

## **Change – The Election’s Effect on Federal Securities Regulation**

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The SEC’s Chairman, Christopher Cox, typically describes the SEC as a “law enforcement agency.” The election of Barack Obama and a House and Senate dominated by the Democratic Party will likely change this job description.

Under the US Constitution, law enforcement is the duty of our executive branch of government. Chairman Cox’s statement shows that he thinks the SEC is part of the executive branch, a view shared by the Security Traders Association and many other industry participants. The SEC’s primary duty, under this theory, is to catch bad guys.

To give credit where it is due, under Chairman Cox’s leadership, the SEC has devoted considerable enforcement resources to rooting out fraudsters, particularly the low budget scammers. The SEC has been particularly effective in recent years dealing with micro-cap and small hedge fund frauds. I receive many fewer emails inviting me to buy some obscure stock because of great news about its issuer. My impression is that the racketeers who made a living selling worthless securities through market quotes on the Bulletin Board have pretty much been driven out of business. This is good work, and Chairman Cox deserves credit for chasing these people away from the nation’s securities markets.

Nonetheless, the SEC is not primarily a law enforcement agency. Instead, Congress organized the SEC as an independent agency, which means it is not part of the executive, legislative or judicial branches of the Federal Government. Independent agencies belong to all three branches. So, in addition to law enforcement powers, Congress endowed the SEC with rule-making authority. This means that it has the power to make laws. Congress also ordained that the SEC would have judicial power. It has the authority to interpret the rules it makes.

Constitutional literalists have always struggled with the idea of “independent agencies.” The Constitution says there shall be three branches of government. Independent agencies would appear to belong to a fourth branch. And placing executive, legislative and judicial powers inside one agency appears to violate the separation of powers doctrine, believed by the founders to be an important protection against tyranny.

Congress created several independent federal agencies as part of President Roosevelt's "New Deal." In some famous cases, the Supreme Court ruled in favor of their creation, provided that certain safeguards existed. So, for example, federal agencies cannot make rules without soliciting comments from the public and considering public views. Judicial hearings must allow defendants notice and an opportunity to be heard. This includes the right to representation by counsel.

In recent years, the SEC has been discouraged from making rules governing the issuers of securities, markets and market participants. In many cases, such as swaps, the SEC was forbidden by Congress from making rules governing their issuance. In addition, over the last few years, securities that were regulated have been permitted to escape the regulatory structure. So, for example, the rules governing Exchange Act registration now effectively require the registration of securities issued only by larger issuers. Registration of the securities of smaller public companies generally is voluntary. The securities of foreign issuers can trade in US markets without their issuers even providing notice to the SEC of their existence. No one reasonably expects the SEC to look for them.

There have been notable exceptions. In the public furor that accompanied the Enron and Worldcom scandals, Congress created Sarbanes-Oxley, which imposed expensive internal audit requirements on larger public companies. However, the SEC continues to suspend the application of this statute to smaller companies, and there has been considerable pressure on the SEC to reduce the compliance burdens of this statute on everyone else.

Those who believe that the SEC should limit its activities to law enforcement advocate "voluntary regulation." The theory is that, with the exception of real scam artists, the market will punish miscreant or foolish behavior. This market discipline would be less costly and more effective than any set of rules the SEC could design. The idea is that the government that governs least, governs best.

We can all agree that the SEC should be engaged in law enforcement activities. And, most people would agree that the SEC should make sure that market participants honor their contracts. For that reason, all but the most cranky support rules against "backing away" – the failure to honor market quotations. But, the recent financial crisis has demonstrated that, while law enforcement activities and upholding contractual obligations are necessary to the existence of healthy efficient markets, more in the way of regulation is needed to prevent economic collapse.

There are those who think that fraud is the basis of every market crisis. Chairman Cox has SEC enforcement officers pestering hedge funds and other market participants, convinced that fraud must be the culprit in the current collapse of the credit markets. The new short sale rules are intended to make it easier for the SEC

to discover manipulative activities and are therefore heavy with implication that someone must be manipulating markets to profit from the crisis.

There may be an example or two of fraudulent behavior out there. But, it is very doubtful that fraud had very much if anything to do with the current crisis. The players in the credit markets are highly sophisticated. It is very difficult to believe that they were not completely aware of the obligations they were creating. Nor is there any evidence to suggest that manipulators are getting rich.

The current crisis is attributable to market failure. The market participants who bought and sold CDOs, or issued and purchased credit default swaps, were just doing their job. They were engaged in the lawful pursuit of profits for their employers. The market rewarded their behavior handsomely. Naturally, this encouraged them to engage in more trading to make larger profits.

It is also not accurate to say that they failed to appreciate the risks inherent in their behavior. Traders in this market generally were quite careful to limit their positions to stay within existing risk compliance guidelines.

The credit crisis occurred because all of these traders doing their jobs collectively generated too much credit. Economists call this a third party effect. Each market participant acts rationally, but the collective actions of all of them result in disaster.

Third party effects cry out for regulation. It is really asking too much to expect any one firm to limit its credit expansion activities in favor of the greater good, unless everyone else must do the same.

I am loathe to predict how the coming regulatory scheme will be enacted. The SEC may not survive the reorganization of federal agencies in the next Congress. But, I am confident that the functions performed by the SEC will have to be performed by some federal agency. I am equally confident that, along with law enforcement, there will be more regulation of the nation's securities markets.

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