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## The SEC's Malfeasance

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Some have proposed in recent years that the Securities and Exchange Commission (SEC) functionally regulate investment banks – that is, provide rules that affect investment bank operations rather than just ensure transparency. I have maintained publicly that it is too much to expect the SEC to develop the kind of functional regulatory infrastructure that bank regulators possess, i.e., examination staff, offices, and rules and procedures, from scratch.

The SEC itself, however, seems to have embraced such an expanded role, if only because of regulatory competition perceived to originate in financial holding company supervision by the Federal Reserve and follow-on capabilities at other bank regulators. The problem is that the SEC has made several key failures early on, seeing no liquidity problems in mortgage markets, no capital problems at investment banks they regulate, and having yet to implement functional regulation at the credit rating agencies. It may, therefore, be time for the SEC to refocus on transparency and leave the functional regulation to others.

### LIQUIDITY PROBLEMS IN MORTGAGE MARKETS

The SEC was created to provide safer financial markets and financial statement transparency. The SEC has been successful in that practice in many regards. But the SEC's lack of diligence regarding mortgage markets ultimately led to a contemporary market crisis in a large financial sector.

The most obvious oversight has been the SEC's pronouncement of no substantial need to oversee the development of mortgage markets: The Securities and Exchange Commission examined RMBS markets four times between 1998 and 2007, each time claiming no significant concerns with transparency.

Even worse, however, is the fact that many of the shortcomings that are contributing to the current crisis were voiced years ago and never addressed. In a speech delivered at the Media Studies Center in 1998, SEC chairman Arthur Levitt remarked that he was, "...concerned that certain mortgage-backed securities are being sold to individual investors without those investors fully understanding the risks involved." Levitt noted specifically, "It's likely that many individual investors are not even aware of the variables that influence the return and duration of their investments."

Levitt continued, "These are complex financial instruments. Even professionals require sophisticated analytical tools to evaluate them properly. I

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doubt that many individual investors realize exactly what they have purchased. I am also very troubled by reports that brokers may be marketing only the higher-risk classes – or tranches – to individual investors, while lower-risk classes are sold exclusively to institutions.” Levitt promised investigation at the time, but no action was taken.

#### CAPITAL PROBLEMS IN INVESTMENT BANKS

The SEC is also supposed to be monitoring investment bank financial conditions. In a recent report, the SEC publicly stated:

*WASHINGTON, March 11 (Reuters) - The U.S. Securities and Exchange Commission is comfortable with capital levels at the five largest U.S. investment banks, including Bear Stearns Cos.*

*"We are reviewing the adequacy of capital at the holding company level on a constant basis, daily in some cases," SEC Chairman Christopher Cox told reporters on Tuesday after a news conference on greater cooperation with the Commodity Futures Trading Commission.*

*"We have a good deal of comfort about the capital cushions that these firms have been on," he said.*

*Under a supervisory program, the SEC is in contact with investment banks Bear Stearns, Morgan Stanley, Lehman Brothers Holdings Inc, Merrill Lynch and Goldman Sachs. The program is designed to allow the SEC to monitor and respond quickly to any financial and operational weakness in the companies. (Reporting by Rachelle Younglai, Editing by Toni Reinhold)*

Bear Stearns began to fall apart the next day and was sold over the weekend for a price that was a fraction of its market value. Such timely and wrong announcements give no comfort that the SEC is adequately supervising its concerns.

#### CREDIT RATING AGENCY SURVEILLANCE

In 2006, Congress passed the Credit Rating Agency Reform Act, which, authorized the SEC to suspend or revoke the NRSRO status of a current registrant if a firm lacks the financial or managerial resources to produce ratings with integrity. Hence, just as bank regulators are responsible for examining commercial banks with regard to such issues as capital, assets, management, earnings, liquidity and sensitivity to market risk, the SEC staff is to review aspects of the rating agencies. In addition, the SEC has some ability to make sure that the agencies are staffed with an appropriate number of experienced analysts and operate independently of the companies they rate.

Nearly two years since the passage of the Credit Ratings Agency Reform Act of 2006 and with a year of demonstrations of the shortcomings of current ratings processes, the SEC has made no overtures toward strict enforcement using the provisions of the Act.

#### CONCLUSIONS

In conclusion, it is not clear that the SEC is up to the task of functional regulation. Bank examiners like those at the Office of the Comptroller of the

Currency have police powers of the Secret Service, allowing them to collect documents forcefully if necessary. Bank examiners maintain resident offices at the largest commercial banks and work out of satellite offices for others. Bank regulators devote considerable staff hours to developing policies and procedures for even the smallest supervisory practices. It is not clear that all this need be reinvented on behalf of the SEC.

Nor is clear that we should want the SEC to be sidetracked from its central goal of financial market transparency. The SEC does not have the time to build substantial functional regulatory capabilities right now. With the implementation of fair value accounting rules and the need for reconsideration of the nature of “true sale” in FAS140 it may be appropriate to allow the SEC to fight the war against financial crisis on merely a single front, indeed the front they are most familiar with: that of ensuring financial transparency.