You Can't Control Animal Spirits

By Arthur Levitt

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Financial regulators are in the unenviable position of being constantly second-guessed.

In good times, when markets are on a roll and the economy is booming, the people that they regulate complain loudly that regulators are heavy-handed, over-regulatory, anti-business and get in the way unnecessarily.

In bad times, times of crisis and economic turmoil, regulators are criticized for not paying enough attention, dropping the ball, letting excesses develop, and not controlling the people, markets and institutions for which they are responsible.

Most recently, the regulatory oversight of investment banks by the Securities and Exchange Commission has come under question. Why didn't the SEC prevent the events leading up to the collapse of Bear Stearns? Is SEC oversight less rigorous than oversight by the Federal Reserve? New York Federal Reserve Bank President Timothy Geithner has gone as far as suggesting in recent testimony that oversight of investment banks be transferred to the Fed, and a new agency be created responsible for sales practices.

There is no doubt that we are in the midst of a severe crisis. For more than a year, we have been inundated with media coverage of turbulent markets, profiteering, fraud, collapse and ruin. Adding to the maelstrom of actual events has been the usual finger-pointing, blame-laying and Monday-morning quarterbacking. There have been increasingly loud calls for action -- for someone to fix everything that has gone wrong. Quick fixes and knee-jerk responses generally do more harm than good, by creating new problems with every attempted "solution."

When the Treasury and the Fed ensured that Bear Stearns shareholders would not benefit (and would, in fact, be punished) by the sale to J.P. Morgan Chase and the associated government credit support, they were attempting to prevent Bear's shareholders from being rewarded for excessive risk taking -- something academics and regulators call "moral hazard." Unfortunately, this unprecedented government action, aimed at preventing moral hazard, encouraged short selling in other financial institutions such as Lehman Brothers, Fannie Mae and Freddie Mac, because both the short sellers in the market and any potential long-term buyers knew that shareholders wouldn't be protected. This caused even more disruption.

The quick fix for this problem, again completely unprecedented, was the SEC restricting short selling the shares of 17 commercial and investment banks, and Fannie Mae and Freddie Mac. Without going into the details of how the stock-loan market works, let me assure you that this SEC action had absolutely no effect on anyone's ability to short any of these 19 institutions. Instead, it has created hidden problems in the back offices of investment and commercial banks across the Street that are likely to manifest themselves in coming months.

Financial markets are not the place to practice field surgery and experimental medicine, because they are too important to the vitality of the world economy. Rather, regulators should stick to the basics -- those things that are at the core of what has made U.S. financial markets strong: disclosure, transparency, fairness and accountability.

A regulator can never, and should never attempt to, control the animal spirits of the market. When markets are going up should a regulator stop them? How can a regulator "decide" that the market is too high? That it is just a bubble? They can't -- no one can.

Similarly, a regulator cannot predict a crisis. Instead, a regulator can and should make sure that investors, the public, the press and government have clear, comprehensive and timely disclosure to allow markets to better correct or respond through investor action.

For example, to control potential abuses in short selling, inject sunlight into the process. Require the reporting of large short positions in the same way that we require the reporting of large ownership positions. Require timely publication of the cost to borrow stock and stock-lending transaction volume. Require disclosure -- don't bias the market by imposing artificial constraints.

On a broader basis, it is clear that we need more transparency -- about the risks firms take on (particularly with new or rapidly growing products), valuation methodologies, potential conflicts of interest, revenue and profit sources, director involvement, actions, and oversight and leverage by business product (such as credit default swaps, collateralized mortgage obligations), instead of a composite leverage ratio which is practically devoid of content. Disclosure, combined with the scrutiny of the press and the investing public is the only way to control excess.

I find the questions about whether or not SEC oversight or Fed oversight is more rigorous to be completely naïve. The SEC's consolidated entity supervision, which applies to the four major investment banks, was developed with the Federal Reserve Board and other banking regulators and mirrors commercial banking regulation. Even a cursory examination of the write-downs associated with subprime mortgages and mortgage-backed securities clearly demonstrates that commercial banks were no more controlled than investment banks.

In fact, one important step regulators could take is to require commercial banks and investment banks to mark-to-market both their securities positions and their loan commitments. But setting aside the straw man of who is the tougher regulator, it is critical to recognize that there is a significant difference in mission between the Fed and the SEC.

I am going to put it simply -- the Fed's duty is to prevent bank failures and bank runs, to protect the banks. The SEC's duty is to investors, protecting investor's cash and securities, and working to prevent securities fraud. Banking regulators give investor protection lip service -- the Fed protects investors only if it coincides with their primary interest of protecting the bank. Under the federal securities laws, investment banks are allowed to fail -- it is the ultimate market discipline -- but investors' assets are protected.

Finally, the idea that the SEC could be replaced with a sales-practice regulator strikes me as a gross misinterpretation of the role and the purpose of the SEC. In addition to being responsible for the efficiency of the capital markets, the commission stands as the sole voice for the investing public, giving a diffuse population that has little or no power as individuals the ability to protect their rights against multibillion-dollar, multinational institutions. Without that voice, the investing public ceases to be important and merely become sheep for the wolves to feed upon.

Market integrity is inextricably linked with investor confidence. As a result, the SEC is the guardian of America's capital markets. Congress should reinforce the SEC's authority to provide global, consolidated supervision, to set liquidity and capital requirements, and to require greater transparency of risks and risk management. Now is the time to strengthen our markets and institutions for the coming decades, not to undermine our financial system by imposing a new, unproven approach to regulation.

Mr. Levitt was chairman of the SEC from 1993 to 2001.