effect of new rules by including references to state law where appropriate similar to one already found in Section 14a-8. It can also commit to a process for seeking guidance on state corporate law by creating a mandatory state court certification procedure similar to that used by the SEC in the AFSCME v. AIG case in 2008.

I thank you again for the opportunity to testify and I look forward to answering your questions.

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J. W. Verret	George Mason Law
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