Commentary: What's the SEC Up To?

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As the Panic of 2008 has evolved into the Second Great Depression, it seems strange how little we have heard from the SEC.

Former Chairman Cox appears to have participated in the dismantling of Bear Stearns, and the SEC's staff wrote several letters in connection with that event. But, we heard even less from the SEC as Lehman and AIG collapsed. Worse, it appears that Treasury Secretary Paulson and Fed Chief Bernanke didn't even bother to check in with the Chairman when they encouraged Ken Lewis not to disclose to Bank of America's shareholders the woeful state of Merrill Lynch prior to their fateful merger.

Then there was the Madoff scandal. That miserable affair only reinforces the impression that the SEC is following, rather than leading the way, as the "investor's advocate."

On the rule-making side, there were a flurry of short-sale rules, which included a prohibition on short sales of the stock of financial institutions. This attempt to fix a problem in the credit markets by tampering with a well-functioning equity market managed to tank the market in convertible bonds, a debacle from which it has not yet recovered. Then, there are the proposed infamous short-sale uptick rules, which prove once again that when the issuer community speaks, the SEC listens.

Those of us who were wondering when the SEC was going to make its move finally got some signals from Chairman Mary L. Schapiro in her recent speech to the Society of American Business Editors and Writers in Denver, Colorado.

The speech made it clear that, first and foremost, Chairman Schapiro is focused on enforcement. A new Director of Enforcement with substantial experience as a federal prosecutor has been brought on board. Chairman Schapiro has streamlined the approval process for launching investigations and obtaining subpoenas. A consulting firm has been retained to improve the SEC's handling of the nearly 1 million complaints and tips the agency receives every year. She is looking at improving the SEC's training programs and hiring financial analysts and traders to explain what is going on with complex trading strategies, making it more likely the SEC will recognize a fraud when they see one.

On the rule-making side, Chairman Schapiro described a number of initiatives.

The SEC plans to enhance the rules governing the credit quality, maturity and liquidity provisions that apply to money market funds. The SEC is also thinking about requiring floating rate net asset values, which would end money market funds' resemblance to bank checking accounts.

In response to the Madoff and other Ponzi schemes, the SEC plans to upgrade the custody rules for registered investment advisers. This rule change will likely involve a resurrection of "surprise audits" that were eliminated when the custody rules were revised in less troubled times a few years ago. Chairman Schapiro also contemplates third party compliance audits.

The SEC plans to allow shareholders to nominate directors for public companies and eliminate broker votes where investors holding shares in street name fail to return a proxy. Brokers tend to vote in favor of current directors' recommendations, a practice condemned by institutional investors for many years. Ken Lewis would not have obtained sufficient votes to remain a director at Bank of America without broker votes.

Finally, Chairman Schapiro is hoping to expand the pay-to-play rules and institute regulation of hedge funds.

So, what is the likelihood that any of this will come to pass?

Chairman Schapiro will have her way with enforcement. Everywhere Mary has gone, enforcement has been ramped up. On her watch at NASD Regulation and then as head of FINRA, firm examinations were transformed from friendly interchanges into table-pounding prosecutions. The most rabid opponent of vigorous enforcement, Commissioner Atkins, left the SEC last year. The remaining Republican Commissioners are outvoted and, in any event, are unlikely to oppose enforcement initiatives in this environment, leaving Chairman Schapiro free to pursue a vigorous enforcement agenda.

The Investment Company Institute and Managed Funds Association will not welcome the return of surprise audits for investment advisers. But, in the wake of the Madoff scandal, it would be political suicide to oppose them. I think there is a 90% chance this will pass.

Third party compliance exams have only been imposed in connection with SEC consent decrees. They would increase investment adviser costs dramatically and provide the SEC with an in-house informant. I would expect opponents to use their political capital to mount a strenuous opposition. The industry is getting beaten up at the moment, but even so, I only give this one a 50-50 chance of being adopted.

The FDIC was forced into the business of insuring investments in Money Market funds the same week Lehman collapsed. This was a breach of the social contract. Money market funds paid higher rates of interest than could be obtained from FDIC insured bank savings accounts with the understanding that the FDIC would not have to support them. The demise of this understanding marks the beginning of the end for money market funds.

I read Chairman Schapiro's remarks as an indication that money market funds are going to be changed into ordinary mutual funds that invest in short-term instruments. With no more buck to break, money market funds, as we have known them, will go the way of the dinosaur. Investors will then move these funds back to bank savings accounts. I think this is very likely to occur, not least because the Fed will insist on it.

The issuer community has been in the trenches on changes to the proxy voting rules for years. Even now, drums are beating and war paint is being applied. Expect the Chamber of Commerce, American Bankers Association and armies of lawyers and lobbyists to apply every bit of force that can be mustered to resist any attempt that would allow shareholders to nominate directors. The SEC has not demonstrated a lot of mettle when it comes to standing up to issuers.

On the other side, institutional investors have lost every battle so far, but have launched more effective assaults each time. Their forces have strengthened with every contest. The current economic crisis has provided them with an edge. It will be close, but I expect institutional investors to win this one.

But, one battle does not win a war. I expect the issuer community to take the conflict to the courts and try to amend the SEC's proxy rules in the Congress and State legislatures. The final outcome won't be known for some years to come.

The SEC already forbids pay-to-play by investment banks and other broker-dealers. Now that we know investments advisers also play this game with State pension funds, the SEC can probably institute rules prohibiting the practice by registered investment advisers. But most investment advisers to hedge funds are not registered, which leaves the SEC only with general anti-fraud rules to use for enforcement in this area.

Which brings us to the regulation of hedge funds. Chairman Schapiro provides no details about how this might be accomplished. The SEC's last attempt to cause the registration of their investment advisers was dumped by the DC Circuit Court of Appeals. The SEC has no authority to directly regulate hedge funds themselves. In either case, Congress would have to change the law for the SEC to have any authority in this area. Significantly, the SEC does not appear to be taking the lead in proposing legislation that would give them this authority, notwithstanding the fact that this issue is being actively pursued by a number of Congressional Committees.

Indeed, Congress is working hard on legislation that purportedly will drastically change the way financial services are regulated. Chairman Schapiro and other SEC Commissioners have argued with force that the SEC has an essential role to play that cannot be replicated by any other agency. Nonetheless, there can be no assurance the SEC will survive to see the brave new world of financial services regulation. If it survives, the SEC's authority, if not its mission, can be expected to change substantially. It is not at all clear that the SEC will be the agency Congress appoints to carry out much of Chairman Schapiro's regulatory agenda.

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