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What (If Anything) Can Fix the SEC?

By: Christopher Matthews – January 28, 2013

When President Obama nominated former U.S. Attorney Mary Jo White to be the next Chairman of the Securities and Exchange Commission (SEC), the reaction was generally positive. White will be the first prosecutor to head the nation's top financial regulator, and many critics of Big Finance are seeing the pick as a clear indication that the President wants to get tough on Wall Street shenanigans. For instance, Dennis Kelleher, president of the nonprofit organization Better Markets, which lobbies for financial regulatory reform, said in a statement:

“Mary Jo White was a tough, smart, no nonsense, broadly experienced and highly accomplished prosecutor. She knew who the bad guys were, went after them and put them in prison when they broke the law. That’s what must happen if integrity and investor confidence is to be restored in our securities markets. Wall Street is a high crime area and Mary Jo White brings the right skill set to restore the rule of law on Wall Street.”

Kelleher is right in that the rule of law on Wall Street has broken down in recent years. Scandal has rocked the financial world for most of the new century, beginning with the collapse of Enron and the dot-com bubble bursting at the turn of the century, followed by the various misdeeds that lead to the 2008 financial crisis, and continuing to this day with banking scandals like LIBOR.

But is a new leader with a bit of prosecutorial zeal all that’s needed at the SEC? After all, according to the SEC, the outgoing head of the SEC Mary Schapiro, oversaw a “record” number of enforcement cases, including bringing action against 129 separate individuals whose transgressions were directly related to the financial crisis. Yet the public still feels like justice has not been done. The most high profile bankers who presided over the crisis are either still in their jobs, or left their positions with lucrative golden parachutes. And the financial industry as a whole appears to have little respect for the law of the land, as it produces scandals at an alarming rate.

Granted, the SEC is just one facet of the nation’s regulatory apparatus. But it’s one of the most important facets, and there is near-universal agreement that it’s not doing the best job it can. So how can we fix the SEC? Here are three suggestions:

Increase funding

Most of the regulatory apparatus in Washington isn’t funded by the taxpayers, nor is its budget determined by the Congressional appropriations process. The FDIC, for instance, is funded through fees on member banks, and its budget is set by its board of directors to meet the needs of the regulatory environment at the time. The SEC is also funded through fees on financial transactions, but that money is funneled into the Treasury, and doled out to the SEC through the normal appropriations process. This doesn’t allow the SEC to boost its funding during years

when the regulatory burden is high, and it doesn't allow the organization to budget long term. Bart Naylor, a financial policy advocate at Public Citizen, says that if he could change one thing about the SEC it would be to increase its funding. "New York City employs 35,000 police officers while the SEC only has 4,000 employees to regulate the entire financial industry," he says. In his opinion, the resources the SEC has at its disposal aren't anywhere near what is needed for the agency to be effective.

But you don't have to be a clairvoyant to know that securing a budget increase in this political environment isn't going to happen. That's why John Coffee, a securities law expert and professor at Columbia Law School has proposed that the SEC retain outside counsel on a contingency-fee basis — especially for cases it brings against large banks with deep pockets. Large corporations, Coffee says, don't rely on their in-house legal departments for important cases; they hire the best law firm they can find. "I think government agencies need to consider the same approach, mostly because they can't have on their own staff the same level of excellence," Coffee says. "I'm not saying that SEC lawyers are bad, I'm saying they're not an all star team. And if you're going to bring a very large case, you bring in an all-star lawyer to litigate that case. He then, if he's looking at a case he thinks is promising, can put on it the requisite number of lawyers."

Go after more individuals

Retaining outside counsel would also allow the SEC do the very difficult work of bringing actions against individuals, rather than firms. For years, the SEC has made it a habit to settle with firms, without requiring those companies to admit wrongdoing, and without going after the individuals at the firm who actually committed the wrong doing. Furthermore, the facts of the cases are kept from the public, making it impossible for voters to judge the efficacy of the regulatory system.

The reason the SEC is often reluctant to bring actions against individuals is because it is difficult to prove that individuals have the "intent" to mislead or defraud. At the same time, if the SEC were more committed to bringing actions against high-profile individuals — even if they often lost those cases — it could put would-be fraudsters on notice that their actions will be closely scrutinized. More resources, or access to outside counsel, would enable the SEC to do the hard work of bringing such actions against individuals.

But Mark Calabria of the Cato Institute believes that more resources aren't a panacea, or even necessary. After all, he points out, it wasn't a lack of resources that prevented the SEC from going after Bernie Madoff. He says the most important change needed is a cultural shift at the organization, towards one that is less risk averse. "You can't be afraid of trying cases and losing," he says. It's bank managers that are fighting these cases, and when they settle, they settle using shareholder money. This dynamic may lead to large settlement headlines, but not to justice being done. "In my opinion, the SEC is choosing the path of least resistance," Calabria says.

Focus on protecting the defenseless

Calabria also thinks the SEC, in a misguided effort to punish those responsible for the financial crisis, is spending too much time going after high-profile banks for misleading other sophisticated investors. The 2010 suit against Goldman Sachs, in which it was charged with misleading investors in relation to its Abacus CDO, is a perfect example. The parties Goldman Sachs was accused of misleading were highly sophisticated investors. Moreover, there has been no suggestion that this sort of behavior was a key factor in causing the financial crisis. So, why — given the SEC's limited resources — is it spending so much time and energy litigating such suits? It's most likely because of the political pressure to see heads roll. But, Calabria argues, this isn't

the best role for the SEC to be playing. “Is the role of the SEC to protect the retail investor, or large multinational banks who are capable of protecting themselves?”

Mary Jo White is a well-respected prosecutor who will bring a much-needed perspective to the SEC. But critics of the organization aren't going to be satisfied merely with a shake-up at the top. The problems afflicting the regulatory system in America aren't because there aren't many good people working at these organizations. There are deeper, structural and cultural issues that are preventing regulators from being as effective as they can be. So while White's experience has some excited for a change at the organization, it will take much more than a leadership change to effect the evolution that is sorely needed at the SEC.