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Statement of the Shadow Financial Regulatory Committee
Open Letter to SEC Chairman Christopher Cox

September 12, 2005

As you take your seat as Chairman of the Securities and Exchange Commission (SEC), the Shadow Financial Regulatory Committee wishes to commend you for the strong statements you made—both in your confirmation hearings and after taking office—in favor of vigorous enforcement of the securities laws and tough action on fraudulent activity. One of the key roles of the SEC is the protection of investors, and full enforcement of the laws is essential for this purpose. But the Committee is hopeful that the SEC's actions will reflect a greater appreciation of the relative costs of regulation and benefits of competition than the Commission has at times exhibited over the last few years.

In past statements, the Committee has identified steps the SEC might take to improve its regulation of the securities markets. We believe the SEC, under your leadership, should consider action in the following areas:

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--Reforming exchange governance. Because exchanges are converting from mutual to corporate form and becoming profit-making entities, it is time to review whether self-regulatory organizations should continue to have a role in the regulation of trading venues. The Committee raised some of these issues in Statement No. 201, New York Stock Exchange Governance and Market Structure Issues (December 8, 2003).

--Reform of mutual fund regulation. The mutual fund industry functions under a 65 year old regulatory structure—written at a time when most investment companies were closed-end, mutual funds were a minor part of the capital market, most funds were managed by their boards of directors rather than by outside advisers, and ETFs did not exist. Major issues still pending today include the late trading problem (in Statement No. 202, December 8, 2003, the Committee proposed a T+1 pricing system to address this issue), the potential for concealing market timing in omnibus accounts, and various methods of payment of marketing expenses by advisers. However, the Committee believes it is time for the entire structure of mutual fund regulation to be reviewed and updated.

--Regulation NMS. Although Regulation NMS has been adopted by the Commission, the Committee still believes the universal trade-through prohibition included in the regulation and made applicable to the entire electronic market was a policy mistake (Statement No. 205, May 24, 2004, and Statement No. 217, February 14, 2005). The SEC should implement the rule with a pilot program, to determine its operational consequences and whether it will have the effect intended by the Commission.

--Reconciliation of accounting standards. The difference in accounting standards between the United States and the EU has been a perennial obstacle to the integration of the two securities markets. The Committee believes that International Financial Reporting Standards (IFRS) are as good for financial reporting as Generally Accepted Accounting Principles (US GAAP), which prevail in the United States. EU companies should be permitted to use IFRS for financial disclosure

when they enter the US securities markets, without a requirement to reconcile to GAAP (Statement No. 209, September 20, 2004).

--Section 404 of Sarbanes-Oxley. This statutory requirement as interpreted by the SEC continues to be an excessively costly burden for all public companies. The Commission's recent statement, attributing this cost simply to excessive attention to details by auditors, was inadequate. The SEC should consider other means to reduce the costs of Section 404. The Committee has previously recommended a study of the costs of Section 404 in relation to its benefits (Statement No. 219, May 16, 2005).

--Relationship between federal and state securities laws. Over many years, Congress has attempted to create a national securities market and to reduce the distortion caused by inconsistent state laws. However, the creation of a national securities market with uniform standards of conduct has still not been achieved. The SEC should take the lead in proposing reforms in this area.

--Promoting the development of a global securities market. The Committee made a statement on this subject, advocating unfettered access by US institutional investors to foreign securities markets, in May 2003 (Statement No. 190)

--Regulatory approvals. Regulated entities, such as securities exchanges, continue to complain that gaining approval for proposed rule changes takes excessively long and interferes with their ability to compete and to adjust to rapidly changing technology. The Committee generally believes that the SEC is unwise to micromanage the securities industry, and could usefully abandon some of its current regulation, leaving entities to compete more effectively. If deregulation in some areas is not feasible, the Commission should take steps to speed up decisions.