REMAPPING DEBATE
Asking "Why" and "Why Not"

SEC: always playing catch-up

Readable Research | By Raphael Pope-Sussman | Corporate influence, Regulation

Oct. 12, 2011 — In the wake of the wreckage of the financial crisis, there have been numerous post-mortems of what went wrong, including some that have focused on the role of the Securities and Exchange Commission (SEC). Indeed, the period from 2000 to 2010 was marked by a series of well known crises, including major corporate accounting scandals at Enron and Worldcom and the perpetration and ultimate demise of Bernie Madoff's $20 billion Ponzi scheme.

PUTTING REGULATORY FAILURES IN CONTEXT

Our specialty is original reporting. But in this case, we thought that it would be useful to compile previous reporting by others on individual instances of regulatory failure. A picture quickly emerges that is very different from the bogeyman of overregulation: an unmistakable, systemic pattern of under-regulation.

The series began with a look at the strikingly limited extent to which the Food and Drug Administration has regulated the cosmetics industry (read it here). We followed up with a look at OSHA's record. This week, we chronicle the sad story of the SEC. More agencies will be examined in the weeks ahead.

The series will conclude later this fall with original reporting that explores the key reasons — both internal to agencies and imposed upon them — for the recurring failures.

— Editor

But questions about the efficacy of SEC enforcement have a much longer history than that. For decades, concerns have been raised that the agency lacks the resources, expertise, or will to regulate the industry it oversees.

February 1977

The SEC receives the highest rating of all agencies in a Senate Government Operations Committee report on the appointment process for regulatory commissioners.[1]

The report, which includes a survey of lawyers on the fitness of federal commissioners for their jobs, gives the SEC "the most favorable ratings of judgment, technical knowledge, impartiality, legal ability, integrity and hard work."[2]

January 1981

The inauguration of Ronald Reagan marks major a shift in the direction of the SEC. In January, presidential advisers present a report recommending massive cuts to the SEC. An Associated Press story carried in the New York Times reads: "The report said the S.E.C.'s staff and budget could be cut 30 percent over three years."[3]

July 1981

SEC Chairman John Shad speaks of a new era, in which industry will play a more active role in policing itself. Shad says he does not want the SEC to be seen as the “cop on the corner of Wall Street and Broad,” but rather as an essential partner in “capital formation,” the Washington Post reports.[4]

October 1981

SEC officials release a study on the potential effects of proposed budget cuts, reports the New York Times. The study says that President Reagan’s proposed 12 percent cut in the agency budget will mean a 20 percent decrease in staff, the closing of several offices, and severely circumscribed regulatory capabilities. The Times also describes the concerns of SEC Chairman John Shad, who warns in a letter to the White House budget director that the proposed 12 percent cut, on the heels of a 6.5 percent cut for fiscal year 1981, would deprive the agency of 400 staffers.

The agency is ultimately spared a cut to its budget. The number of staffers remains at 2,021.

In 1982, a skeptical staffer on the House Commerce subcommittee on oversight and investigations tells the Post, “The quantity may be up, but the quality of enforcement cases is down.”

October 1982

The SEC reports that enforcement actions are up 42 percent, despite budget cuts that according to the Washington Post “cut staff time devoted to those actions by 12 percent.” A skeptical staffer on the House Commerce subcommittee on oversight and investigations tells the Post, “The quantity may be up, but the quality of enforcement cases is down.”[5]

1982

In a rule change, the SEC reduces capital requirements for brokerage firms. Firms were previously required to hold funds equal to at least 4 percent of customer debt; they now need only hold funds equal to 2 percent of debt. This change is designed to free more capital for investment; it enables brokerages to operate with greater leverage, increasing potential rewards and risks.[6]

March 1983

Rep. Timothy Wirth (D-Colo.), chairman of the House subcommittee on telecommunications, consumer protection, and finance, criticizes Shad's leadership of the agency, particularly the path he has set concerning the treatment of insider trading. Wirth expresses his frustration with Shad's "apparent lack of commitment" to securing a larger budget for the SEC in a letter to Shad, which Wirth shares with Washington Post Reporter Stuart Auerbach.[7]

> "Given what is at stake, and the fact that there is no demonstrated problem, it would be irresponsible to take on the considerable risks surrounding the proposed rule. There is no evidence that broad scope of services has an adverse effect on audit quality."
> — Robert R. Garland, a managing partner at Deloitte, arguing in 2000 against enhanced controls to thwart conflicts of interest in the accounting industry

Later in March, four of Shad's fellow commissioners on the SEC challenge the chairman's claim that the agency does not need greater staff resources. The Washington Post reports on a letter sent by the commissioners to Rep. Wirth, in which they state that "a 4 percent increase in staff positions is necessary." Shad, the Post notes, had told Congress the agency could make due with 6 percent cut in staffing. The commissioners' letter expresses their belief that "at the present funding level, we are stretched thin — so thin, in fact, that we have concluded it is the minimum responsible staffing level."[8] Staffing still sits at 2,021.

November 1984

The Lion Capital Group and RTD Securities, two dealers of government securities, declare bankruptcy. Among the victims of the collapse of Lion Capital: more than 20 school districts in New York State, which together suffer losses exceeding $20 million. Despite concerns of some observers about the adequacy of the self-regulatory regime in place for government-securities dealers, the SEC and other federal agencies do not push Congress for the power to regulate the market; interviewed in American Banker, a staffer at the Office of the Comptroller of the Currency is grim on the prospect of regulation: "What will happen this time? I think you'll see more of the same — that is to say, nothing will happen unless there is a disaster."

March 1985

Markets in government securities are again shaken when the Bevill, Bresler & Schulman Asset Management Group and E.S.M. Government Securities Inc., additional players in the government-securities market, collapse after the discovery of massive fraud at the firms. The Los Angeles Times reports on Congressional testimony from Thomas Tew, court-appointed receiver for ESM, who says executives plundered the firm to fund their lavish lifestyles, in which they bought boats, mansions, and even a $78,000 dog. Tew calls the executive's acts the "most abusive corporate raping that I had ever seen."

Officials at both firms are later tried and convicted on federal charges. A New York Times report published after the sentencing of Bevill executives describes how, "Investigators and court-appointed officials…found a string of fraudulent transactions indicating that the firm had been technically insolvent for four years. They also said that its executives had been taking huge salaries and bonuses while it was going bankrupt."

Investor losses at BBS are pegged at $240 million; losses at ESM exceed $300 million. BBS and ESM firms are charged with fraud and executives from both firms are later convicted on federal charges.

The failure of ESM sets off a banking crisis in Ohio, when Cincinnati-base Home State Savings Bank, a thrift with significant exposure to ESM, collapses. Depositors across the state fear for the safety of their savings and the governor declares a bank holiday for 71 savings and loan associations to prevent a run on the institutions.

Rep. Wirth observes in a memo that, under current law, "the SEC lacks the authority to inspect the books of unregulated government securities dealers or take other steps that might prevent fraud."[9]

Despite the turmoil, industry insiders continue to oppose regulation of government securities.

Francis X. Cavanaugh, director of the Treasury's office of government finance and market analysis, tells the New York Times, "We don't want regulation of the government securities market until there is clearly a need for it...Regulation is no guarantee against fraud or bad business judgment."

August 1985

The General Accounting Office (GAO) reports on the decrease in enforcement actions at the SEC. American Banker reports, "According to data gathered by the GAO, the agency completed 206 enforcement actions during a six-month period on 1978, compared to 191 during the same period in 1985 — despite a huge leap in the volume activity on Wall Street." The results of the study echo the concerns of agency critics, who say the SEC is consistently outgunned by the industry it regulates.[10]

1986

Another GAO study finds that the SEC often fails to review — or reviews only superficially — the corporate filings it receives. Reporting on the study in the Washington Post, David Vise writes, "The inventory of unprocessed annual reports and quarterly filings has nearly tripled, from 5,846 in 1983 to 15,1551 in the first half of this year." Rep. John Dingell (D-Mich.), chairman of the House Committee on Energy and Commerce, blames the backlog on a "lack of staff resources."[11]

The agency's regulatory staff is 9 percent smaller than it was in 1980, despite significant increases in the volume of activity on Wall Street.[12]

Dingell speaks of a "growing concern in Congress and in the securities industry about the agency's long-term effectiveness in deterring future violations."[13]

Royce Griffin, president of the North American Securities Administrators Association, testifies before the House Energy and Commerce Committee's subcommittee on telecommunications, consumer protection, and finance about the state of the SEC. Griffin blasts the agency, arguing that "because of a retreat from enforcement we have sent a message to scam peddlers that deregulation means that anything goes. SEC staff levels must catch up." SEC Chairman John Shad denies Griffin's claims.[14]

The SEC brings insider-trading charges against Dennis Levine, a managing director in mergers and acquisitions at the New York investment bank Drexel, Burnham, and Lambert. The case against Levine (who will later lead federal investigators to Ivan Boesky's massive insider trading scheme) is seen as a high-profile victory for the SEC. But the revelation that Levine's fraud occurred over six years and brought the banker more than $12 million in profits sheds light on the enormity of the task the SEC faces in controlling insider trading.

> "The consensus approach to regulatory coordination is destined to fail…the SEC will constantly be outvoted and crippled by those who value ideology more than confidence in our capital markets." — Rep. John Dingell, 1988

Richard Phillips, a former SEC staff attorney and head of the American Bar Association's securities regulation committee, expresses his concern for the agency's capabilities to Martha Hamilton and Peter Behr of the Washington Post: "It's not a great display of enforcement power to catch someone who allegedly did 54 transactions over six years…they need help." Writing in the Post, Hamilton and Behr note that because the agency is "unable, by virtually everyone's account, to monitor" an industry that dwarfs it in size, wealth, and influence, the SEC "must count on deterrence to help limit abuses." The agency, explain Hamilton and Behr, has only 600 staffers in its enforcement office; its budget has not increased in the past five years, despite "a 300 percent increase in the volume of trading on the New York Stock Exchange."[15]

1988

Regulatory lapses are cited as one of the causes of the October 19, 1987 "Black Monday" market crash, in which the Dow Jones Industrial Average dropped 508 points and $500 billion in market value evaporated within a matter of hours. The proliferation of index-arbitrage program trading is identified as a significant factor leading to (or driving) the crash, and the SEC is criticized for its failure to identify the systemic risks posed by the intensification of that program trading.[16]

An aide at the General Accounting Office tells Time Magazine that the agency lacks the capability to "go in and analyze a computer system to see if it functions correctly."

In March of 1988, the White House convenes a working group of administration officials to study the causes of the crash. The working group is composed of Fed Chairman Alan Greenspan, Undersecretary of the Treasury for Finance George D. Gould, Commodity Futures Trading Commission Chairman Wendy Gramm, and SEC Chairman David Ruder. The group, Nathaniel C. Nash reports in the New York Times, is “dominated by three members — Mr. Gould, Mr. Greenspan and Mrs. Gramm — who are avid believers in the efficiency of markets that operate with a minimum of Government regulation and interference,” and who are “almost automatically predisposed against legislative proposals.”

The working group rejects a proposal by Ruder for more stringent margin rules for investors. It suggests no further restrictions on computerized trading.

Frustrated with the group’s report, Rep. John Dingell (D-Mich.) tells the Associated Press, “The consensus approach to regulatory coordination is destined to fail…the SEC will constantly be outvoted and crippled by those who value ideology more than confidence in our capital markets.”[17]

1988-1992

In the late 1980s, the SEC asks Congress for the power to regulate stock-index futures, a class of securities overseen by the Commodity Futures Trading Commission. The agency’s effort to expand its regulatory reach sets off a heated turf-war with the CFTC. The conflict between agencies escalates in the spring of 1990, when the Bush Administration advances legislation to shift the regulation of index futures from the CFTC to SEC.[18]

Testifying in front of the Senate Committee on Banking, Housing, and Urban Affairs in July, Thomas Eagleton, former senator from Missouri and former official at the Chicago Mercantile Exchange, says the CFTC “trembles at the sight of Chicago” and calls the agency “a pygmy of federal regulation.”[19]

Legislation to shift oversight of index futures to the SEC stalls in Congress. When legislation is finally passed, as the Futures Trading Practices Act of 1992, it includes only superficial changes to the CFTC and leaves stock-index futures under that agency’s oversight. Wendy Gramm, a free-market economist, president of the CFTC, and wife of then-Senator Phil Gramm (R-Texas), is credited as a major force behind the CFTC’s jurisdictional victory.

> “U.S. banks will soon become an endangered species if they are not allowed to compete in the broader market for financial services both at home and abroad.”
> — Thomas P. Rideout, former president of the American Bankers Association, 1990

September 1989

After a multi-year SEC investigation into insider trading at Drexel Burnham Lambert, the firm pleads guilty to six counts of mail and securities fraud. Drexel also agrees to pay a penalty of $650 million. The discovery of the massive fraud at Drexel had begun in 1986, with the arrest of managing director Dennis Levine. The continuing investigation of insider trading widened, ensnaring a litany of major figures on Wall Street. Investigators also uncovered massive fraud at Drexel, concentrated in the Beverly Hills-based junk bond division run by Michael Milken.

February 1990

Unable to weather increasing volatility in the junk bond market and the fallout from its criminal activities, Drexel's parent company, Drexel Burnham Lambert Group, defaults on a $100 million loan and files for bankruptcy protection, under Chapter 11. Reporting in February of 1990, Time Magazine notes, "The 152-year-old titan — with 5,300 employees and $3.6 billion in assets — will vanish almost overnight." At the time, the firm's collapse is the largest in Wall Street history.

> The SEC will be unable to provide "meaningful, direct...regulation over the investment advisory industry unless the resources dedicated to its responsibilities...are significantly increased." — Mary L. Schapiro, then-SEC commissioner, 1990

March 1990

Writing in American Banker, Thomas P. Rideout, former president of the American Bankers Association, calls for the deregulation of the banking industry. Rideout warns that, "U.S. banks will soon become an endangered species if they are not allowed to compete in the broader market for financial services both at home and abroad."[20]

April 1990

Milken pleads guilty on six felony charges of securities fraud and conspiracy. He is sentenced to 10 years in prison and ordered to pay $600 million in fines and penalties. Including later settlements with investors he defrauded, Milken's fines total $1.3 billion. In August of 1992, a federal judge reduces Milken's sentence to two years. He is released from prison in January 1993, having served only 22 months in prison.

July 1990

A bill to add consumer protections to the Investment Advisers Act of 1940 is introduced in Congress after a GAO report finds that fraud and abuse by financial planners cost consumers between $90 and

$200 million annually. Consumer losses are thought to be even greater than these figures suggest, as much fraud goes unreported

SEC Commissioner Mary L. Schapiro applauds Congress's effort to strengthen regulation of the investment advisory industry, but warns that the agency will be unable to provide "meaningful, direct…regulation over the investment advisory industry unless the resources dedicated to its responsibilities…are significantly increased." The American Institute of Certified Public Accountants, a trade group, attacks the bill for covering "an unduly large array of individuals and services." It stalls in Congress.[21]

The SEC's ability to police the investment advisory industry is tested further in 1991, as the agency cuts the number of investment advisor inspectors to 46 from 64, a decrease of more than 25 percent. John M. Doyle reports in the Associated Press on the Congressional testimony of Richard L. Fogel, an official at the GAO. Fogel says the SEC lacks the statutory authority and the resources to oversee the 17,500 registered financial planners managing more than $5 trillion — up from 4,580 planners managing only $440 billion in 1981.[22] Rep. Edward Markey (D-Mass.), chairman of the House Energy and Commerce subcommittee on telecommunications and finance, tells the Associated Press that under the current regulatory regime, "an SEC registration comes perilously close to being a license to plunder."[23]

Bills regarding the regulation of investment advisers are introduced in both houses of Congress. In the Senate, Phil Gramm (R-Texas), a long-time foe of regulation, proposes a number of amendments to weaken the Senate version of the bill. The Associated Press reports on Gramm's successful attempt to eliminate from the bill "a provision that would have barred advisers from recommending investments that are unsuitably risky for their clients." Ultimately, no bill on the matter will pass Congress. No further action is taken.[24]

May 1992

After a 10-month Justice Department and Securities and Exchange Commission investigation into fraudulent bidding at Treasury auctions by Salomon Brothers, the firm settles with the federal government for $290 million. The government declines to bring criminal charges against the firm, citing its cooperation in the investigation and the conclusion that wrongdoing "was not a common, everyday occurrence" at the firm.[25] Salomon had previously disclosed, as reported by the Washington Post, that "its chairman…and other top executives learned of 'clear wrongdoing' … involving the purchase of Treasury securities…but failed to inform government regulators until months later."[26]

A New York Times article notes that the settlement "poses no financial jeopardy to Salomon, which last quarter had a $190 million profit and whose broker-dealer affiliate alone has more than $2 billion in capital."

March 1994

The Los Angeles Times publishes a major article on the "revolving door" between the SEC and Wall Street: "Life is lucrative these days for Wall Street's former top cops who, following a time-honored path, often come to represent the firms they once probed." Both David Ruder and John Shad, chairmen of the SEC under President Reagan, followed this path. After leaving the SEC, Ruder joined a corporate law firm, where he represented Chatfield Dien, a penny-stock firm. During his tenure as chairman, Ruder had pushed for more regulation of penny-stock dealers. After Shad left the agency, he joined Drexel Burnham Lambert, the New York investment bank, as chairman of the board. As chairman of the SEC, Shad oversaw the agency's investigation into Drexel's junk-bond operation, which resulted in a (then) record $650 million fine and a criminal indictment for the firm.

The steady stream of high-ranking officials moving from the SEC to the financial industry raises concerns among agency critics about its independence. Monroe H. Freedman, a law professor at Hofstra University, tells the Los Angeles Times he believes firms who hire former SEC officials receive preferential treatment. He also expresses concern about former regulators bringing valuable insider knowledge to firms: "It puts a premium on putting up for private sale to a particular law firm or client what should either be confidential information or should be available to the public."

> "Unless we speak out against the SEC's intrusion into a municipal finance industry that is serving well the public interest, there will be no end." — Harlan Boyles, then-state treasuer of North Carolina, 1994

A number of state regulators describe the murky world created by the revolving door in state regulation. The Times notes that regulators "make key prosecutorial decisions without thorough investigation" as a result of being "overburdened." Instead of rendering independent judgments, they defer to the counsel of former colleagues working as defense lawyers — on the very cases about which the regulators seek advice.[27]

Defenders of the current system say government work offers poor compensation and that it is only natural for former SEC officials to eventually leave the agency for high-paying private sector jobs. According to the Times, a staff lawyer with 10 years at the SEC will earn about $70,000 [$107,000 in 2010 dollars] annually. "What do you want somebody to do after serving their country for 15 years?" Philip A. Feigin, Colorado's securities commissioner, asks the Times. "Become a divorce lawyer?"

Writing in Bond Buyer, Harlan Boyles, state treasurer of North Carolina, accuses the SEC of "McCarthy-type" tactics and blasts the agency's move to curb influence-peddling in the municipal-bond industry. "Where does it all end?" asks Boyles. "Unless we speak out against the SEC's intrusion into a municipal finance industry that is serving well the public interest, there will be no end."[28] In April, despite industry protests, SEC approves Rule G-37, which bars municipal-bond brokers from engaging "in municipal securities business with an issuer within two years of any contribution to an official of such issuer" doing business with a municipal bond issuer for two years after contributing to any official or candidate who can influence the bond's sales." [29]

September 1994

The General Accounting Office releases a report criticizing the SEC for its lax treatment of stockbrokers who run afoul of the law. As reported in the Los Angeles Times, the GAO study finds that "formal disciplinary action against brokers was rare" and that many brokers "who have committed serious violations…are eventually allowed to return" to the industry.[30] The GAO, reports the New York Times, also urges the SEC to improve "its existing monitoring system, known as the Central Registration Depository."

The GAO report identifies 9,800 brokers with disciplinary records — out of 470,000 registered brokers. But the report suggests the figure (which does not include brokers disciplined informally) could be low, citing the difficulty of identifying fraud and the weakness of the SEC's detection mechanisms. James Bothwell, a GAO official, says, "The numbers we have could be the just the tip of the iceberg."

Later in September, the agency announces a nationwide sweep of small and medium-sized stockbrokers to weed out so-called "rogue brokers."[31]

The 1994 GAO study finds that "formal disciplinary action against brokers was rare" and that many brokers "who have committed serious violations...are eventually allowed to return" to the industry.

1996

An SEC investigation of the National Association of Securities Dealers, the industry group responsible for overseeing the Nasdaq Stock Market, finds the association did nothing to curtail long-standing price fixing by brokers trading on the exchange. The illegal and anti-competitive trading practices are estimated to have cost investors tens of millions of dollars. The SEC censures NASD and orders the association to spend $100 million, over five years, to create a new, independent regulatory body to police Nasdaq.[32] As the Washington Post reports, some industry insiders complain that the SEC crackdown will cut into dealer profits.[33]

In a February opinion piece in Roll Call, Rep. Thomas Bliley (R-Va.), chairman of the House Commerce Committee, attacks the financial regulatory regime, criticizing margin regulation — the rules that govern how much collateral investors must hold to make investments — as "outmoded" and promising to "resist any efforts to shackle our derivatives market with federal regulation."[34]

1998

Long Term Capital Management, a hedge fund that had managed more than $100 billion in assets, teeters on the brink of collapse after suffering catastrophic losses in the bond market. Fearing that the failure of the enormous fund will set off a system crisis, the Federal Reserve orchestrates a $3.5 billion bailout by private investors.

> "The Commission is impeded in its ability to formulate public policy that appropriately protects the interests of the U.S. investing public unless it also has access to accurate and current information about hedge funds and their advisers." — SEC report, 2003

After studying the near-collapse of LTCM, a White House task force recommends stronger disclosure requirements for hedge funds, but stops short of recommending more federal oversight for the largely unregulated firms. The Washington Post reports that Treasury officials on the task force "favored regulating hedge funds, but [SEC Chairman] Arthur Levitt and [Federal Reserve Chairman] Alan Greenspan were staunchly opposed."[35]

In October of 1999, a GAO report on LTCM identifies the lack of regulation of hedge funds as a significant factor in the LTCM crisis. The report finds that the SEC lacked the statutory authority necessary to evaluate the financial stability of LTCM or the systemic risks posed by the fund's market positions.[36]

2001

Enron collapses (see discussion in the box on next page).

2002

In response to the accounting scandals at Enron and WorldCom, Congress passes the Sarbanes-Oxley Act, a major piece of financial-reform legislation. The law includes sweeping changes to the regulation of corporate accounting, including a ban on auditors performing a dual role.[37] Industry groups and executives criticize Sarbanes-Oxley as onerous and unnecessarily costly to business.

2003

The SEC staff issues a report on the rapid growth of hedge funds. The report warns that, "The Commission is impeded in its ability to formulate public policy that appropriately protects the interests of the U.S. investing public unless it also has access to accurate and current information about hedge funds and their advisers." In 2004, responding to the staff report, the SEC adopts rule 203 (b) to the Investment Advisers Act of 1940. The new rule would require most hedge funds to register with the SEC. The hedge fund industry sues the agency and, in June 2006, the rule is struck down in federal court.

Testifying before the Senate Banking Committee later that summer, SEC Chairman Christopher Cox asks for the power to regulate hedge funds (which now manage more than $1 trillion in assets).[38] As reported by Bloomberg, Cox says, "The commission stated, when we adopted the hedge fund rule [Rule 203 (b)], that its then-current program…was inadequate … that is once again the case."

Regulation stymied...and Enron blows up (part 1)

In September of 2001, Enron, the Houston-based energy-trading giant, files for bankruptcy. The company's collapse is followed by revelations that it had engaged in a massive, wide-ranging fraud, deceiving investors about its performance for years. The once-mighty firm leaves behind $67 billion in debts and legions of wiped-out investors. Many of Enron's employees lose their pensions and their life savings, which they had invested in the company's now worthless stock.

The size and extent of the fraud raises questions about the state of financial regulation. In particular, the rules governing corporate accounting come under fire, when it is discovered that Arthur Anderson, Enron's auditor, participated in the fraud. The Big Five firm had maintained extensive consulting contracts with Enron while acting as Enron's auditor, a common (and legal) practice thought by industry critics to represent a potential conflict of interest.

In 2000, the SEC had proposed a series of rule changes to control conflicts of interest in the accounting industry, including a rule that would have prevented firms from consulting for the same companies at which they were auditors. As reported in the New York Times, Chairman Arthur Levitt said the change was essential because, ''Without confidence in an auditor's objectivity and fairness, how can an investor know whether to trust the numbers?'' The proposal was met with fierce opposition from the industry, notably three of the Big Five firms (Ernst & Young and PricewaterhouseCoopers supported the plan) and the American Institute of Certified Public Accountants.

Robert R. Garland, a managing partner at Deloitte, was quoted in the New York Times at the time: "Given what is at stake, and the fact that there is no demonstrated problem, it would be irresponsible to take on the considerable risks surrounding the proposed rule. There is no evidence that broad scope of services has an adverse effect on audit quality. My own personal experience has caused me to conclude just the opposite."

Continued on next page...

2005

After the Senate repeatedly defeats bills to control corporate bankruptcy abuses, Stephen Labaton writes in the New York Times about the increasing congressional hostility to financial regulation. Labaton describes a radically different climate from that which prevailed after Enron and WorldCom, in which "corporate lobbyists…ask for and receive more from lawmakers, who no longer seem to be concerned about recrimination at the polls."

November 2006

New York City Mayor Michael Bloomberg and Sen. Chuck Schumer (D-N.Y.) commission a report by McKinsey on the state of the financial services industry in the United States.

The report paints an ominous picture, asserting a clear "loss in financial services competiveness" for the US and criticizing the nation's "increasingly heavy regulatory burden." Its authors argue that the American system's "complexity, cost, and perceived lack of responsiveness" threatens the financial sector and recommend that policymakers "re-examine implementation of [Sarbanes-Oxley]" and "undertake broader reforms," including providing greater protection for financial institutions against lawsuits claiming wrongdoing by those institutions.

Regulation stymied…and Enron blows up (part 2)

After an extensive lobbying campaign by the plan's opponents — described by the chairman of the SEC as "the fiercest, most vitriolic, political opposition campaign I have ever experienced," the SEC dropped the outright ban on auditors serving a dual role from its proposal.

What emerged instead, Floyd Norris writes in the New York Times, are new rules that simply restrict the "amount and nature of the work that the auditing firms will be doing for their clients, and will require that the auditing committees of corporate boards consider whether the non-audit services are consistent with maintaining auditor independence." Firms are still allowed to perform internal audits and consulting work for audit clients — a practice Arthur Anderson continues at Enron.

In the wake of Enron's collapse, SEC Chairman Harvey Pitt, who has strong ties to the accounting industry, continues to defend the SEC's rules for auditors. Quoted in the New York Times, Pitt says: "Auditor independence is not the cause of the problems that we are witnessing…This system has enough flaws and enough difficulties in it that cry out for repair."

The report also suggests that proposals to strengthen capital requirements for the largest U.S. banks would put those banks at a competitive disadvantage in relation to their international rivals. The report proposes that the U.S. follow the "Basel II" regime, under which "larger institutions can implement a risk-based model." These risk-based models later fail to capture the extent of banks' exposure to mortgage-backed securities; their use is cited as a major factor in the Financial Crisis of 2008.

Bloomberg and Schumer also pen an op-ed in the Wall Street Journal, calling for decreased regulation of the financial services sector. Bloomberg and Schumer attack the regulatory climate in the U.S., particularly Sarbanes-Oxley, which they criticize for its high cost to business. They also call regulators "overzealous." Warning that a failure to cut back regulation will have dire consequences, Bloomberg and Schumer recommend that the U.S. adopt a lighter regulatory system, similar to that seen in countries like England: "If we do not rise to the challenge, the speculation that New York is losing its pre-eminence in the global marketplace will become more than just chatter."

> Calling regulators "overzealous" and decrying the burdens on the finanical sector, a dire warning is issued: "If we do not rise to the challenge, the speculation that New York is losing its pre-eminence in the global marketplace will become more than just chatter." — NYC Mayor Michael Bloomberg and Sen. Chuck Schumer, arguing that Wall Street is over-regulated, 2006

2006

Sarbanes-Oxley continues to come under attack from industry. In December, Peter Wallison of the American Enterprise Institute tells Investor's Business Daily that because of the law, "Corporations have now become much more focused on financial reporting than creating value."[39]

February 2007

Accepting hedge fund industry claims that the massive investment vehicles are designed to carefully manage risk and pose no threat to the economy as a whole, the Bush Administration steps back from attempts to regulate the industry. Stephen Labaton reports in the New York Times on the Bush Administration's retreat from attempts to regulate the funds. The Administration, he writes, ultimately decided that "hedge fund companies and their lenders could adequately take care of themselves by adhering to a set of nonbinding principles."

March 2007

Jenny Anderson reports in the New York Times on the successful lobbying efforts of the hedge fund industry: "So far the industry's efforts have witnessed remarkable results…The Treasury Department, the Federal Reserve, Congress and the S.E.C. seem to agree: hedge funds are as regulated today as they should be." Anderson attributes the industry's lobbying victories — won despite a relatively small $7.7 million in donations to members of Congress between 1998 and 2006 — to an "unusually benign environment for regulation."

June 2007

Bear Stearns informs clients that two of its hedge funds, High-Grade Structured Credit Fund and High-Grade Structured Credit Enhanced Leverage Fund, have suffered catastrophic losses on collateralized debt obligations linked to mortgage-backed securities. According to the Daily Telegraph, Bear's letter to investors states that "there is effectively no value left" in High-Grade Fund and "very little value left" in Enhanced Leverage Fund. The SEC investigates the collapse of the funds and charges two fund managers at Bear with securities fraud, claiming they deceived investors about the value of the funds' assets. The managers are later tried and acquitted.

> In the event of a crisis, "all you would be able to do is get the license-tag number of the truck that just ran over you." — Rep. Richard Baker, arguing for more regulation of hedge funds

July 2007

The SEC adopts a rule change that will allow the agency to file suit against hedge funds that mislead investors. The change still leaves the SEC with far less oversight authority than it would have had if the 2004 rule rejected by a court in 2006 had been sustained.

August 2007

Writing for McClatchy, Kevin G. Hall and Robert A. Rankin describe a "worrisome new wrinkle" in the financial system: "A huge share of the money through the U.S. financial markets is being invested by giant 'hedge funds' that aren't subject to much regulation. No one really knows what they own. And there's a chance that some of what they own is worthless."

Hall and Rankin recall the fears of Rep. Richard Baker (R-La.), who had earlier that year criticized the regulatory regime in place. In the event of a crisis, Baker said, "all you would be able to do is get the license-tag number of the truck that just ran over you."[40]

J. Bonasia reports in Investor's Business Daily on a series of studies of the effectiveness of Sarbanes-Oxley, five years after its passage. These studies find the law has helped to curb some fraud in corporate accounting. Bonasia writes: "In 2006, restatements by large public companies that have to comply with SarbOx fell by 14 percent over the prior year…last year was the first time such restatements by larger companies have declined, notes Mark Grothe, a research analyst with Glass Lewis. He says it shows that big companies are cleaning up their books." Industry continues to criticize the law for the cost and difficult of compliance.[41]

October 2008

In a major Washington Post story on the financial crisis, Anthony Faiola, Ellen Nakashima, and Jill Drew examine the regulatory failures that led to economic meltdown. The Post story cites a series of decisions in the late 1990s and early 2000s to place oversight of derivatives in the hands of industry as a major factor in the financial crisis. An SEC-sponsored voluntary program of risk analysis, implemented by the major investment banks in 2004, is also faulted. At the time, commissioner Harvey Goldschmid, who supported the voluntary program, said, "If anything goes wrong, it's going to be an awfully big mess," the Post notes. When the voluntary program is finally shuttered in September of 2008, it is written off as an utter failure. Wrote SEC Chairman Christopher Cox on the SEC website, "The last six months have made it abundantly clear that voluntary regulation does not work."

When a voluntary program of risk analysis is finally shuttered in September of 2008, it is written off as an utter failure. Wrote SEC Chairman Christopher Cox on the SEC website, "The last six months have made it abundantly clear that voluntary regulation does not work."

2009

Business Week reports that 1,471 hedge funds went out of business in 2008, almost twice the previous record for a year. A shortage in liquidity as well as losses on mortgage-backed securities are cited as prime causes of the weakness of the hedge fund sector; widespread redemptions by anxious or cash-hungry investors also endanger funds' stability.

In the wake of the global financial crisis, hedge funds continue to resist regulation. In particular, the industry takes issue with a plan to designate certain funds as "systemically significant." But Andrew W. Lo, a professor at the Massachusetts Institute of Technology, is quoted on Dealbook criticizing this opposition: "It's disingenuous for anyone to claim in this day and age that no hedge fund is systemically important...Frankly, I don't think any hedge fund manager in his right mind could argue that the industry needs no oversight."

July 2010

Congress passes the Dodd-Frank financial reform act. Chris Dodd (D-Conn.) says the act will safeguard the American economy and American investors: “Never again will we face the kind of bailout situation as we did in the fall of 2008 where a $700 billion check will have to be written.” The legislation is criticized for not providing sufficiently thoroughgoing structural reform.

Both during the consideration of Dodd-Frank and thereafter, the legislation is subject to withering criticism from the financial industry, featuring dire predictions of doom and gloom. Among other things that Dodd-Frank does — two years after the collapse of two of Bear Stearns’ funds and more than a decade after the bailout of Long Term Capital Management — is to give the SEC regulatory oversight over hedge funds.

The Madoff scandal: where was the SEC?

In December 2008, Bernie Madoff is arrested after investigators discover he has defrauded investors out of billions in the largest Ponzi scheme in Wall Street history. Thereafter, a paper trail of earlier complaints to the SEC about Madoff’s investment business come to light. The Associated Press describes, for example, one of a series of complaints from Harry Markopolos, an industry executive, who “contacted the agency’s Boston office in May 1999, telling SEC staff they should investigate Madoff because it was impossible for the kind of profit he was making to have been gained legally.” The AP also notes that the Boston office had previously “been accused...of brushing off a whistleblower’s legitimate complaints.” The SEC comes under increasing fire for its failure to act.

The Washington Post describes how, in the view of Chairman Cox, “the agency inappropriately discounted allegations that staff did not relay concerns to the agency’s leadership and that examiners relied on documents volunteered by Madoff rather than seeking subpoenas to obtain critical information.”

Rep. Paul Kanjorski (D-Pa.), chairman of the House subcommittee on capital markets, quoted in the Los Angeles Times, blasts the SEC at a panel in Washington: “We now know that our securities regulators have not only missed opportunities to protect investors against massive losses from the most complex financial instruments like derivatives, but they have also missed the chance to protect them against the simplest of schemes, the Ponzi scheme... Clearly, our regulatory system has failed miserably. And we must rebuild it now.”

January 2011

The Financial Crisis Inquiry Commission finds that federal regulators failed absolutely in their role overseeing the financial industry. The SEC comes under heavy criticism. Reporting in the Washington Post, Zachary Goldfarb and Brady Dennis quote the report, which says the agency "failed to restrict their [investment banks'] risky activities and did not require them to hold adequate capital and liquidity for their activities, contributing to the failure or need for government bailouts of all five of the supervised investment banks."

Sewell Chan, of the New York Times, sees the commission casting "a wide net of blame, faulting two administrations, the Federal Reserve and other regulators for permitting a calamitous concoction: shoddy mortgage lending, the excessive packing and sale of loans to investors and risk bets on securities backed by the loans."

> "Frankly, I don't think any hedge fund manager in his right mind could argue that the industry needs no oversight." — Andrew W. Lo, MIT professor, 2010

February 2011

Less than three years removed from the heart of the financial crisis, the Washington Post reports that budget freezes are threatening the SEC's attempts to carry out its regulatory responsibilities, notably those specified in Dodd-Frank. Dodd-Frank. The Post quotes Mary Schapiro, chairman of the SEC, who says "we need to ask ourselves if we want our market analysts to continue to use decades-old technology…to monitor trading that occurs at the speed of life…if we want our chief securities regulator…to pull the plug on data management systems and on a digital forensics lab." Shapiro also complains about inadequate staffing. In April, the agency receives a small increase in its budget, which remains more than $100 million below the amount originally requested by President Obama.

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