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THE TENTH ABRAHAM L. POMERANTZ PROGRAM: WALL STREET IN TURMOIL: WHO IS PROTECTING THE INVESTOR?: State-Federal Relations Post-Eliot Spitzer *

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SUMMARY:

... Whatever the long-run economic consequences of the waves of corporate, securities, and accounting scandals that have rocked Wall Street and Main Street, one thing is clear: the scandals have created a fertile climate for new regulatory initiatives and for regulatory entrepreneurship by ambitious politician-bureaucrats. ... Indeed, nobody would seriously contend that Eliot Spitzer, whose staff has been far more aggressive in filing complaints against the securities industry, is more of an expert in securities law and capital markets than his counterpart at the SEC. ... On December 18, 2003, the Securities and Exchange Commission announced "a settled enforcement action against Alliance Capital Management L.P. (Alliance Capital) for defrauding mutual fund investors by allowing market timing in certain of its mutual funds in exchange for fee-generating investments in other Alliance Capital investment vehicles. ... This proposal is the SEC's poorly disguised attempt to link itself to a new constituency: public interest pension funds and other "activist" shareholder groups, whose preferences and agendas are unlikely to reflect the profit-maximization motive that is embraced by the average investor. ...

TEXT:

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Introduction

Whatever the long-run economic consequences of the waves of corporate, securities, and accounting scandals that have rocked Wall Street and Main Street, one thing is clear: the scandals have created a fertile climate for new regulatory initiatives and for regulatory entrepreneurship by ambitious politician-bureaucrats. We have observed both in abundance. Regulation has come in the form of the Sarbanes-Oxley Act n1 and the new corporate governance rules recently adopted by both the New York Stock Exchange n2 and Nasdaq. n3 Regulatory entrepreneurship has come in the form of state attorneys general's efforts, especially New York's Eliot Spitzer, to achieve fame and political support by aggressively entering the regulatory vacuum created by the Securities and Exchange Commission's failure vigorously to pursue the corporations implicated in the various scandals. n4 The SEC's passivity was [*118] likely caused by the agency's capture by the same special interests it was ostensibly regulating. n5

This article looks at the current regulatory disequilibrium in the U.S. capital markets from the allied perspectives of political theory and federalism in order to make two points about the current regulatory environment. First, I observe that the recent history of scandals, followed closely by new regulation, illustrates the importance of utilizing opportuni-

ties created by crisis. Crisis, in this case manifested in the sudden collapse of Enron Corporation, followed closely by the collapse of WorldCom and a spate of other highly salient corporate frauds (e.g., Symbol Technologies, Adelphia, Global Crossing), created a "policy window" through which political entrepreneurs could launch their initiatives. Second, the various governmental responses to the crises reflect the nature of the ongoing jurisdictional competition between and among state and federal regulators in the U.S. Federal system. State regulators have moved decisively to claim territory within what they see as a regulatory vacuum created by the SEC. The SEC has been forced to respond. The long term effects of this competition, however, are far from clear.

Part I describes the relationship between crisis and regulation. I argue that public policy crises, whether real or imagined, provide an opportunity for entrepreneurial politicians and regulators to break the typical log-jams that make it difficult to pass new rules during times of ordinary politics. Part II outlines three stages of a four part taxonomy that describes the evolution of New York Attorney General Eliot Spitzer's response to this crisis. As this Article is written, I contend that we are in the third and penultimate stage of the post-Enron relationship between the SEC and Eliot Spitzer. Spitzer, the most successful of what might best be described as an emerging generation of "Enronian Policy Entrepreneurs," saw the collapse of Enron as opening what political scientists describe as a "policy window" -- a window in time during which the political environment is unusually welcoming of new regulations and policy proposals. This emergent generation of Enronian Policy Entrepreneurs, consisting primarily of lawyers, policy-makers, lobbyists, and, of course, their [*119] constituents, clients, and potential clients, has used the opportunities created by the collapse of Enron and other corporate scandals as a pretext for enhancing their own political powers. Part III considers the future of the SEC in light of Spitzer's recent successes, and determines that the fourth and ultimate stage of this taxonomy will involve a shift in the Agency's agenda. Recent rules proposed by the SEC suggest a move toward preempting areas of regulation that have previously been left to the states in an attempt to appeal to special interests. In concluding, I make various predictions about the legacy of this competition between state and federal regulators for the future of U.S. capital market regulation.

I. Crisis and the Growth of Government

If we assume that bureaucrats, like other people, want to lead interesting and relevant lives, then it stands to reason that crisis is good for bureaucrats. Crisis not only provides a justification for administrators to lay claim to more power and larger budgets; it also provides a basic rationale for the continued existence of an agency whose relevance might otherwise be questioned. For example, due to the recent spate of corporate scandals, it would now be unimaginable to think of reducing the size and power of the SEC. Today's policy debates are framed not in terms of whether the Agency is relevant, but rather in terms of how much larger its budget needs to be in order for it to improve its effectiveness in ferreting out fraud and improving the quality of corporate financial reporting.

The SEC received a cool \$ 100 million budget increase in fiscal year 2003. Although it was not the only agency to receive budget increases during this period, the SEC was the only federal agency to receive substantial budget increases in both 2003 and 2004. n6 Testifying before the House Commerce-Justice-State Appropriations Subcommittee, SEC Chair William Donaldson said President Bush's request for \$ 841.5 million in fiscal 2004 "recognizes that the Commission's needs are growing and ongoing." n7 He predicted that the funding the SEC [*120] provided under the recent omnibus appropriation "will enable us to meet the remaining fast-approaching deadlines of the Sarbanes-Oxley Act, hire over 800 new staff and advance initial start-up funds to the Public Company Accounting Oversight Board." n8

The 2005 budget request of \$ 893 million for the SEC, an increase of \$ 81 million, was 10% above the 2004 level. n9 The President's fiscal year 2004 budget included \$ 842 million for the SEC -- the largest increase in the history of the Agency. The 2005 budget request would nearly double the SEC budget over fiscal year 2002 levels. According to the White House, the agency plans to use the additional money to hire new accountants, lawyers, and examiners "to protect investors and combat corporate wrongdoing." n10 From an economic perspective, these gigantic budget increases seem odd. Firms that are subject to market forces at best shrink, and sometimes shrivel and die, when they underperform. In other words, the market punishes rather than rewards failure in the private sector. The recent spate of scandals, particularly among mutual funds and market analysts, can hardly be viewed as a success story for the Securities and Exchange Commission.

In case it were needed, this recent wave of scandals can be viewed as additional evidence that administrative agencies are not subject to the same Darwinian pressures as firms in the private sector. As New York Attorney General Eliot Spitzer observed, "heads should roll" at the SEC for failure to detect and act upon abuses in the mutual fund industry. n11 And while heads (or at least one head) did roll with the token firing of long-time SEC staffer Juan Marcelino, head

of the [*121] Commission's Boston office, n12 the crisis of confidence in U.S. capital markets was clearly beneficial to the SEC in general.

Luckily for the SEC, the situation did not devolve into a "competitive situation between regulators." n13 Rather, SEC Chief William Donaldson summed up the situation aptly when he said that "the spectacle of one regulatory agency criticizing another is not healthy." n14 Clearly he is correct in a sense; from the perspective of the regulatory agencies, competition is not healthy. The proclivity for collusion is one way in which regulatory agencies resemble firms, in that collusion is generally a much better strategy than competition. And, happily for administrative agencies, if not for the public, unlike private firms, there are no antitrust laws that seek to constrain collusion among agencies.

Nevertheless, competition is a hard thing to quash, particularly in a federalist system. Institutions, including administrative agencies, are composed of people. People are ambitious. Over time, the private incentives of the people who work in agencies will tend to replace the public objectives articulated when the agencies were founded. n15 If one agency departs from a policy space, a rival bureaucrat is likely to emerge to attempt to fill that space. This, in my view, explains what might be described as the "Spitzer phenomenon." Eliot Spitzer, the Attorney General of the State of New York, is ambitious. He wants to be governor. And suing (and settling cases with) securities firms is a much better strategy for obtaining this objective than suing used car dealerships in Utica, N.Y., where he soon will be shaking hands on his quest for new lodging in the Governor's mansion. n16

Spitzer's strategy has already achieved a certain amount of success. His name is probably more widely recognized than any New York attorney general since Robert [*122] Kennedy. Time Magazine dubbed Spitzer "crusader of the year" in 2002, and in that same year then-presidential candidate Wesley Clark mentioned him as a possible running-mate. n17

My purpose is not to lampoon Attorney General Spitzer's efforts to police the securities markets. Rather, my purpose is to provide a richer description of the nature of those efforts. Of particular interest, of course, are the future implications of Mr. Spitzer's capital markets crusade. As in the world of private markets, regulatory initiatives and, above all, bold, entrepreneurial initiatives such as Mr. Spitzer's, do not take place in a vacuum. These initiatives inevitably upset settled equilibriums and distributions of power among regulators and, in this case, jarred the relationship between the SEC and state securities regulators.

The question now is how the SEC and its friends, allies, and competitors are likely to respond to Spitzer's actions. In my view there are only three possible outcomes of Mr. Spitzer's efforts. We know that Mr. Spitzer will not remain the Attorney General forever, regardless of whether he succeeds in attaining higher political office. We also know that the SEC will survive. Despite the quality of its performance, it appears that the Commission will thrive, at least from a budgetary perspective. One clear possibility, then, is that Mr. Spitzer's efforts will re-energize and revitalize the SEC, causing it to become not only a richer, but also a more effective administrative agency.

A second possibility is that Mr. Spitzer will fill the power and policy spaces once occupied by the SEC and cause the venerable federal agency to suffer by weakening its prestige, its moral authority, the morale of its employees, and its historical capacity to recruit bright and able staff. As the following chart demonstrates, the turnover of personnel at the SEC, while not high, is higher than that in other branches of government. These numbers reflect both the "revolving door effect," the ability of SEC employees, particularly professionals, to move into the securities industry's private sector, as well as dissatisfaction with the SEC as a career. [*123]

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Table 1: SEC and Government-wide Turnover Rates

SEC Turnover Rate, 1994-2001 Fiscal Year Permanent Employees Attorneys Accountants Securities Compliance Examiners GS-14s GS-15s 1994 9.59% 13.90% 6.91% 5.51% 11.27% 11.45% 1995 11.39% 15.15% 9.38% 14.29% 9.61% 12.98% 1996 6.52% 11.32% 8.96% 10.31% 10.50% 9.59% 1997 11.94% 16.01% 12.13% 10.78% 14.82% 15.83% 1998 12.46% 15.19% 12.87% 10.48% 14.77% 11.36% 1999 13.72% 13.50% 13.72% 14.92% 14.35% 14.43% 2000 13.83% 17.47% 13.76% 13.93% 14.75% 11.48% 2001 8.48% 9.86% 7.00% 9.34% 8.73% 10.96%

Government-Wide Turnover Rate, 1994-2001 Fiscal Year Permanent Employees Attorneys Accountants Financial Institution Examiners* GS-14s GS-15s 1994 7.83% 6.51% 6.44% 8.31% 6.93% 8.63% 1995 12.33% 11.95% 8.11% 7.05% 7.84% 8.64% 1996 7.03% 6.66% 6.61% 13.77% 5.60% 7.02% 1997 7.62% 7.41% 7.14% 8.05% 6.21% 7.95% 1998 7.07% 7.05% 8.01% 5.56% 5.59% 7.02% 1999 7.08% 6.78% 6.62% 5.58% 6.08% 7.59% 2000 6.82% 8.18% 7.68% 6.12% 5.89% 7.19% 2001 6.42% 6.61% 5.80% 5.15% 5.54% 6.61%

Source: Pay Parity Implementation Plan and Report n18

*The SEC is the only government agency that uses Securities Compliance Examiners. Financial Institution Examiners in other agencies perform similar work to Securities Compliance Examiners. n19

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A final possibility is that Mr. Spitzer's legacy will invigorate the SEC, but not in the benign, positive way mentioned above (i.e. by providing its staff with incentives to better police the securities industry). Instead, the Spitzer legacy will invigorate the SEC politically, by inducing the staff and directors to forge new interest group allies who will support them in turf wars against insurgent state bureaucrats modeled after Mr. Spitzer. Under this view (recognized by Mr. [*124] Spitzer as the likeliest possibility), n20 once a new attorney general is in place, the SEC and its industry supporters will galvanize into an effective political coalition to lobby Congress to preempt state law in the securities area. If such preemption occurs, it is likely that nothing will stop the Agency and its agenda from suffering from internal atrophy and external capture by powerful interests.

II. Spitzer's Legacy: A Tale in Four Parts

A. "New Deal" Stage

While difficult to quantify with precision, significant disparities in prestige exist among regulatory agencies. The SEC, one of the more prestigious federal agencies, provides a complete set of governmental functions for the securities industry, exercising not only executive power, but also legislative (rulemaking) power and judicial power. n21

SEC Chairman and Commission members have been chosen from the ranks of the most distinguished, high profile lawyers in the United States. They include Joseph P. Kennedy (1934-1935), James M. Landis (1935-1937), William O. Douglas (1937-1939), William L. Cary (1961-1964), Manuel F. Cohen (1964-1969), A.A. Sommer, Jr. (1973-1976), Irving M. Pollock (1974-1980), and Harvey Pitt (2001-2003). n22

The SEC has outlasted many of its fellow New Deal agencies. A staff position at the SEC, particularly in the Division of Enforcement, has long been viewed as an excellent path to a successful career in the private securities bar. The SEC Historical Society, founded in 1999, cultivates the SEC's traditions and makes sure that the "new generation of SEC and industry staff" is aware of the "unique history and meaning of the work of the SEC and the securities industry." n23 [*125]

The SEC has never faced a major corruption scandal. The staff enjoys a high reputation for professionalism and integrity. Although the Commission has been criticized for responding too slowly to recent corporate, accounting firm, and investment banking scandals, these criticisms have had more to do with agency capture by powerful interest groups than with agency incompetence or incapacity. Indeed, nobody would seriously contend that Eliot Spitzer, whose staff has been far more aggressive in filing complaints against the securities industry, is more of an expert in securities law and capital markets than his counterpart at the SEC. Rather, the intensity of Spitzer's efforts can in some measure be attributed to the fact that the New York Attorney General's Office enjoys more distance from, and is therefore less susceptible to capture by, the very entities it is charged with regulating. n24

The SEC probably reached the apogee of its power and prestige in relation to state regulators in 1996, with the passage of the National Securities Markets Improvement Act (NSMIA). The NSMIA explicitly pre-empted vast areas of securities law previously regulated by the states. n25 The conference committee from which NSMIA emerged used adjectives like "duplicative," "unnecessary," "redundant," "costly," and "ineffective" to describe overlapping state and federal securities regulation, and expressed a clear preference for the New Deal administrative agency solution to this problem: federal pre-emption of antiquated state law. n26

The purpose of the NSMIA was to firmly ensconce the SEC as "the exclusive regulator of national offerings of securities." n27 Indeed, as SEC officials observed in the wake of Spitzer's blitzkrieg into the SEC's traditional territory, the creation of the SEC in 1934 and the passage of the New Deal [*126] Securities Acts in 1933 and 1934 was in response to "widespread demand for the federal government to assume a rule in policing the markets" due to the failure of state laws in the period prior to their passage. n28

Thus, when Eliot Spitzer began to move into the SEC's regulatory turf, he was moving into the regulatory turf of a venerable, prestigious New Deal agency whose authority, competence, and integrity were long-standing and unquestioned. Initially, Spitzer was viewed as a maverick and an opportunist, advancing inexplicably into territory where he was unneeded and unwanted. This phase of his crusade can be labeled the "New Deal" phase. The phase began in 2002

with the Attorney General's investigation of investment banks' financial analysts. It culminated with the May 21, 2002 Settlement Agreement between Merrill Lynch, Pierce, Fenner & Smith and the Attorney General of the State of New York, followed later in the year with settlements against ten other major investment banks. With these successes, Eliot Spitzer and the office of the New York Attorney General, once known for regulating "auto repair shops, nursing homes and crooked landlords," became known as the "Sheriff of Wall Street." n29

B. The "Federalism" Stage

The core characteristic of the "New Deal" stage of the Spitzer-era was a recognition that the SEC lacked motivation to pursue fraud, and that the highly publicized enforcement efforts of Eliot Spitzer were not only accomplishing useful results in and of themselves, they were also motivating the Commission. As SEC Enforcement Chief Stephen M. Cutler acknowledged:

A visible and aggressive state enforcement machine may motivate federal regulators, like me, to respond more quickly to potential securities-related misconduct. Of course, if we in the federal government want to be the dominant securities enforcement authority, we must be vigilant in protecting the investing public. And I think that I can safely say that (SEC) Chairman Donaldson, as well as the Commission and its staff, are single-minded in our determination to do just that.

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Such competition among regulators to be first on the scene, if tempered by the other principles I've just identified (regulatory consistency and protection of investors), will help ensure that investors' needs are addressed promptly. As public servants, we must admit to ourselves, however, the possibility that a contest to be the most responsive regulator could easily become a contest to become the most popular but most irresponsible regulator. This in turn can have untold costs -- to investors, to issuers, to financial institutions, to the capital markets, to the justice system, and ultimately, to our credibility as regulators. Federal and state securities agencies must bear this in mind at all times and exercise our judgment and discretion accordingly. n30

During the "Federalism" stage of the Spitzer era, people stopped asking the question that was asked during the "New Deal" phase of the Spitzer era. That question was, according to Spitzer himself, "well, what's the state attorney general's office in New York doing, going after this problem (cases involving stock analysts and improper allocations of shares in Initial Public Offerings). Shouldn't this be the SEC?' And my response was, 'Yes but they haven't. And if they haven't, and there are investors being ripped off, we will do it.'" n31

The Attorney General stopped being viewed either as a "meddler, poking around in things that were none of his business" or as an "opportunist, grandstanding to the masses to advance his own political career," n32 as he was during the New Deal Stage. Instead, Spitzer came to be viewed as someone who produced real reform. The turning point came when people started asking "the most obvious and embarrassing question: 'where has the Securities and Exchange Commission been while all of this (the mutual fund and IPO allocation scandals) was going on?'" In 2003, CBS News reported that "in the past 10 years, the SEC has failed to bring a single case involving stock analysis or IPO allocations." n33

In this intermediate stage, Spitzer's early successes converged with the public's expectations. Not only was the SEC expected to be increasingly vigilant; the public required active, meaningful enforcement of securities regulations at a level not seen before. Spitzer responded quickly to this opportunity to achieve national recognition. [*128]

C. The "Hostile Takeover" Stage

Up to this point, the story has been simple. In a deft display of political entrepreneurship, Eliot Spitzer moved in to fill the vacuum created by the lack of initiative at the SEC. The SEC was fully acclimated to existing market practices and saw no urgent need to change them. The SEC staff identified with the market participants they were ostensibly regulating, and, predictably, found it difficult to visualize these people as "evil-doers." But very quickly things moved beyond the mere pursuit of fraudulent conduct within the jurisdictional boundaries of the state of New York, the realm to which the SEC would have liked to relegate state regulatory action. n34

Spitzer soon moved to usurp the SEC's core regulatory function: dictating general regulatory policy for the capital markets. In doing so, Spitzer moved from being just another policeman on the beat into a new role, that of "the most feared, most hated and most powerful man on Wall Street." n35 In this new role, assumed in a period I characterize as the "hostile takeover" phase of Spitzer's career as Attorney General, he began to engage in what is known as "rulemak-

ing by enforcement." n36 The ineluctable reality is that an enforcement proceeding can, in fact, realign an industry standard, where parties "agree to change or restrict their future conduct in significant and far-reaching ways" in order to resolve the enforcement action. n37

It is preferable, and more consistent with the rule of law, for administrative agencies to clarify their positions by making formal rules or issuing interpretive releases that parties can use to guide their behavior. However, the Office of [*129] the New York Attorney General, unlike the SEC, does not have the power to engage in formal rulemaking or the authority to issue interpretive releases. Its only option, if it wants to engage in rulemaking or to otherwise affect basic conduct or structure within the securities industry, is to do so through an enforcement mechanism.

Clearly, this is not an ideal strategy for rulemaking. It lacks the usual notice and comment period associated with the promulgation of rules. It does not permit participation by all, or even most, affected parties. Perhaps most disturbingly, when rulemaking takes place in the context of an enforcement action, the regulator has such a power advantage over the regulated entity that unjust results are likely to occur. Moreover, as SEC officials have stressed, in adopting the securities laws, including the New Deal legislation, the National Market System legislation of 1985, and NSMIA, Congress clearly intended "that the federal government, not the states, establish the rules and policies governing the securities markets, and that it do so on a national rather than a piecemeal (state-by-state) basis." n38

Thus it seems that when Eliot Spitzer and other state attorneys general and securities regulators engage in enforcement actions, they are acting properly. But when they engage in policy-making, which is precisely the effect of Eliot Spitzer's enforcement actions, they are threatening to "destroy the balance Congress struck in its effort to strengthen and streamline our national market system." n39

Perhaps the point of greatest tension between the SEC and the N.Y. Attorney General was in connection with the separate settlements in the Alliance Capital case. On December 18, 2003, the Securities and Exchange Commission announced "a settled enforcement action against Alliance Capital Management L.P. (Alliance Capital) for defrauding mutual fund investors by allowing market timing in certain of its mutual funds in exchange for fee-generating investments in other Alliance Capital investment vehicles." n40 [*130]

The Commission ordered Alliance Capital to pay \$ 250 million, consisting of \$ 150 million in disgorgement and \$ 100 million in penalties. n41 Under the settlement agreement, all of the money was distributed to the Alliance shareholders who were harmed by the firm's market timing arrangements. n42 Alliance Capital was also ordered to undertake numerous compliance and fund governance reforms aimed at preventing a recurrence of the type of conduct described in the Commission's Order. n43 According to the SEC, the changes were intended to enhance the independence of the mutual fund companies' boards and strengthen Alliance Capital's internal compliance and oversight functions with regards to federal securities laws. n44

The Commission's Enforcement Order found that, in some of its mutual funds, Alliance Capital had entered into arrangements permitting market timing (trading to exploit short-term pricing inefficiencies). n45 In exchange for these arrangements, Alliance Capital solicited from these market timers' long-term investments. n46 Although these arrangements allowed Alliance Capital to earn additional management fees, they also exposed its mutual funds to the potential adverse effects of market timers, thereby breaching its fiduciary duty to both the funds and the investors. n47

The Commission's Order made the following specific factual findings:

. At their height in 2003, Alliance Capital arranged over \$ 600 million in market timing in its mutual funds. Its single biggest market timer, Daniel Calugar, owner of Security Brokerage in Las Vegas, Nevada, peaked at \$ 220 million of timing capacity in certain mutual funds; in exchange, Mr. Calugar invested in hedge funds run by some of the same portfolio managers overseeing the mutual funds. For example, Alliance Capital granted Calugar \$ 150 million timing capacity (the right to make multiple roundtrip trades up to \$ 150 million each) in the AllianceBernstein Technology Fund in return for a \$ 30 million investment - a 5:1 ratio - in a hedge fund managed by the same portfolio managers.

[*131]

. Alliance Capital solicited shareholder approval to lift a restriction on futures trading in one of the funds by means of a misleading proxy. Alliance Capital failed to disclose that one reason for seeking to lift the restriction was to enable the portfolio manager to manage better the cash flows resulting from market timers.

. Alliance Capital provided confidential information about the portfolio holdings of certain mutual funds to one of the timers, Canary Investment Management. The disclosure enabled Canary to profit from market timing in declining markets. n48

In agreeing to this settlement, the SEC took into account Alliance Capital's cooperation in the investigation. n49 This cooperation included the fact that the firm promptly reported its discovery of internal misconduct, conducted a thorough and independent investigation, shared the results of that investigation with the SEC, obtained the resignations of certain supervisory personnel and other employees, and implemented remedial action. n50

The SEC's investigation and enforcement action were coordinated with the New York Attorney General's Office. However, unlike the SEC's settlement, the New York Attorney General reached a settlement that required Alliance Capital to offer fee discounts to its mutual fund customers. In an unusual statement attached to the Alliance settlement announcement, all five of the SEC's commissioners stated that there was "no legitimate basis [for a regulator] to act as a rate setter." n51 The Commission issued a separate statement that discussed at length why the relief demanded of Alliance by Eliot Spitzer's office "would not serve (its) law enforcement objectives":

Today we announce our settled enforcement action against Alliance Capital Management, L.P. ("Alliance Capital") in connection with its illegal market timing arrangements. The Commission's settlement requires Alliance Capital to pay a total of \$ 250 million (including a penalty of \$ 100 million), all of which is to be returned to investors harmed by the violations. This amount will provide those investors with full compensation for fund losses due to the illegal market timing arrangements. In addition, we are requiring Alliance Capital and its mutual fund boards to adopt significant governance and

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compliance reforms. These reforms are designed to prevent a recurrence of the kind of conduct described in our order.

The Commission's settlement does not require Alliance Capital to offer fee discounts to its mutual fund customers. We determined - unanimously - that such relief would not serve our law enforcement objectives in this case. There were no allegations that Alliance Capital's mutual fund fees were illegally high. This is a case about illegal market timing, not fees. Therefore, we see no legitimate basis for the Commission to act as a "rate-setter" and determine how much mutual fund customers should pay for the services they receive in the future from Alliance Capital. This decision is better left to informed consumers, independent and vigorous mutual fund boards, and the free market. Mandatory fee discounts would (i) require that customers do business with Alliance in order to receive the benefits of the discounts, and (ii) provide monetary relief to customers who were not harmed by the violations set forth in the order. That is why our efforts focused on providing full compensation to harmed investors and a significant upfront penalty.

Issues surrounding mutual fund fees are critically important. As part of our broad and unique rulemaking powers, we plan to take up these issues in the period ahead. We firmly believe that rules uniformly applicable to the entire industry are more desirable than a piecemeal approach that fragments the marketplace. The rulemaking process - with its attendant protections of notice and public comment - is a better way to address fee issues than the imposition of arbitrary discounts in individual enforcement actions about market timing. While we can all applaud fair and reasonable fees, we think the best way to ensure them is a marketplace of vigorous, independent, and diligent mutual fund boards coupled with fully-informed investors who are armed with complete, easy-to-digest disclosure about the fees paid and the services rendered. n52

The SEC clearly thought that in requiring Alliance to cut its fees, Spitzer had exceeded his authority and engaged in inappropriate rulemaking through enforcement action.

The N.Y. Attorney General is not reticent about this subject, or subtle. For example, with regard to the complaint his office filed against Merrill Lynch for publishing false and misleading analyst reports, he was clear that "what we are seeking here is to reform the system and restore integrity...." n53 Mr. Spitzer appears to be of the view that the SEC routinely tolerated pervasive wrongdoing, and that until he came along, there was no hope for reform of wrongdoing because "nobody believed that anybody was going to put a stop to it." n54 In other [*133] words, Mr. Spitzer has not been content to share power with the SEC. He certainly has not been content to follow the SEC's lead, or to let the SEC set the regulatory agenda. While Eliot Spitzer is driven by the spirit of political entrepreneurship, the SEC is driven by a sense of rivalry. Clearly, the SEC has been far more influenced by Eliot Spitzer than Eliot Spitzer has by the SEC. In a real sense, Mr. Spitzer has engineered a successful "hostile takeover" of the SEC, hijacking its agenda and forcing the

Commission to pursue his preferred approaches to capital market regulation, or else risk appearing slow and indifferent and suffering a major public relations defeat. Mr. Spitzer has replaced the SEC as "policy czar." n55

For example, Spitzer upstaged the joint investigation by state and federal regulators of market timing by mutual funds, analyst conflicts of interest, and, more recently, market manipulation by hedge funds. It appears that the SEC has been "embarrassed" and "upstaged," not only by Spitzer's ability to "extract a whopping \$ 1.4 billion in penalties (from Wall Street's largest broker-dealer firms), bigger than any ever won by the SEC," but also by making the Commission "look inept." n56 At present, it appears that the pace and vigor of even relatively small investigations, such as insider trading by a single individual, is influenced by the Spitzer-SEC rivalry because "they don't want the New York Attorney General's office to make them look like Keystone Kops again." n57

III. The Once and Future SEC: Securities Regulation Post-Spitzer

Having moved through the initial suspicion about his motives and ability in the "New Deal" stage of his tenure, to subsequent acceptance of his competence and professionalism in the "Federalist" stage, Eliot Spitzer has now successfully engineered a de facto hostile takeover of the SEC, controlling its agenda and seemingly even its personnel. n58 The important question, to be answered in the ultimate stage of the Spitzer era, is what will come next for capital markets regulation in the United States. In my view, this question invokes the three [*134] (and only three) possible "post-Spitzer scenarios" that were illustrated in Part I:

Scenario 1: the SEC will experience real institutional reform and be more agile and aggressive after Mr. Spitzer leaves office, filling the vacuum left by Mr. Spitzer;

Scenario 2: the SEC will be weakened and demoralized after Mr. Spitzer moves on, and oversight of the securities markets and regulatory enforcement of the securities laws will be diminished over the long run as the SEC loses stature and prestige as an institution;

Scenario 3: the SEC will continue roughly unchanged, but a political coalition will emerge to extend the partial preemption of state securities laws accomplished by the 1996 NSMIA legislation, so as to bar states attorneys general such as Mr. Spitzer from encroaching on the SEC's regulatory turf in the future.

The nature of Mr. Spitzer's legacy will depend on which of these scenarios occurs in the wake of his inevitable departure from office. As for the first scenario, there is no evidence or even any indication that Mr. Spitzer's initiatives have strengthened the SEC. There is not even an extant theory in political science or the theory of federalism to support the belief that the SEC will emerge a better, stronger institution in the long-run as a result of the competition Mr. Spitzer posed in the short-run. Rather, it seems more likely that the SEC's "identity crisis" will cause the agency to be more susceptible to capture by special interest groups as it seeks to curry favor with new constituencies and strengthen ties with old constituencies in the wake of its recent loss of prestige.

Two recent policy initiatives by the SEC seem consistent with this view. Both the SEC's shareholder access initiative and its ruling regarding mutual fund boards of directors represent a clear change in its institutional direction and focus. It seems impossible to avoid the conclusion that the competitive pressures exerted by the New York Attorney General are at least partially responsible for this dramatic change. Having lost its original core constituency of small investors in U.S. capital markets to Eliot Spitzer, the SEC is in search of a new one.

A. SEC Shareholder Access Proposal

Under long-standing law and corporate practice, corporations controlled the election of corporate directors [*135] through control of access to the corporate ballot box. When it came time to elect directors at the annual meeting, a company's board of directors would typically nominate the slate of candidates generated by the (generally management-controlled) nominating committee of the board of directors. If a shareholder was unhappy with the slate of candidates nominated by the board and management, she would be obliged to mount a proxy contest at considerable expense and risk, and in full compliance with applicable state and federal securities laws. The insurgent group would also exclusively shoulder the fees and expenses for the election campaign of this alternative slate of candidates.

In late 2003, reeling from pressure mounted by Eliot Spitzer and desperate to be seen as capable of making a meaningful, or at least politically salient, regulatory initiative, the SEC proposed Rule 14a-11. Under this proposed rule, some outside shareholders (though not all) n59 would be able to require the corporation to place their nominee on the corporation's proxy card and publish that nominee's supporting statement, if one of the following two triggering events were to occur: (a) a shareholder proposal to authorize shareholder nominations is placed on the ballot under SEC Rule

14a-8 and a majority of the outstanding shareholders approves this proposal; or (b) shareholders representing at least 35% of the total votes in a corporate election for directors withhold proxy authority from the incumbent board of directors.

If there are 35% "withholds" at one meeting, or if a majority of the outstanding shares votes to approve a shareholder proposal under Rule 14a-8, then at the following annual meeting at which directors are to be elected, shareholder nominees must be included in the company's ballot and accompanying proxy statement. n60 This initiative reflects the SEC's "desperate attempt to regain control of the [*136] regulatory agenda" n61 in the field of capital markets regulation. Interestingly, this move represents a clear incursion into the director nomination process, an area traditionally reserved for state law. The U.S. federalist system has long granted states a position of primacy in the promulgation of rules related to the internal corporate governance of corporations. n62

Even more oddly, the SEC has long dragged its heels in efforts to assist shareholders in improving the quality of corporate elections. In particular, the SEC has withheld vigorous support of the shareholder rights bylaw, which would allow investors to enact corporate bylaws requiring directors to permit shareholders to vote on whether a company should nullify anti-takeover devices, such as the poison pill, when a company receives a fully funded cash takeover bid for all of its outstanding shares at a substantial premium to market. n63 The political pressures imposed by Eliot Spitzer provide the only reasonable explanation for its new-found interest in reforming the corporate election process.

The SEC's proposed new rule also represents a radical departure from the past in terms of the constituencies that the agency has addressed. Traditionally, the SEC has appealed to shareholders, securities firms, lawyers, and other capital markets "insiders." This proposal is the SEC's poorly disguised attempt to link itself to a new constituency: public interest pension funds and other "activist" shareholder groups, whose preferences and agendas are unlikely to reflect the profit-maximization motive that is embraced by the average investor.

B. SEC Mutual Fund Board Chairman Independence Rule

On June 23, 2004, by a vote of three to two, the SEC elected to require that the chairs of mutual funds' boards of directors be independent of the advisors of such funds. There is no empirical or theoretical basis for this rule. Indeed, the rule appears to be simply a political public relations ploy, which, if anything, will harm rather than benefit mutual fund investors. Commissioner Cynthia Glassman commented on the lack of bases for this proposal: [*137]

It is a fact that many of the top-rated funds today based on high performance and low fees have inside chairs. Why should we tell shareholders they can no longer have the form of governance that produced this high level of performance? And further, why should we require them to pay for it? There can be no doubt that this requirement will add to fund expenses. An independent chair cannot be expected to have -- and in most cases, will not have -- hands-on knowledge about fund operations. Therefore, to be effective, the chair would have to hire a staff. Shareholders will bear that expense as well as the likely additional cost of the independent chairman. In sum, the benefits are illusory, but the costs are real. n64

She also noted that there is no empirical evidence that mutual funds with independent chairs have either higher returns or lower overhead and administrative costs than mutual funds chaired by insiders. n65

As with the SEC's proposed shareholder ballot-access rule, it appears that in promulgating the chairman independence rule, the Commission is clearly less concerned with shareholder welfare and the quality of U.S. capital markets than it has been in the past. The public interest concern with the quality of U.S. investors and capital markets appears to have been replaced by a regulatory agenda that includes rulemaking oriented towards special-interest groups.

These examples illustrate the ways that the recent spate of corporate scandals, combined with Eliot Spitzer's bureaucratic turf-grabbing, have influenced the SEC's behavior. Whether this is a short-term phenomenon or not will depend on what happens after Mr. Spitzer leaves his post as Attorney General of the State of New York.

Conclusion

The SEC's success in procuring more resources, in the form of higher budget allocations, does not necessarily mean that the SEC's power and prestige has increased in the wake of recent corporate scandals. Neither do the SEC's budget increases reflect heightened public recognition of the SEC's relevance or effectiveness. Rather, the SEC's success in the budgetary process reflects the need for federal officials to appear to be "doing something" in the wake of the crises that [*138] have emerged on Main Street (e.g., Enron, Global Crossing, Adelphia, Tyco, Waste Management, Sunbeam) and in the wake of the scandals that Eliot Spitzer has uncovered on Wall Street. As such, it does not seem

that the first scenario presented will materialize: the SEC will not experience meaningful institutional reform. It will not emerge from the Spitzer era a more agile and aggressive regulatory agency.

The second possibility, that the SEC will be weakened and demoralized after Mr. Spitzer moves on, and that oversight of the securities markets and regulatory enforcement of the securities laws will consequently be diminished, is equally unlikely. The SEC's apparent resilience in the budgetary process, coupled with steadily rising pay for SEC staffers, suggests continued stability. In 2004, the SEC obtained "pay parity" with banking regulatory agencies, allowing it to pay its professionals at the highest pay scale allowed in government. n66 As long as the SEC continues to serve as a training ground for high paying jobs in the nation's top law firms, it will attract bright, talented, ambitious, hard-working people, if only for relatively short periods of time. Thus the SEC will continue to attract high quality professionals and find success in obtaining funding, without repercussion due to past poor performance in anticipating and responding to scandals in the capital markets. Nobody is calling for the dismantling of the SEC.

The final scenario appears highly likely: the SEC will continue roughly unchanged, but a political coalition will emerge to enlarge and extend the partial preemption of state securities laws accomplished by the 1996 NSMIA legislation. I expect that this legislation will bar future states attorneys general who would seek to emulate Eliot Spitzer from [*139] encroaching on the SEC's regulatory turf. This kind of preemptive legislation would attract the support of a powerful farrago of interest groups. Deregulatory Republicans would join with anti-federalists to support this legislation. The deregulatory Republicans would likely support preemption because they prefer that the state attorneys general be stripped of power and be prevented from interfering with the operation of the markets; the anti-federalists because they would like to see federal administrative agencies gain power at the expense of state governments. To the extent that corporate and special interests have captured the SEC, these groups will similarly favor preemption, since they have more control over the SEC than they do over a world in which the SEC and the states are locked in competition for headlines, political support, and relevant targets to prosecute.

Legal Topics:

For related research and practice materials, see the following legal topics:

Public Health & Welfare Law
Healthcare Services for Disabled & Elderly Persons
Care Facilities
Nursing Facilities
Securities Law
Additional Offerings & the Securities Exchange Act of 1934
Issuer Recordkeeping & Reporting
Sarbanes Oxley Act
Securities Law
Initial Public Offerings & the Securities Act of 1933
General Overview

FOOTNOTES:

n1 Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of Titles 11, 15, 18, 28, and 29 of the U.S.C.).

n2 See NASD and NYSE Rulemaking: Relating to Corporate Governance, *68 Fed. Reg. 64, 154* (Nov. 12, 2003).

n3 See *id.*

n4 For a glimpse of how the Attorney General views his role as securities regulator, see his website, <http://www.oag.state.ny.us/investors/investors.html> (last visited Oct. 26, 2004).

n5 John C. Coffee Jr., A Course of Inaction, *LEGAL AFF.*, Mar.-Apr. 2004, at 46, 49 (discussing the SEC's passivity with regard to the mutual fund crisis); Jonathan R. Macey, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty, *15 CARDOZO L. REV.* 909 (1994).

n6 Susan Dudley & Melinda Warren, Regulatory Spending Soars: An Analysis of the U.S. Budget for Fiscal Years 2003 and 2004, 14-19 (published jointly by the Mercatus Center, Arlington, Va. & the Weidenbaum Center, St. Louis, Mo.) (July 2003), available at <http://wc.wustl.edu/RegBudgetfinal.pdf> (last visited Aug. 9, 2004).

n7 See Pamela Barnett, SEC Chief Applauds Budget Increase, Promises to Beef up Staff, GOVEXEC.COM (Mar. 14, 2003), at <http://www.govexec.com/dailyfed/0303/031403cdam2.htm> (last visited Oct. 8, 2004).

n8 Id.

n9 Actually, the SEC FY 2005 budget request to Congress totaled \$ 913 million and was 12.5 percent above the amount authorized for the SEC in fiscal 2004. The amount consisted of \$ 893 million in new budget authority and \$ 20 million in anticipated balances from the prior year. This budget request - the first crafted by Chairman Donaldson since his arrival in February 2003 - permitted the Commission to hire 106 new employees. Press Release, SEC, SEC Releases FY 2005 Budget Information (Feb. 2, 2004), at <http://www.sec.gov/news/press/2004-11.htm> (last visited Aug. 9, 2004).

n10 Press Release, Office of the Press Secretary, Restoring Economic Confidence and Tackling Corporate Fraud (Jan. 11, 2003), at <http://www.whitehouse.gov/news/releases/2003/01/20030111-1.html> (last visited July 24, 2004).

n11 National Accounting News, TEXAS SOC'Y OF CERTIFIED PUB. ACCT. (Accounting Web, Inc., Indianapolis, Ind.) (Nov. 7, 2003), at <http://www.tscpa.org/welcome/AcctWeb/acctweb110703.asp#3> (last visited July 24, 2004).

n12 Need to Know: Global Business Briefing, TIMES (London), (Nov. 4, 2003), available at <http://www.timesonline.co.uk/article/0,,5-880041,00.html> (last visited July 24, 2004).

n13 See Spitzer Blames the SEC; Donaldson Admits Mistakes, The Corporate Reform Weekly: Citizen Works' Look at the Campaign for Corporate Reform, Vol. II, #41 (Nov. 3, 2003), at <http://citizenworks.org/news/index.php?id=106> (last visited Oct. 4, 2004).

n14 Id.

n15 See ANTHONY DOWNS, INSIDE BUREAUCRACY 13 (1967).

n16 See Daniel Gross, Eliot Spitzer, Wimp, SLATE, May 21, 2004, at <http://slate.msn.com/id/2100951/> (last visited July 24, 2004). See also Interview by Gabe Pressman with Eliot Spitzer, N.Y. Att'y Gen., New York, N.Y. (Dec. 17, 2003) at <http://www.wnbc.com/news/2711555/detail.html> (last visited July 24, 2004).

n17 See Interview by Gabe Pressman with Eliot Spitzer, *supra* note 16.

n18 Pay Parity Implementation Plan and Report, SEC (Mar. 6, 2002), at <http://www.sec.gov/news/studies/payparity.htm> (last visited Oct. 8, 2004).

n19 Id.

n20 Eliot Spitzer, Remarks at the Fifth Occasional Breakfast of the Yale Law School Center for the Study of Corporate Law (Nov. 17, 2003) (transcript on file with the Brooklyn Law Review).

n21 The SEC is an "independent" agency comprised of five members appointed by the President and confirmed by the Senate for staggered five-year terms. See LOUIS LOSS & JOEL SELIGMAN, FUNDAMEN-

TALS OF SECURITIES REGULATION 67 (5th ed. 2004) (citing Securities Exchange Act of 1934 § 4(a), 15 U.S.C. § 78(d) (2000)).

n22 Definition of Securities and Exchange Commission Appointees, W. I.Q., at <http://www.wordiq.com/definition/SecuritiesandExchangeCommissionappointees> (last visited Oct. 8. 2004).

n23 SEC Historical Society Website, at <http://www.sechistorical.org/join/index.php> (last visited July 24, 2004).

n24 See Arnoud W. A. Boot & Jonathan R. Macey, Monitoring Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance, 89 *CORNELL L. REV.* 356 (2004) (pointing out trade-off between proximity and objectivity).

n25 Remarks of Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, at F. Hodge O'Neal Corporate and Securities Law Symposium, in 81 *WASH. U. L. Q.* 545, 548 (2003); Kevin A. Jones, The National Securities Markets Improvement Act of 1996: A New Model for Efficient Capital Formation, 53 *ARK. L. REV.* 153, 154-55 (2000). See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3417 (codified as amended in scattered sections of 15 U.S.C. (2000)).

n26 Joint Explanatory Statement of the Committee of Conference, Conference Report, National Securities Markets Improvement Act of 1996, H.R. 3005, H.R. CONF. REP. NO. 104-864 (1996).

n27 H.R. REP. NO. 104-622, at 16 (1996).

n28 Remarks of Stephen M. Cutler, *supra* note 25, at 547.

n29 The Sheriff of Wall Street [hereinafter The Sheriff of Wall Street] (May 25, 2003), at <http://www.cbsnews.com/stories/2003/05/23/60minutes/printable555310.shtml> (Oct. 24, 2004).

n30 Remarks of Stephen M. Cutler, *supra* note 25, at 551-52.

n31 The Sheriff of Wall Street, *supra* note 29.

n32 *Id.*

n33 *Id.*

n34 Remarks of Stephen M. Cutler, *supra* note 25, at 551.

n35 William Hanley, What Makes Spitzer Run, *FINANCIAL POST*, Dec. 30, 2003, at 1.

n36 Rulemaking by enforcement refers to the presumptively illegitimate process by which regulators proceed with rulemaking "ex post," i.e. after certain conduct occurs, rather than through more legitimate formal notice-and-rulemaking procedures. See Harvey L. Pitt & Dixie L. Johnson, Fried, Frank, Harris, Shriver & Jacobson LLP, SEC Found Acting in Excess of its Powers, *SEC MAIL* (June 2, 1999) (analyzing the decision in *Victor Teicher v. Securities and Exchange Commission*, and finding that it will result in beneficial rulemaking and rule clarifications by SEC release, thereby offering "more clarity and less rulemaking by enforcement"), at

<http://www.ffhsj.com/secreg/archives/sc990602.htm> (last visited Oct. 8, 2004); see also Stephen M. Culter, Remarks at the F. Hodge O'Neal Corporate and Securities Law Symposium (Feb. 21, 2003) (noting SEC Chief of Enforcement Stephen Culter's observation that he was "quite familiar with the complaint [] that a proposed settlement [of litigation] amounts to rulemaking by enforcement."), at <http://www.sec.gov/news/speech/spch022103smc.htm> (last visited Oct. 8, 2004).

n37 Cutler, *supra* note 25, at 552.

n38 *Id.* at 552-53.

n39 *Id.*

n40 Press Release, SEC, Alliance Capital Management Will Pay Record \$ 250 Million and Make Significant Governance and Compliance Reforms to Settle SEC Charges (Dec. 18, 2003), at <http://sec.gov/news/press/2003-176.htm> (last visited Oct. 8, 2004).

n41 *Id.*

n42 *Id.*

n43 *Id.*

n44 *Id.*

n45 Press Release, *supra* note 40.

n46 *Id.*

n47 *Id.*

n48 *Id.*

n49 *Id.*

n50 Press Release, *supra* note 40.

n51 Statement of the Commission Regarding the Enforcement Action Against Alliance Capital Management, SEC NEWS DIGEST, (Dec. 18, 2003), at <http://www.sec.gov/news/digest/dig121803.txt> (last visited Oct. 8, 2004).

n52 See Press Release, *supra* note 40.

n53 *The Sheriff of Wall Street*, *supra* note 29, at 2.

n54 *Id.*

n55 Monica Langley, *The Enforcer: As His Ambitions Expand, Spitzer Draws Controversy*, WALL ST. J., Dec. 11, 2003, at A1.

n56 Paul Tharp, *SEC's Eliot Envy*, N.Y. POST, Jan. 27, 2003, at 33.

n57 *Id.*

n58 See discussion of Juan Marcelino's dismissal from the *SEC*, *supra* text accompanying notes 11-12.

n59 Only shareholders who meet four criteria will have access to the company's proxy materials. The four criteria are: (a) beneficial ownership of more than 5% of the company's voting stock, held continuously for at least two years; (b) declaration of intent to continue owning the requisite number of securities through the date of the relevant shareholders' meeting; (c) eligibility to report their holdings on Schedule 13G rather than 13D; and (d) filing of a Schedule 13G before their nomination is submitted to the corporation. Security Holder Director Nominations, Exchange Act Release No. 34-48626 (proposed Oct. 14, 2003), available at <http://www.sec.gov/rules/proposed/34-48626.htm> (last visited Aug. 9, 2004).

n60 *Id.*

n61 Jonathan R. Macey, *Securities and Exchange Nanny*, WALL ST. J., Dec. 30, 2003, at A10.

n62 *Business Roundtable v. SEC*, 905 F.2d 406, 412-13 (D.C. Cir. 1990).

n63 See Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 *HOFSTRA L. REV.* 835, 837 (1998).

n64 Commissioner Cynthia A. Glassman, *Statement by SEC Commissioner Regarding Investment Company Governance Proposal* Address at U.S. Securities and Exchange Commission Open Meeting (June 23, 2004), at <http://www.sec.gov/news/speech/spch062304cag.htm> (last visited July 28, 2004).

n65 *Id.*

n66 Pub. L. No. 107-123, the Investor and Capital Markets Fee Relief Act (Pay Parity Act), requires the Securities and Exchange Commission (SEC or Commission) to submit a report to the Committee on Governmental Affairs and the Committee on Banking, Housing, and Urban Affairs of the Senate, the Committee on Government Reform and the Committee on Financial Services of the House of Representatives, and the Office of Personnel Management (OPM) describing the Commission's plan to implement Section 4802 of Title 5 of the U.S. Code. This provision of law provides the Commission with the authority to appoint and fix the compensation of such officers, attorneys, economists, examiners, and other employees as may be necessary for carrying out its functions under the securities laws as defined under Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. § 78c). The statute "places the SEC on equal footing with its sister federal financial regulatory agencies." Pay Parity Implementation Plan and Report, SEC, (Mar. 6, 2002) at <http://www.sec.gov/news/studies/payparity.htm> (last visited Oct. 13, 2004). The SEC "worked closely with Congress and the Administration throughout this process of resolving the agency's ongoing staffing crisis and appreciates greatly the support that it has received." *Id.*