U.S. Securities and Exchange Commission

Speech by SEC Commissioner: Facilitating Real Capital Formation

by

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Good morning. I am delighted to be here at the Council of Institutional Investors' Spring Meeting. I have appreciated that the Council and its members have been a strong voice working toward meaningful reform in the aftermath of the financial crisis. As these challenging times continue, I encourage you to continue to be a strong, proactive voice for investors. Before I begin my remarks this morning, I need to issue the standard disclaimer that the views I will express today are my own and do not necessarily reflect the views of the Commission, my fellow Commissioners, or members of the staff.

Today, I want to talk about capital formation. For over 30 years, I advised many clients as to their capital raising efforts in order to grow their businesses, and I worked with institutions that held significant stakes in companies who grew their operations by making better products, and selling more of them.

I have been growing increasingly concerned about the discussion that is taking place in our country regarding capital formation. This discussion seems to confuse the singular act of capital raising with the much broader concept of capital formation. Moreover, this discussion fails to take into account the importance of disclosure in helping investors assess risks and make informed investment decisions. Disclosure leads to an informed investor - and informed investors are ones who will make investment decisions that collectively, in the aggregate, will yield productive benefits and growth to the real economy.

I know you understand exactly what I mean. The Council is an association of members who have a long-term stake in the U.S economy. You are self-described as the "patient capital" of the markets because, in general, you have "30-year investment horizons and heavy use of indexing strategies."[1] You understand that for most investments to make money, the company generally requires organic or strategic growth over a period of time.

I share this long-term view.

At a time when too many people are facing tough economic conditions in our country, with persistently high levels of unemployment, we need to understand what is needed for investments to result in productive uses. With millions of Americans unemployed, and with those who are employed earning less,[2] our recovery will be anemic until all Americans can share in it and, by participating in the recovery, drive economic growth.

In particular, for this effort to be robust, the SEC must be clear about the benefits of regulation and how regulation has been, and can continue to be, a driver of informed investments and economic growth. I am concerned about the negative ramifications that will flow from those who refuse to face the reality that regulation and mandatory disclosure are essential to strong capital formation and to real economic growth.[3]

I think that a focus on reality was a large part of what President Obama meant when earlier this year he issued an executive order on regulation.[4] I agree with President Obama when he stated that the purpose of "the nation's regulatory system" is that it "must protect public health, welfare, safety, and our environment while promoting economic growth, innovation, competitiveness, and job creation." In doing so, the President made clear that regulation "must be based on the best available science."

I plan to spend my time with you today discussing the following:

- The way that strong regulation facilitates capital formation and real economic growth and the science that supports it; and
- My concern that the U.S. capital markets are being exploited by certain foreign companies, not only harming U.S. investors, but also negatively effecting the environment for capital formation.

The Real Economy and Capital Formation

Let me begin by talking about the real economy and the essential and positive role of securities regulation. By the "real economy," I mean our country's capacity to produce goods, to provide services, and for our citizens to earn a living wage. From my standpoint, one of the most important insights from the financial crisis was that deregulated and poorly regulated markets misallocated our country's capital and other scarce resources, resulting in trillions in mispriced assets, devastating the savings of American families, and resulting in painful levels of unemployment that persist to this day.[5] As credit contracted, businesses saw their lending costs soar and hoarded cash in the face of weak demand.[6]

The Reality About Capital Formation

As an SEC Commissioner focused on the real economy and on our recovery from the financial crisis, I am gratified that the SEC's mandate includes the consideration of capital formation. Facilitating capital formation and improving the real economy go hand in hand.

However, it is important that we define what facilitating capital formation means. When Congress included the consideration of capital formation in the SEC's mandate it did not define the term.[7] The term, however, has been around for decades. It is generally understood that capital formation is a macroeconomic benchmark that measures changes in the amount of productive capital in the economy as a whole.[8] In essence, capital formation is about all the ways of creating productive capital in our economy, including but not limited to improving infrastructure, building plants, and hiring workers.[9]

But, in the discussions about capital formation, it seems to have become synonymous with the ability to raise funds. Whatever makes it easier and cheaper for issuers to raise money seems to constitute capital formation.[10] However, the singular act of raising capital does not necessarily result in capital formation.

Let me illustrate this with a prime example where a lot of money was raised from investors who received little to no information and where, as a result, fewer productive assets were produced. This example involves securitizations of asset-backed securities. It is true that securitization can lower borrowing costs and be an important way to facilitate capital formation, but we have learned that the process must be improved. The vast majority of asset-backed securities – especially the structured finance products that were key drivers of the financial crisis – were sold in private placements where no disclosure was required.[11] Moreover, for those securitizations that were sold in registered deals, ongoing public reporting generally terminated after one year.[12]

As the Financial Crisis Inquiry Commission observed, "By the time the financial crisis hit, investors held more than $2 trillion of non-GSE mortgage backed securities, and close to $700 billion of CDOs that held mortgage-backed securities. These securities were issued with practically no SEC oversight. And only a minority were subject to the SEC's ongoing public reporting requirements."[13] As the SEC said last year, "Securitization in the private, unregistered market played a significant role in the financial crisis."[14] In fact, one might argue that we had capital destruction rather than capital formation.[15]

Additionally, if capital raising is the sole consideration to define capital formation, individuals who engage in Ponzi schemes could be considered the best facilitators of capital formation in the business. That simply cannot be right. Following this idea to its logical conclusion leads to capital destruction rather than capital formation.

Facilitating true capital formation is about helping investors and other capital providers to make informed decisions. Almost all investments have risks, and while we all understand the need for investors to take risks, I want them to take informed risks. Capital formation is about ensuring that the companies with the best ideas, even if those ideas are risky, can get the financing to make those ideas a reality. The goal is for issuers to provide potential investors with appropriate information so that investors can assess the risk of investing their capital.[16] For that goal to be reached, we need strong and effective securities regulation that fosters appropriate disclosures.

By comparison, just think about the recent financial crisis, as well the Great Depression, and you will see that poor securities regulation does not facilitate the formation of productive capital. In both crises, the savings of hard working Americans went into investments that wound up being worth little, if anything. And in many cases it was because of a lack of regulation and disclosures.[17]

In addition to the lessons of history, there are several recent studies that clearly demonstrate that capital formation is facilitated by a strong, mandatory disclosure regime.

The Best Available Science: Strong Securities Regulation is Important to the Real Economy

As those of us who took science in school will remember, in science, there is theory and there is empirical evidence. The theory of why strong mandatory disclosure drives capital formation is straightforward. Disclosure improves the accuracy of share prices, and helps to determine which investment projects should receive society's scarce capital. In addition, disclosure assists shareholders in monitoring management and in proxy voting, which helps ensure that the projects that are undertaken are managed better.

Disclosure also helps the broader public determine how best to invest capital. For example, imagine an entrepreneur contemplating entry into the telephone business. She learns from AT&T's segment disclosures that revenue from landline telephone service has declined by over 10% each of the last two years.[18] It's not hard to imagine that this entrepreneur may decide that a new startup aiming to improve telephone service should also consider whether it would be effective in a wireless or VOIP context. Venture capital investors would also look harder at a business plan whose profitability was based solely on landline telephone service. The public disclosure improves the quality of their decision making.

Economic theory explains not only why disclosure is valuable, but also why regulation is essential for adequate disclosure to be provided. There are a lot of reasons for this. One principal reason is that disclosure is, in economic terms, a "public good" in that its benefits are enjoyed broadly by the public – across all investors, prospective investors, competitors, and other interested parties. However, because the benefits are shared broadly, there may not be any single group that will fight for disclosure at a level that benefits all. This includes companies. Even the best companies and their management who are focused on high-quality disclosure live in a world where the costs and inconvenience of preparing disclosure are borne by them but the disclosure benefits shareholders and other market participants. Without regulation requiring disclosure, management, especially with bad news to report, can be expected to resist disclosure.

Regulation also sets a level playing field by subjecting all companies to the same requirements. Without regulation mandating public disclosures, the widespread benefits of disclosure would not be achieved, and investors and the public would not receive the information they need. As a result, shareholders would be unable to judge how management is performing, and investors would be denied information to inform their investments decisions. The public nature of the disclosure leads to decisions that allow our economy to be as strong as it can be.[19]

This theory has been evidenced in several empirical studies over the past decade that clearly show the positive effect of securities regulation and mandatory disclosure.[20] Let me briefly summarize just a few of the recent studies and their results:

First, a 2003 study that looked at the effect of the Commission's rules requiring management to discuss and analyze the company's financial and operating results, the so-called MD&A requirements. MD&A was a significant new disclosure rule when it was adopted. It required management to reveal trends and risks that made the information about the company's current results more understandable. The study found strong evidence that MD&A disclosure resulted in more accurate and informed share prices – and that it contributed to a better functioning real economy.[21]

Second, a 2006 study that looked at what happened to widely-held companies that were traded over-the-counter after the securities laws were amended to require these companies to make disclosures specified by the SEC.[22] The study found that the newly required disclosures created billions of dollars of value for shareholders of the OTC companies.[23] This study is strong evidence of the benefits that public disclosure provides.[24]

One last study I want to draw to your attention to is quite recent. This 2010 study examined the effect on share price accuracy and trading arising from the SEC's rules requiring separate "segment reporting" or "line of business" reporting. These regulations required issuers to disclose the sales and net income derived from each of the lines of business in which they were significantly involved. The study finds "strong evidence" that this disclosure did, in fact, increase share price accuracy and improve market liquidity.[25]

There are many other economic studies that find public disclosure is valuable to the companies that make it, but more importantly to the economy as a whole.[26]

Moreover, in addition to the economic arguments explaining how strong disclosure is beneficial to the real economy, we should not forget that disclosure also is supported by classic notions of investor protection and by the basic notion of fairness– that a capital provider, the shareholder, as principal, should know what its agent, the corporation and its management, is doing. There is also a sense of marketplace fairness that is part of the fabric of this country: that a buyer shouldn't pay more than something is worth, especially because of a lack of information.

Where would our economy be, and how much real, productive capital would our country have, if there had been better disclosures about asset-backed securities, about CDOs, and all the other securities that were offered and sold in poorly regulated markets? With trillions upon trillions of dollars being allocated in the capital markets, and with an economy that is increasingly sensitive to information, even small changes in disclosure can have a tremendous impact. That is the reality. And it is important we keep the facts in mind.

Certain Foreign Companies Abusing U.S. Capital Formation Process

With that foundation, I would like to highlight a disturbing trend that seems to have challenging implications for capital formation and investor protection. In recent years, we have seen a spike in private companies merging with a public shell company as a way of going public. While it is Chinese companies that have grabbed recent headlines, the problems coming to the forefront would not necessarily be limited to companies based in China.

There are a lot of different ways for companies to access the public markets, but not all of them are equal. They differ in the quality of the disclosures, the time investors and the SEC typically have to consider them, and the protections that investors have against false and fraudulent statements.

The traditional IPO remains the gold standard. In a traditional IPO, the SEC and the public receive robust disclosures, along with the time to review and consider them, backed up by real liability that puts the risk of false statements on the people in the best position to ensure accuracy, not on the investors. In addition, underwriters and auditors engage in due diligence which enhances the disclosure quality.

Another way to access the public markets is Exchange Act registration of a class of securities, rather than through registration of a public offering. For example, when the company reaches a certain size and has a class of equity securities that is considered widely-held because of its number of shareholders, it is required to provide public disclosures. However, unlike a traditional IPO, there is no underwriter performing due diligence.

A common but lesser known way of accessing the public markets is the reverse merger into a public shell, or where a public shell merges into a private company, a so-called "backdoor registration."[27] For those of you not familiar with these types of mergers, what typically happens is a private company seeking to go public merges with a public shell company. Before the transaction, the public shell company no longer has substantive operations, but its public company registration remains in effect. The transaction gives the formerly private company the credibility and access to capital of being registered as a public company, without any of the vetting from underwriters and investors that companies undergo when they perform a traditional IPO.

Since January of 2007, there have been over 600 backdoor registrations. Over 150 of these have been by companies from China and the China region.[28] Notwithstanding the SEC rulemaking of a few years ago to respond to abuses involving shell companies,[29] we are seeing increasing problems. While the vast majority of these Chinese companies may be legitimate businesses, a growing number of them are proving to have significant accounting deficiencies or being vessels of outright fraud.[30]

As just one example of this phenomenon, two companies that were numbers 1 and 2 on the Investor's Business Daily 100 have now been shown to have significant issues.[31] One of these companies had to restate its earnings and was delisted just last week.[32] The other has admitted that at the very least two of its manufacturing contracts didn't actually exist.[33] Just last Friday, the SEC suspended trading in another Chinese company that became public in the United States through a shell.[34] This was the second SEC trading suspension imposed on Chinese companies in this situation in the month of March alone.[35] Additionally, NASDAQ and NYSE Amex have recently suspended trading in several of these companies.[36]

I support all of the efforts to address these problems. The SEC staff has been working collaboratively and tirelessly with many others to investigate and shed light on this situation. It has been widely reported that the SEC set up an internal task force to investigate fraud in overseas companies with listings on U.S. exchanges, with particular emphasis on companies engaging in these mergers to achieve backdoor SEC registration. The staff's hard work has yielded, and will continue to yield, results.

In the world of backdoor registrations to gain entry into the U.S. public market, the use by Chinese companies has raised some unique issues, even compared to mergers by U.S. companies. Two important ones are:

- First, there appear to be systematic concerns with the quality of the auditing and financial reporting; and

- Second, even though these companies are registered here in the U.S., there are limitations on the ability to enforce the securities laws, and for investors to recover their losses when disclosures are found to be untrue, or even fraudulent.

I am worried by the systematic concerns surrounding the quality of the financial reporting by these companies. In particular, according to a recent report by the staff of the Public Company Accounting Oversight Board (PCAOB), U.S. auditing firms may be issuing audit opinions on the financials, but not engaging in any of their own work.[37] Instead, the U.S. firm may be issuing an opinion based almost entirely on work performed by Chinese audit firms. If this is true, it could appear that the U.S. audit firms are simply selling their name and PCAOB-registered status because they are not engaging in independent activity to confirm that the work they are relying on is of high quality. This is significant for a lot of reasons, including that the PCAOB has been prevented from inspecting audit firms in China.

Moreover, the PCAOB noted that these issues were layered on top of other factors that may have a negative impact on the audit, including:

- The need to understand the local language;
- The use of local audit firms or personnel from an outside audit firm to complete a portion of the audit work;
- Additional travel time and expense; and
- The need to understand the local business environment in which the client operates.

An additional problem with these backdoor registrations is that there may be difficulty in prosecuting violations. Enforcement against falsehoods in the context of these companies is difficult. The documents and people who have the information about the company and whether there was misconduct are often outside the reach of subpoena power. However, notwithstanding these obstacles, our staff is committed to doing everything they can with the resources we have. The SEC has already brought cases and will continue to do so.

Nonetheless, investors should still be aware that the SEC and private plaintiffs may have a more difficult time enforcing their remedies and that recovery for investor losses could be limited. For one thing, the persons to punish and the assets that could satisfy a judgment may be located outside of the United States and harder to access. In addition, remedies obtained in the United States may not be enforceable in foreign countries, where the bulk of the assets might reside.

The consequences of the growing problems in this area has real significance, because it has been reported that billions of U.S. savings and investment dollars have been entrusted with these companies.[38]

Finally, and to return to our earlier topic of capital formation, it’s important to see the connection between capital formation and strong enforcement of securities laws. We have seen clearly that capital formation is improved with solid disclosures – but what happens when the disclosures are lies? That’s when we need strong enforcement. Capital formation is strengthened when investors have confidence that the laws will be obeyed and that, when they’re not, that the fraudsters will be made to pay. Moreover, strong enforcement – by providing deterrence - helps to ensure the disclosure is truthful and complete in the first place. Where savings and investments are allocated under inadequate or false information the environment for capital formation is negatively affected. That is why I’ve been a consistent advocate for a robust enforcement program and an adequately funded SEC. My hope is that potential fraudsters are scared into telling the truth to avoid the consequences.

Conclusion

With our country in an anemic recovery, with persistent unemployment and underemployment, we must facilitate real capital formation. There is compelling evidence that securities regulation must be strong. We need to take the lessons learned in the crisis and the findings from high-quality empirical analysis and use them to improve our regulations and the economy.

How we move forward will set the tone for future economic growth in this country. It is important that all of us continue to fight for effective regulation. As I said in the beginning, the Council has been a strong advocate of investors, and I know you will continue to be actively engaged.

Thank you for having me here today. I have enjoyed being with you. Best wishes for an outstanding conference.

Endnotes

[1] http://www.cii.org/about.

[2] See, e.g., Catherine Rampell, Higher-Paying Jobs Lost, but Lower-Paying Jobs Gained, New York Times, Economix, February 23, 2011. (Observing that "the private sector job market still has a long way to go before it returns to its previous peak. Worse, those jobs that have been created in the last year typically pay less than the jobs they're replaced.")(emphasis original.) http://economix.blogs.nytimes.com/2011/02/23/higher-paying-jobs-lost-but-lower-paying-jobs-gained/.

[3] Some have called on the SEC to permit public offerings without public disclosures by repealing the prohibition on general solicitations in private placements. Others have called on the SEC to permit companies to be held by an increasing number of shareholders before public disclosures are required to be made.

[4] See, Executive Order 13563 of January 18, 2011, 76 FR 3821 (January 21, 2011). Although this order applies to executive agencies, it does not apply to independent agencies such as the Securities and Exchange Commission. However, the SEC is seeking public comment on how its regulations may be modified to improve the economy. See Reviewing Regulatory Requirements to Ensure They Continue to Promote Economic Growth, Innovation, Competitiveness, and Job Creation, http://www.sec.gov/spotlight/regulatoryreviewcomments.shtml (stating that "Given that our mission includes the facilitation of capital formation, we are seeking suggestions from the public on modifying, streamlining, expanding or repealing our existing rules to better promote economic growth, innovation, competitiveness and job creation … .").

The SEC is generally required by statute to consider the effect on capital formation of its rules, and this is an important responsibility. However, Congress intended investor protection to remain the foremost mission of the SEC. See, Report of the House Committee on Commerce, H.R.Rep. 104-622 at 39 (stating that "Section 106 requires the Commission to consider efficiency, competition, and capital formation when it engages in rulemaking or reviews SRO-proposed rules pursuant to the Securities Act, the Exchange Act, or the Investment Company Act under a ''public interest'' standard. The new section makes clear that matters relating to efficiency, competition, and capital formation are only part of the public interest determination, which also includes, among other things, consideration of the protection of investors. For 62 years, the foremost mission of the Commission has been investor protection, and this section does not alter the Commission's mission.")(emphasis added).

[5] See, e.g., Benjamin M. Friedman, The Failure of the Economy & the Economists, New York Review of Books (May 28, 2009) (observing that, "By now there are few people who do not acknowledge that the major American financial institutions and the markets they dominate turn out to have served the country badly in recent years. The surface evidence of this failure is the enormous losses—more than $4 trillion on the latest estimate from the International Monetary Fund—that banks and other lenders have suffered on their mortgage-related investments, together with the consequent need for the taxpayers to put up still larger sums in direct subsidies and guarantees to keep these firms from failing. With nearly 9 percent of the labor force now unemployed and still more joining their ranks, industrial production off by 13 percent compared to a year ago, and most companies' profits either falling rapidly or morphing into losses, it is also evident that the financial failure has imposed huge economic costs.") http://www.nybooks.com/articles/22702.

[6] See, Simon H. Kwan, Financial Crisis and Bank Lending, Federal Reserve Bank of San Francisco Working Paper Series (May 2010) ("This paper focuses on the extent and the mechanism of credit tightening during the recent financial crisis. The main findings of this study are the following. As of 2010:Q1, the ["commercial and industrial"] loan rate spread over the federal funds rate was about 66 basis points higher than its long-term average. Because lending terms were unusually loose just prior to the eruption of the crisis, the increase in the loan rate spread from the trough in 2007:Q2 to 2010:Q1 was almost one percentage point. [Moreover, I do not find evidence that smaller bank-dependent borrowers, proxied by loan size, suffered more from bank tightening than large borrowers.]"), http://www.frbsf.org/publications/economics/papers/2010/wp10-11bk.pdf.

Kathleen M. Kahle and René M. Stulz, Financial Policies, Investment, And The Financial Crisis: Impaired Credit Channel Or Diminished Demand For Capital?, Fisher College of Business Working Paper Series (February 2011) ("The conventional view of the financial crisis is that bank losses from toxic assets led to fire sales by banks and a bank credit contraction (see Brunnermeier (2009) and Shleifer and Vishny (2010)). These toxic assets were mostly securities backed by subprime and related mortgages, so their loss in value had little to do with the performance of industrial firms, making the credit contraction an exogenous event for these firms. Research in finance, including research on the recent financial crisis, shows that exogenous credit contractions have real effects on firms by forcing them to reduce investment. However, an exogenous contraction in the supply of credit was not the only adverse development in the recent crisis. Credit contracted endogenously as well because of a demand shock that led to lower cash flows, loss of investment opportunities, and weaker balance sheets. Further, risk increased sharply in the fall of 2008, making firms less credit worthy and leading to a flight to quality that increased risk premia. Most of the evidence is inconsistent with the view that the direct impact of the bank credit supply shock on firms was the dominant factor. Contrary to the predictions of the exogenous credit supply shock hypothesis, net debt issuance does not fall during the first year of the crisis and firms most likely to be bank dependent decrease their net equity issuance rather than increase it. After September 2008, net debt issuance drops sharply, but firms hoard cash, and firms more likely to be bank dependent do not decrease capital expenditures more than other firms. Overall, our evidence shows that the demand shock, the resulting endogenous credit contraction, and the reaction of [operating companies] to the increase in risk play a dominant role in explaining firms' financial and investment policies."), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1754660.

[7] The mandate to consider capital formation in connection with certain rulemaking was added to the federal securities laws in the National Securities Markets Improvements Act of 1996.

[8] See, e.g., Simon Kuznets, Capital in the American Economy: Its Formation and Financing (Princeton University Press 1961), at 15-16 and 389 ("In modern society, capital is the stock of means, separable from human beings and legally disposable in economic transactions, intended for use in producing goods or income. … Capital in the hands of various units within a country—households, business firms, nonbusiness associations, governments—may take the form of goods (tangible assets) or claims (financial assets or intangibles). The claims may be domestic, against residents of the country, or foreign, against residents of other countries. In totaling the stock of capital of the country, domestic claims are exactly offset by domestic obligations, and only the net balance of foreign claims remains. Nationwide capital, by definition, therefore, consists of the stock of goods within the country and the net balance (positive or negative) of foreign claims. Capital formation, strictly speaking, denotes additions to the stock of tangible goods within the country or to foreign claims. These additions are usually taken on a net basis,

which means that for some owner or user groups, for some periods, or for some types of goods or claims, there may be subtractions rather than additions, declines rather than rises. We should, then, speak of capital dissolution or reduction. But it has become customary to use the term capital formation for all changes in the stock of goods or claims, whether positive or negative, and to use the latter as qualifying adjectives. Thus, nationwide capital formation is a sum of the net changes in the stock of goods within the country and in the net balance of foreign claims. For some purposes, changes in the stock of durable (long-lived) capital goods are estimated on a gross basis: capital goods consumed are not subtracted from the total additions to stock. And gross capital formation is distinguished from net in that it, too, is gross of the allowance for current consumption." Id. at 15-16). ("By capital formation we mean diversion of part of the current [national] product for use as capital, that is, goods to produce other goods or income." Id. at 389.) http://www.nber.org/books/kuzn61-1.

[9] Over time, economically efficient capital raising would be expected to effectively facilitate capital formation.

[10] While capital raising and capital formation are not the same, the financing environment affects capital formation. See, e.g., Benjamin M. Friedman, Financing Corporate Capital Formation (University of Chicago Press 1986) (collecting papers and noting the "The central importance of capital formation to the economy's further growth and development is broadly recognized, and physical investment decisions and their financial counterparts are fundamentally interdependent. The financial environment therefore influences both the amount and the composition of the capital formation that an economy like that of the United States undertakes." Id. at 1.) Available online at http://www.nber.org/books/frie86-1.

[11] Technically, disclosure is not required in Rule 506 transactions under Regulation D except to investors who are not accredited. Offers and sales of asset-backed securities to non-accredited investors was essentially non-existent. See, Release No. 33-9117, Asset-Backed Securities, 75 FR 23327 (May 3,2010)(stating that "Except for a few types of ABS, we believe that investors in privately issued asset-backed securities typically would qualify as accredited investors, and therefore, issuers would not be required to provide the prescribed information to them in order rely on Rule 506 of Regulation D for the sale of the securities."). http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

[12] Section 942(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act addressed the concern regarding ongoing reporting following registered offerings of asset-backed securities. See also, Release No. 34-63652 (proposing rules to implement this provision).

[13] FCIC report at 169.

[14] Release No. 33-9117, Asset-Backed Securities, 75 FR 23327 (May 3, 2010). http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

[15] The Dodd-Frank Wall Street Reform and Consumer Protection Act sought to improve the asset-backed securities market. In addition to the provision discussed above in note 12, another example is Commission rulemaking pursuant to Section 943 of the Dodd-Frank Act, which requires certain disclosures in respect of registered as well as unregistered asset-backed securities. See, Release No. 33-9175 (76 FR 4489 January 26, 2011].

[16] See, e.g., George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, The Quarterly Journal of Economics (August 1970)

(discussing the market for used cars, for medical insurance for those over 65 years old, and others to demonstrate how a lack of adequate information about the quality of an item being purchased can drive a market out of existence: "There may be potential buyers of good quality products and there may be potential sellers of such products in the appropriate price range; however, the presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.").

17 Regarding the Great Depression, see, e.g., H.R. Rep. No. 1383, 73d Cong. 2d Sess. at 11 (1934) (stating that: "No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug of conflicting interests and the influence of powerful groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges. Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet.").

Regarding the recent financial crisis, see the FCIC report.

18 See, Form 10-K of AT&T Inc., Exhibit 13, Selected Financial and Operating Data, Wireline Segment Results, at 9. http://www.sec.gov/Archives/edgar/data/732717/000073271711000014/ex13.htm.

19 See, e.g., Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment, 85 U. Va. L. Rev. 1335 (1999).

20 There are studies that find otherwise. For example, two earlier studies (Stigler 1964 and Bentsen 1973) purported to find no significant positive effect from mandatory securities disclosure arising from the passage of the Securities Exchange Act of 1934. These studies have been criticized on methodological grounds and, for one study, the data appear to actually support the opposite conclusion. See, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment, referenced above at note 20.

21 See, Merritt B. Fox, Randall Morck, Bernard Yeung, and Artyom Durnev Law,

Share Price Accuracy, and Economic Performance: The Empirical Evidence, , 102 Mich. L. Rev. 331 (2003) (the conclusion that more accurate and informed share prices contribute to the real economy referenced (i) Jeffrey Wurgler, Financial Markets and the Allocation of Capital, 58 J. Fin. Econ. 187 (2000) and Artyom Durnev et al., Value Enhancing Capital Budgeting and Firm-specific Stock Return Variation, 58 J. Fin 64 (2004), Id. nn 86 and 87.).

[22] Exchange Act Section 12(g) was adopted in the Securities Act Amendments of 1964. [Pub. L. 88–467 (August 20, 1964)]

[23] See, Michael Greenstone, Paul Oyer, and Annette Vissing-Jorgensen, Mandated Disclosure, Stock Returns and the 1964 Securities Acts Amendments, Quarterly Journal of Economics, May 2006 (stating that the "results imply that the 1964 Amendments created $0.5 to $1.0 billion (1963$) or $3.2 to $6.2 billion (2005$), of value for stockholders" after excluding Royal Dutch Company to "avoid potentially overstating the effects.") A summary version of the paper is available at http://www.stanford.edu/group/siepr/cgi-bin/siepr/?q=system/files/shared/pubs/papers/briefs/policybrief_jan06.pdf.

[24] See also, Allen Ferrell, Mandated Disclosure and Stock Returns: Evidence from the Over-the-counter Market, 36 J. Legal Studies 1 (2007). An earlier draft is the John M. Olin Center for Law, Economics, and Business Discussion Paper No. 453 (December 2003). http://www.law.harvard.edu/faculty/fferrell/pdfs/Ferrell-MandatedDisclosure2.pdf.

[25] Durnyev, Fox, Morck and Yeung, The Effectiveness of Mandatory Disclosure: An Empirical Test of the Line of Business Regulations (June 23, 2010 Draft on file) ("These results are useful in two regards. First, taken together, they constitute very strong evidence that the LOB Regulations, one of the most important reforms in the history of the U.S. mandatory disclosure regime, had effects on how the shares of the issuers to which they applied were priced and traded. They provide a substantial basis for believing that these effects included both improved liquidity and increased share price accuracy. Second, they advance our still imperfect understanding of the way that information relevant for predicting firms' future cash flows is created, distributed among investors and used in trading and, in this connection, of the role that mandatory disclosure plays in the determination of share price accuracy and liquidity.").

[26] See, e.g., Frank B. Cross and Robert A. Prentice, The Economic Value of Securities Regulation, 28 Cardozo L. Rev. 333 (2006)(surveying empirical research regarding securities regulation, conducting an examination of the effects of mandatory disclosure on the equity markets and concluding that "Our findings consistently show a positive effect for securities law on equity markets in models with high levels of statistical significance, and that the effect of securities is frequently an independently statistically significant one. As we better capture the full effect of securities law, the association becomes stronger, providing substantial evidence of the benefits of such laws. When these results are combined with the prior cross-country research, the historical research, and other empirical studies discussed in the prior section, the case for strong securities regulation, particularly mandatory disclosure rules, seems exceedingly strong.").

See also, Lambert, Leuz and Verrechia, Accounting Information, Disclosure, and the Cost of Capital, Journal of Accounting (May 2007) ("We demonstrate that the quality of accounting information influences a firm's cost of capital, both directly by affecting market participants' perceptions about the distribution of future cash flows, and indirectly by affecting real decisions that alter the distribution of future cash flows. The direct effect occurs because the quality of disclosures affects the assessed covariances between a firm's cash flow and other firms' cash flows. This effect is not diversifiable in large economies. Our finding provides a direct link between the quality of a firm's disclosures and accounting policies and its cost of capital. In addition, it extends prior work in the estimation risk literature. … Finally, we briefly comment on the impact of mandated disclosures or accounting policies on firms' cost of capital. Based on our model, increasing the quality of mandated disclosures should generally reduce the cost of capital for each firm in the economy (assuming that the expected cash flow of each firm and the covariance of that firm's cash flow with the market have the same sign)."); Leuz, Triantis and Wang, Why Do Firms Go Dark: Causes and Economic Consequences of Voluntary Deregistration, 2006 ("We examine a comprehensive sample of SEC deregistrations from 1998 to 2004 where public companies "go dark", i.e., cease filing with the SEC, but continue to trade in the OTC market. … We also document a large negative abnormal return to going dark, even when firms already trade in the OTC market and there is no need to change trading venue. … We find that many firms go dark in response to poor future prospects, financial distress and increased compliance costs after SOX. But we also find evidence suggesting that some controlling insiders take their firms dark to protect their private control benefits and decrease outside scrutiny, particularly when corporate governance is weak and outside investors are less protected."); Leuz and Verrechia, The Economic Consequences of Increased Disclosure, Journal of Accounting Research, Vol. 38, Supplement: Studies on Accounting Information and the Economics of the Firm (2000) ("Economic theory provides compelling arguments that a commitment by a firm to increased levels of disclosure should lower the information asymmetry component of the firm's cost of capital. Documenting this relationship, however, has been difficult empirically. In this paper, we study a sample of German firms that have adopted IAS or U.S. GAAP accounting standards in their consolidated financial statements. This international reporting strategy commits firms to substantially increased levels of disclosure but has no immediate tax or dividend implications. Moreover, the disclosure levels in Germany under German GAAP have been characterized as being low. For these reasons, the experimental setting of our study seems particularly suited to document the economic consequences of increased disclosure. Our evidence is consistent with the notion that firms committing to increased levels of disclosure garner economically and statistically significant benefits. We show in a cross-sectional analysis that an international reporting strategy is associated with lower bid-ask spreads and higher share turnover when we control for various firm characteristics (e.g., performance, firm size, and foreign listings) as well as selection bias. Additional sensitivity analysis supports the robustness of our findings. A subsequent "event study" around the switch to international reporting produces corroborating results.").

[27] See, Release No. 33-8587, (July 15, 2005) [70 FR 42233] (stating that "These transactions generally take one of two forms: In the most common type of transaction, a "reverse merger," the private business merges into the shell company, with the shell company surviving and the former shareholders of the private business controlling the surviving entity. In another common type of transaction, a "back door registration," the shell company merges into the formerly private company, with the formerly private company surviving and the shareholders of the shell company becoming shareholders of the surviving entity.").

See also, Release No. 33-8407 [69 FR 21650]. at note 54 (citing interpretive letter by SEC staff to Lisa Roberts, Director of NASDAQ Listing Qualifications (Apr. 7, 2000), and explaining that although SEC staff took the position that "back-door registration" did not constitute a succession of the surviving entity to the rights and obligations of the reporting shell company, "nevertheless, the staff permitted nonreporting acquiring companies to file Form 8-K reports and enter our reporting system, so long as specified information was included, rather than requiring these companies to file registration statements under Section 12 of the [Exchange] Act to become reporting companies.").

[28] See, Public Company Accounting Oversight Board, Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010, Research Note # 2011-P1 (March 14, 2011).

The reported numbers may understate the number of "transactions that are structured differently, but with the result being similar to a [China reverse merger]." As explained by PCAOB staff, "there may be unidentified reverse merger transactions that occurred … because no Form 8-K Item 5.06 was required to be filed, such as those transactions involving special purpose acquisition companies, or that did not involve a shell company. In addition, the research excluded reverse merger transactions involving foreign private issuer shell companies filing Form 20-F." Id. at 3.

[29] See Release No. 33-8587 [72 FR 42234 (July 21, 2005)]. See also, Release No. 33-8407, 69 FR 21650 (a proposal designed to "protect investors by deterring fraud and abuse in our securities markets through the use of reporting shell companies," this release also discussed the SEC's history of combating "the fraudulent methods used to manipulate the market in highly speculative securities," and the ways in which transactions involving public shell companies have been problematic.).

[30] See, e.g., SEC Files Fraud Charges Against China Energy Savings Technology, Inc. and Others; Court Orders Asset Freeze. http://www.sec.gov/news/press/2006/2006-200.htm.

[31] See, James Surowiecki, Don't Enter the Dragon, The New Yorker, January 31, 2011.

[32] See, NASDAQ Delisting Chinese Manufacturer Fuqi, Jewelers' Circular Keystone, March 29, 2011. http://www.jckonline.com/2011/03/29/nasdaq-delisting-chinese-manufacturer-fuqi.

[33] See, James Surowiecki, Don't Enter the Dragon, The New Yorker, January 31, 2011.

[34] See Release No. 64164, April 1, 2011 (announcing suspension of trading in the securities of China Changjiang Mining & New Energy Co., Ltd.). http://sec.gov/litigation/suspensions/2011/34-64164.pdf.

[35] See Release Nos. 64164, referenced above in note 34, and Release No. 64101, March 21, 2011 (announcing suspension of trading in the securities of Heli Electronics Corp.). http://sec.gov/litigation/suspensions/2011/34-64101.pdf.

[36] See Press Release, NASDAQ OMX, NASDAQ Halts China Agritech, Inc. (March 14, 2011), http://www.globenewswire.com/newsroom/news.html?d=216129; Press Release, NASDAQ OMX, NASDAQ Changes Trading Halt Status of China MediaExpress Holdings, Inc. (March 14, 2011), http://www.globenewswire.com/newsroom/news.html?d=216199; Press Release, NYSE Euronext, NYSE Amex to Halt Trading in the Securities of China Century Dragon Media, Inc. (March 21, 2011), http://www.nyse.com/press/1300701752438.html; Press Release, NYSE Euronext, NYSE Amex Halts Trading in the Securities of China Intelligent Lighting and Electronics, Inc. (March 24, 2011), http://www.nyse.com/press/1300963610692.html; Press Release, NYSE Euronext,

NYSE Amex Halts Trading in the Securities of NIVS IntelliMedia Technology Group, Inc. (March 24, 2011), http://www.nyse.com/press/1300963610893.html; Press Release, NYSE Euronext, NYSE to Suspend Trading in Duoyan Printing, Inc. (March 28, 2011) (suspension to take effect prior to the opening on Apr. 4, 2011), http://www.nyse.com/press/1301307616164.html; Press Release, NASDAQ OMX, NASDAQ Halts China Electric Motor, Inc. (March 31, 2011), http://www.globenewswire.com/newsroom/news.html?d=217571.

[37] See Public Company Accounting Oversight Board, Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010, Research Note # 2011-P1 (March 14, 2011) (discussing Audit Alert 6, where “the Board’s inspection staff observed audit quality concerns in certain audits in which U.S. registered accounting firms performed audits of companies with substantially all of their operations in another country. In some situations it appeared that U.S. firms provided audit services by having most or all of the audit performed by another firm or by assistants engaged from outside the firm without complying with PCAOB standards applicable to using the work and reports of another auditor or supervising assistants. … For example, in one instance described in the Alert, a U.S. registered accounting firm retained an accounting firm in the China Region, and the audit procedures performed by the other firm constituted substantially all of the audit procedures on the issuer's financial statements. The U.S. firm's personnel did not travel to the China region during the audit, and substantially all of the audit documentation was maintained by the firm in the China Region. As noted in the Alert, AU sec. 543 does not contemplate an auditor taking responsibility for the work of another auditor that has audited an issuer's financial statements substantially in their entirety.”).

[38] See, Bill Alpert and Leslie P. Norton, Beware This Chinese Export, Barron’s, Aug. 30, 2010 (reporting that the combined capitalization of the companies entering the U.S. public markets through backdoor registrations at their peaks exceeded $50 billion, but has dropped by $20 billion, or 60%. By comparison, the value of Chinese companies who became listed in the U.S. through more traditional ways, not involving a backdoor registration, has increased 60%. Chinese reverse merger companies have also performed poorly compared to small U.S. listed companies generally, “lagging behind the Russell 2000 index of small-cap stocks by 66%.” Id.).

http://www.sec.gov/news/speech/2011/spch040411laa.htm