WHAT WENT WRONG AT THE SEC?

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Many observers have noted the U.S. Securities and Exchange Commission has been upstaged by Attorney General Spitzer of New York State who, with a very small staff, uncovered and prosecuted with great vigor, serious abuses occurring in a significant number of investment banking firms and mutual fund organizations. The question I will discuss is why the SEC, often pointed to as the crown jewel of the alphabet agencies created by Franklin D. Roosevelt's "New Deal", suddenly seems to have lost its luster and has been reduced to playing "catch up ball". As with most things institutional decline is rarely sudden, the signs have usually been there for a long time for those who cared to see them. Underlying a dramatic institutional collapse is rarely a single cause - more than one thing must go wrong.

There were many precursors that might have served as warnings of something having gone badly awry at the SEC. One need look no further than the scandals surrounding the dot.com bubble of the '90's, when the SEC seemed frozen in inaction while dubious new stock issues were bid up to bizarre levels, assisted by devices employed by investment bankers to artificially restrict supply and/or increase demand. This occurred in tandem with their highly paid investment analysts adding fuel to the fire, by touting these stocks through the print and broadcast media. Some of these activities were virtually public, making it difficult to understand why the SEC did not discern patterns of behavior that clearly signaled the existence of serious systemic problems in the new issue markets. These problems, which go back at least a decade, were finally uncovered in the wake of the inevitable collapse of the bubble.

Another example is the laissez faire attitude exhibited for years by the SEC with respect to the New York Stock Exchange while a band of unscrupulous specialists and other floor members were utilizing their central positions at the heart of the market to deny investors the best prices by needlessly interpositioning themselves between public orders for their own profit. While the financial press was diverted by the compensation scandal involving a colorful Stock Exchange CEO his conduct was only one minor facet in a broad failure by the SEC to discern the governance crisis afflicting a supposedly highly regulated institution. And, it may be recalled that several years ago the SEC was caught clueless when many OTC traders in large Stock Brokerage houses were exposed as having been rigging prices in the NASDAQ over the counter trading system.

The underlying causes of the regulatory collapse of the SEC are multiple and complex. It would take a major study to untangle one from another. The agency seems to have lost its ability to discharge its statutory mission to protect investors – but why? Part of this diminished capacity is undoubtedly attributable to years of under funding by the Administration and the Congress. However, a less tangible but, in my view, an equally important cause has been the ever-growing reluctance by the SEC to use its rule making authority. The SEC's authority to carry out its investor protection mission rests on twin foundations – its power to promote and require timely corporate and market disclosures and second, its power to adopt rules designed to prevent fraud and other abuses. While the Commission does adopt many interstitial and perfecting rules it would be unimaginable to think of the SEC proposing or adopting a rule today even approaching the scope and breadth of the great anti-fraud rule 10b-5 which transformed Wall Street the "you take the risk, I'll take the profit" conflict of interest prohibition of Rule 17d-1 under the Investment Company Act. The broad rule making authority granted by the Congress in 1934 has virtually atrophied. I do not believe this atrophy is wholly caused by under-funding

A major inhibiting factor has been the ascendancy of the so-called Chicago school of economic theory, which, in recent decades, has swept the field with a philosophy that views as anathema any governmental regulatory initiative perceived to interfere with the workings of the marketplace. The most enthusiastic disciples of the Chicago School do seem to take a Panglossian view that the market is a perfect force of nature and left unrestrained will reach the best result in the public interest. This is not mere academic or quasi religious theorizing; some its ardent proponents like the economist George Stigler (who believed that the SEC served no useful purpose) and law school academic Henry Manne have proposed that insider trading should not be prohibited or regulated and that most rules regulating markets or players therein are presumptively off base. A careful listener will hear echoes of this thinking in some of Federal Reserve Chairman Greeenspan's musings about hedge funds. Regulated industries, and those resisting any regulation at all, such as hedge funds, have been quick to adopt free market reasoning to oppose rule-making initiatives before the agencies, the Congress and in the Courts, with growing success. In my view this has undercut the basic predicates for regulation underlying the Securities Exchange Act as well as sapping the morale of the SEC's professional staff.

Other causes may be of equal or greater significance in the story the SEC's current malaise. I think it was Justice Douglas who once advocated killing government regulatory agencies on their 50th birthday. While Douglas may have had in mind that the agencies must ultimately be captured by the industries they regulate, a valid concern, I would like to turn the spotlight on a much more humble area – that of bureaucratic organization – a more modest focus than the drama of agencies succumbing to the blandishments of the regulated, or the triumph of a particular economic theory. Here, I take as my example the current mutual fund scandals and the role of the SEC.

Before proceeding with this matter, I should make it clear that I do not suggest that any possible shortcoming in the regulatory apparatus excuses the egregious securities market and mutual fund conduct first exposed by Attorney General Spitzer. Also, I leave for another day, Stanley Sporkin's admonishing question from the bench in a major banking scandal case some years ago, "Where were the lawyers, where were the accountants?" But, as the fund industry, the bar and the accounting professions must not shrink from the necessary reforms, so too the regulators should take an intense look at their own procedures and organization. I must say that this is a difficult for me personally to argue that the SEC may be on the way to joining the ranks of bureaucratic agencies that time has passed by. Even after forty-five years, like most former SEC staff members, I retain a strong loyalty and affection for an organization that, in its glory days, made major contributions to the economic strength of the country by re-establishing public trust in the securities markets following the Great Crash in 1929.

Stating my conclusion first, I believe that the internal organization of the SEC is in dire need of substantial reorganization and improvement to meet current and future challenges. And what I am saying applies across the entire broad jurisdiction of the SEC not only to mutual fund regulation. I start with observation that except for the creation of the Division of Enforcement in 1972 under Chairman Casey and the Office of Compliance Inspections under Chairman Levitt the organization of the SEC looks remarkably unchanged since I first joined the Commission in 1960 and in fact since it was created in 1934. However, the securities industry has changed dramatically in that period. The influx of capital, following the SEC's agreement to permit public ownership of NYSE member firms in the late 60's, and the consequent acquisition of many of these firms by domestic and foreign conglomerates, spurred the creation of mega-securities firms involved in every aspect of the securities and financial services industry. With the influx of banks following the repeal of the Glass-Steagall Act additional capital became available, which encouraged and fueled new types of securities activities and products, many of which crossed traditional jurisdictional lines. The sharply delineated single product securities firms of history disappeared and were replaced by the full service financial firm. This amalgamation has combined firms as diverse as New York Stock Exchange specialists and the old stand-alone mutual fund organizations.

As the securities industry developed, the SEC's three traditional operating Divisions, Investment Management, Market Regulation and the Division of Corporation Finance, organized along the lines of the three major federal securities statutes remain conceptually and functionally isolated from each other, each as it were, in its own silo. They report upwards to a five member Commission which has no real coordinating and integrating facilities of its own, although in recent Senate testimony Chairman Donaldson stated that an Office of Risk Assessment not bound by divisional lines is being created as well as inter-divisional task forces to work on special problems. I should also note that the Director of the Division of Enforcement also promised better communication in the future with the operating divisions. While these are laudable steps, even if fully implemented, more fundamental changes may be needed.

Take the chopped up regulation of the fund industry as an example of how the system now works – or doesn't. Although the SEC Division of Investment Management regulates mutual funds under the Investment Company Act, retail sales activities of fund dealers fall within the 1934 Act jurisdiction of the Division of Market Regulation. However, much mutual fund promotional activity is not regulated by the SEC but is delegated to the NASD. Thus, there is no single group at the Commission that looks at the activities of a mutual fund organization as a whole much less its connections with parents and affiliates. And, adding to the problem of remoteness, the two organizational reforms I mentioned a moment ago, the centralization of enforcement and inspections by the creation of the Division of Enforcement and OCIE, has had had the unintended consequence of taking away the eyes and ears of the operating Divisions thus adding another degree of insularity.

Let me give very two examples of what I am talking about. On January 14, a New York Times article indicated that the Division of Enforcement was taking a hard look and might be planning enforcement actions against mutual fund organizations that are not adequately disclosing non-sales charge compensation paid to fund retailers through payments for shelf space, etc. Yet, four years ago the SEC's General Counsel's Office filed an amicus brief in a lawsuit then pending in New York, indicating that certain very general prospectus disclosures provided an adequate legal blessing to these payments.

The second instance involves market timing. I believe that between 1993 and 2003 there was at least six reported lawsuits in which market timers, complaining about efforts by mutual funds to curtail their activities, sued insurance and mutual fund organizations. The SEC did not file an amicus brief in any of these cases. I believe that any careful study of these two examples and others would substantiate that the view that the regulatory voids which followed action in the one case and inaction in the other helped create a false image of regulatory tolerance in two extremely important and problematic areas. I strongly believe that the internal fragmentation I have described played a significant role.

An equally bizarre example is one that even more sharply illustrates how the quality of regulation of comparable securities products depends on which SEC division is vested with jurisdiction. While the SEC, the Congress and the media have expressed intense and generally critical interest in the level various mutual fund fees there has been total silence about so called "wrap accounts" the broker-dealer analogue to mutual funds which may command higher fees. While there is a difference between the regulatory authority of the SEC over mutual funds and wrap accounts, if both products were regulated, say by, a "Division of Retail Securities Products" rather than two separate divisions - the Division of Investment Management and the Division of Market Regulation - there would be a convergence of the regulatory precepts applying to these similar products

It may be argued that we have lived with these anomalies for a long time and major structural reform is would be too difficult to achieve and efforts aimed at incremental improvement may be all that is necessary. However, I believe that the problems will get worse, given the ever more complicated financial innovations which find their way into retail investment products.

As new retail products continue to proliferate which cross the traditional internal jurisdictional lines the ability of the Commission's operating Divisions to identify emerging problems is significantly impaired. A case in point is the development and growth of Exchange Traded Funds, so called ETF's. While the pools of assets underlying ETF's are usually (but not always) subject to regulation as investment companies, the operations of ETF's that enable them to maintain their share trading prices in sync with underlying net asset values, depend on market trading operations by arbitrageurs who are granted unique privileges by the fund managers. The extent to which the operations of these funds are consistent with the best interests of investors and their growing impact on the securities trading markets remains obscure. Although the Commission has several studies about various aspects of these funds underway the lack of central responsibility and direction both protracts and dilutes the quality of these piecemeal efforts.

Time does not permit further discussion. For those who may be interested in pursuing these themes I should suggest a look at web-site of the U.K.'s Financial Services Authority (fsa.gov.uk) where you find some thoughtful papers on how that regulatory body is developing a holistic approach, which utilizing risk assessment tools, is focusing its supervision on the financial services firm as a whole, rather than individual lines of business. While the FSA's plans are yet to be wholly effectuated and their efficacy cannot be judged the thinking behind this approach commends itself to other financial regulators seeking to modernize their regulatory apparatus.

While certain steps such as revamping the emphasis and scope of inspections can be initiated within the Commission's present structure, in the longer term it seems clear to me that the SEC should embark on a major study of whether its present organization makes sense under modern conditions and the extent to which major adjustments are needed. If any of you view as utopian or eccentric the idea that a bureaucracy can reform itself I hasten to say that I agree.

As an endnote I should also say that I believe that all is not lost. In the 1950's the SEC also lost touch with the reviving and burgeoning capital markets yet after the congressionally mandated Special Study of Securities Markets in the early 60's a burst of creativity marked a strong revival of the SEC, including such reforms as the non-legislative integration of the disclosure provisions of the Securities laws, the abolition of the stock exchange minimum commission rate schedules and under SEC prodding, the creation of NASDAQ by the NASD. Unhappily we must probably await a new scandal for the next Special Study and the next turn of the wheel.