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The SEC: What's Wrong And How To Fix It

Marc Morgenstern is the Founder and Managing Partner of Blue Mesa Partners. He serves as a Senior Advisor and/or Board member for growth companies in industries as diverse as telecom, enterprise software, social broadcasting, specialized steel service centers, printing and imaging, and solutions for protection and renewal of residential and municipal infrastructure.

Over his 25 year plus career as a nationally prominent corporate and securities lawyer, he has been a director of numerous public and private companies, and a principal advisor at hundreds of public and private companies board meetings advising about corporate governance, mergers and acquisitions, executive compensation, public and private equity financing, financial statement restatements, Sarbanes-Oxley compliance, and hostile takeover defenses.

Prior to devoting his full-time efforts to entrepreneurial activities, Mr. Morgenstern was the leader of the West Coast Corporate and Securities Group for a national law firm, and previously had been the long-time Managing Partner and CEO of a midwest regional law firm focused on entrepreneurs and emerging growth companies (public and private).

His observations have appeared in national media, including CNBC's Squawk Box (private equity), The Deal (private equity and hedge funds), CFO magazine (Sarbanes-Oxley), Wall Street Journal (cost of being public), Los Angeles Times (Blackstone IPO), Tech Republic (strategic planning), New York Times (how a good board helps grow companies), Compliance Week (stock option expensing), Entrepreneur Magazine (problem investor syndrome), San Francisco Chronicle (Sarbanes-Oxley and IPO's), and the San Jose Mercury News (sale of restricted securities).

We are thrilled to present this Leadership Interview with Marc Morgenstern.

Greg Selker: Marc, thank you for participating in our on-going series of leadership interviews.

Marc Morgenstern: My pleasure.

Greg Selker: I'm looking forward to talking with you in this context. We've known each other for a number of years, but our interactions have generally been about specific projects, rather than a more broad philosophical conversation on these particular issues.

Marc Morgenstern: Indeed.

Greg Selker: Marc, you have developed an expertise and have written extensively about the SEC, and specifically how the regulatory environment affects both the IPO process and privatization of companies.

In your recent article published on *The Huffington Post*, you wrote about the U.S. capital markets regaining their once world-renowned reputation for safety, transparency and liquidity. To me the necessary ingredients to bring this about are the SEC creating rules that are designed to balance long-term results, as opposed to short-term profits, their enforcement of these rules, and the degree to which an executive team is held accountable by a Board of Directors for behaving in accordance to these rules.

Do you agree with my categorization of these three major areas?

Marc Morgenstern: Well I think the short answer is that I sort of agree in part, and don't agree in part. I think you've described very closed ended categories, and I think the real answers lie in a more open-ended way of thinking about our current condition.

As a starting point, it makes sense to try to understand where we are in the context of looking at the dynamics that drive behavior as a very broad concept. In other words, what do people believe that their mission is and how does their behavior match up?

If you talk about the SEC, the first thing that everyone needs to understand is that the SEC has a dual mandate. On the one hand, their very clear mandate going back to 1933 is that they're supposed to protect investors.

Now starting with Reagan in 1980 or 1981, the rules changed and an additional mandate to the SEC was added, (and by the way I think it is quite a sensible one) and that is that the SEC is also responsible for capital formation.

These are absolutely counter-cyclical charges from the government. They're supposed to protect toward safety, which generally means driving farther away from capital formation. Or enable capital formation, which generally means driving further away from safety. I don't know really what Congress intended, but I'm going to assume that these dual mandates reflect a fundamental characteristic of the capital market place, which is striking the balance between risk and reward.

So the goal of the agency is to achieve this balance. Now I don't think that the balance is there, and there are many reasons for this.

Greg Selker: Well, regardless of the reasons for this imbalance, how would you describe it?

Marc Morgenstern*:* Let's talk about it philosophically first, and this get's back to my response to your categorization of the possible solutions to regain our transparency, safety and liquidity. What is the SEC's long

standing mandate and how do they regulate things? The answer is that there's a very sharp distinction between how the Federal government historically is regulated, and how state governments are regulated.

The Federal Government operates in a disclosure driven securities model which assumes that the marketplace is grown-up and sophisticated. The role of the SEC and the Federal Government is to make sure that investors have the facts that they need in order to make informed, rational investment decisions. That's a disclosure system.

The States have always had a sharply different, very paternalistic view to protect investors from things that the regulators don't think they should invest in. It's substantive regulation. As an example, in the tax shelter days of the 1980's, many states had leverage ratios governing investments. You couldn't invest in an oil and gas deal if the leverage ratio was more than 3 to 1 or 5 to 1.

The SEC's view was different saying, "You can do whatever you want to as long as investors are **aware** of the leverage ratio. We're not here to tell you whether or not to make the investment. We're just here to make sure that you know what you're investing in."

So part of what has happened over the last couple of years, particularly around Sarbanes-Oxley, is that I think the Federal mandate has gotten quite confused. And to me the tipping point was Sarbanes-Oxley when the legislation said that a public company **cannot** make a loan to one of their Executive Officers or Directors. That moved the Federal Government into regulating the **substance** of what a company can or cannot do. Previously, these kind of substantive regulations were always governed under State (corporate) law.

Greg Selker: As opposed to Federal law and the SEC, which was really more focused on transparency and full disclosure?

Marc Morgenstern: Yes, and my comment at the time was - well, if the SEC can regulate that aspect of compensation, because that's what loans tend to be, why can't they say that you can't have more than six weeks or three weeks vacation or a limit on your bonus?

Greg Selker: Little did you know that you were being prescient.

Marc Morgenstern: Well actually I did know, because it was just a little thing, but sometimes little things lead into very big things. And although I didn't know exactly what it would lead to, it changed Federal philosophy from disclosure to substantive regulation.

And unfortunately, much more troubling to me was the fact that this outcome is so frequently true of well-intended, but ultimately self-defeating rules. New rules were implemented because people were outraged. You may remember the scandals from the 80's where people had taken loans from their companies and didn't repay them?

***Greg Selker*: **Yes, absolutely.

Marc Morgenstern: And the fact of the matter was that those loans were fraudulent and illegal, all conduct which was subject to State law. You know, Boards of Directors did not authorize $100 million dollar loans. That was a violation of all corporate law.

Those loans were concealed from the Board of Directors. There were 50 statutes on the books that would have recovered the money, but instead of acknowledging that the **laws** were perfectly okay and **enforcement** was needed, populist outrage moved to eliminate the variable. That, by the way, is the consistent pattern of human behavior and regulation over time. And it is happening again today for very predictable reasons. People are angry about things and the legislative response is to say, "Let's look at the variables and make them go away." And that never works.

Greg Selker: This is why you said you both agree and disagree with my categorization of the solution to our crises?

Marc Morgenstern: Yes. If we automatically default to more rules and regulations, which is where many people want to go, the first question is, how many laws will the SEC inherit? Congress passes a law and the SEC is then charged with enforcing it.

And the second question is, what does enforcement mean when you're the SEC? And that answer takes us right back to compliance. Public companies have to file their annual reports and their quarterly reports, and the SEC is charged with going through them and saying, "it's ok or it's not ok". And every three years – and notice it's only every three years - they must review the 10-K for every public company. Well, think how much happens in a three-year period.

Greg Selker: Right, an enormous amount.

Marc Morgenstern: Anybody who really believes for a second that this represents active enforcement is foolish. Of course, it isn't. But the SEC has only so many resources, and the three-year review was again, a very consistent regulatory response. Which is to say, 'We'll make a rule and assume that it fits all categories across all public companies.'

What possible sense does that make? Because with finite resources, doesn't it make more sense to allocate resources on a risk adjusted basis so that SEC personnel spend the time where it counts the most? So the SEC's charge shouldn't be to review 10-K's every three years. The charge should have been: the SEC will evaluate where risk is, and review most often the disclosure documents that it thinks represent the highest level of risk - and review least often the documents that they think represent the lowest level of risk. Recognizing that it's not perfect – that perfect is not one of the alternatives.

Many years ago in response to a question about Sarbanes-Oxley and the regulatory environment in general, Irwin Federman, the founding partner of US Venture Partners said, that in his experience, "one-size-fits-all only works with muu-muus and athletic socks." I thought that was a really telling observation.

So you have to give the SEC a much more flexible approach to managing risk. And if you think about it, this approach is completely consistent with how the largest accounting firms conduct their audits.

A Big 4 audit report typically would say, "We know our audit isn't perfect. We concentrated our efforts on identifying and auditing the riskiest components of this business. And we are telling you, the Board of Directors and the people reading the financial statements, what we think are the greatest levels of risk, and then what we believe is the best approach to disclose and mitigate this risk."

And to me this kind of audit says, mathematically, we can't do everything.

A Big 4 audit report says, "What we **can** do is tell you what we did and how we did it. You can agree with our methodology or not. You can question our assumptions. But you can't question our transparency."

Transparency doesn't mean perfect – and transparency doesn't mean you go down to the smallest variable on someone's balance sheet. And that's where I think people consistently have a very serious misperception. Because the goal cannot be perfection. The goal can only be progress.

Greg Selker: So in the spirit of progress – and also given what you described as the reality both of human nature and the tendency to default to ruling out a variable as the path of least resistance, what do you think would be a new way of looking at the SEC that would help bring back transparency, safety and liquidity, but also increase accountability?

Marc Morgenstern: Well, I think maybe the easiest way to start (oddly enough) is with SEC **operations** rather than with the SEC's **mission**. Because if you give somebody a mission that they cannot accomplish with their personnel or their tools, then it's doomed to fail.

So to me the right question is – what's the best thing you can do to improve the SEC? And it has nothing to do with rules. It has to do with the **people** who are there, and the **tools they have to do** their job.

This is fairly straight-forward. When you have relatively inexperienced people, and many of the staff at the SEC are lawyers who have 2-6 years experience, they're going to be, intentionally or unintentionally, unarmed and inadequately prepared to deal with the people they're investigating who have been in business for 30 or 50 years and who have much greater capital and technology resources. That is an unfair fight to begin with.

So the first thing to do is to make the SEC a place that highly compensates its employees, and will therefore attract highly skilled and experienced individuals. And for some reason, paying people what they're worth is an unpopular view in Congress. But the simple truth is you need to pay more to get the best people. And this may be more than a Congressman or Senator makes – I can't help that. The marketplace sets compensation, not me.

Greg Selker: Agreed. And what would you say about the revolving door between the SEC and financial institutions?

Marc Morgenstern: I don't have a problem with it and I'll tell you why. When I first started practicing law, the best and the brightest worked at the SEC. They were an astounding agency in the 60's, 70's and 80's. And by the way, today, the employees of the SEC get paid less than people at Treasury for reasons that are obscure to me. In my opinion this is the main source of the problem, not the fact that people leave the SEC for jobs in the private sector.

A very common pattern in the past was people would do their public service at the SEC for 5,10 or 12 years, and then they would take a well-paid job in the private sector. I simply don't have a problem with that. This populated the private sector with people who understood the regulatory environment, while having the best people spend significant, effective time at the SEC.

Greg Selker: So you're suggesting that if we raise the pay scale to competitive levels, the SEC will again attract the best and the brightest? And while there may be a revolving door, the tenure of SEC employees will be longer. The SEC won't just become a jumping off point to a more lucrative position within the private sector.

Marc Morgenstern: That would be absolutely correct. This would shift the pattern of 2 or 3 years at the SEC as a resume builder, to people who are there for 10 or 15 years, while bringing tremendous value to the institution, including adding to the institutional memory.

Greg Selker: Absolutely. Over the past 15 or 20 years, being employed at the SEC has defaulted more towards building your resume and establishing connections for a more lucrative job – rather than trying to build longevity within the institution and to make a difference.

Marc Morgenstern: Right, because when people are in their first couple of years out of law school, the economic disparity between them is not that great. But as people get older, they have families, and larger responsibilities. They need more money. They have to put their kids through college just like everybody else does. So today the system rewards leaving early. This is a real problem.

Greg Selker: So rather than try and legislate against the revolving door, let's raise the pay scale and let the competitive marketplace do its thing.

Marc Morgenstern: Yes, I think this is an approach that will work better than what we have now. Now an unintended consequence of a more seasoned SEC employee base may be that there will be a far greater likelihood that SEC staff will potentially be investigating companies, and people, with whom they've had prior contact and relationship. In other words, we may have greater regularity of conflicts of interest. Here are my thoughts on how to deal with this, and, I know my suggestion is one about which reasonable people can have philosophical disagreement. People will look at the same set of circumstances, and see either a "conflict" or a "convergence". The question should be is that conflict or convergence **good** or **bad**?

If you are dealing with people that you've dealt with before, and for many transactions there can be many related parties, some people simply instinctively recoil and say – "Oh, if these are related parties it's a conflict and that is bad".

Other people look at it and say – "Oh, if they're related parties, I'm going to get much better service because if there's a problem, there's a much higher likelihood that it will get solved precisely because they are related parties. This is good."

So it's the same set of circumstances with two different interpretations. And I'm definitely not suggesting that either one is right or wrong. But I grew up really believing in the concept of disclosure. In other words, what

you do with conflicts is to disclose them, make sure that the impacted people really understand them, and then let those people make an informed decision. And that, by the way, is the basis for most corporate law.

If you look at the responsibilities of a Board of Directors and the exercise of the Business Judgment Rule, you know that this rule is built on twin towers; Duty of Loyalty, and Duty of Care. Duty of Loyalty basically says the only reason a Director is taking a particular action is because he or she believes it's in the best interest of the corporation.

Now does that mean that a Director with a conflict **cannot** vote in the case of a conflict? No, it does not. It means that there are three ways that people typically approach the problem. The first step is obviously if a Director has a conflict, this must be disclosed Now it's been disclosed, so what are the company's options? They could say, "Gee, we're still uncomfortable with this; we don't want the Director to vote or be in the room, please leave while we discuss this matter."

But there are people who say, "No, we know that there's a conflict, and we're happy to have you be part of the **discussion**, but you shouldn't **vote** on it." And the third option is everybody just says, "We know the conflict and therefore, we understand your bias. Please be in the room and vote because we all understand what your motivation may be, and with this understanding, we can make an informed decision as a board."

To my way of thinking, the ability to make an informed decision among adults is a major driving principle. I don't want to tell people which one of those three routes to take. I'm okay with having them decide whatever they want that will work for their particular environment. And I think dependent upon the environment and circumstances, any one of these options will be the **best** choice, but not necessarily a **universal** choice.