SEC role is scrutinized in light of Bear woes

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On March 11, amid rumors that Bear Stearns Cos. was in trouble, Securities and Exchange Commission Chairman Christopher Cox said he had "comfort" with the amount of capital held by five of the largest investment banks, including Bear Stearns. Two days later, Bear sought emergency funding from the Federal Reserve. By March 16, the following Sunday, the brokerage firm had been sold to J.P. Morgan Chase & Co. in a government-backed fire sale.

As a result, the SEC has come under increasing criticism. Some say the agency didn't move quickly enough to spot risks in the market or at the companies it directly reviews. Treasury Secretary Henry Paulson, with the support of key Democrats, on Wednesday backed the idea of temporarily allowing the Federal Reserve to have an expanded role overseeing investment banks -- the SEC's traditional bailiwick. (Please see related commentary in Breakingviews.) The Senate Banking Committee has scheduled for next week a hearing about the collapse of Bear, and likely will grill the agency.

In assuring investors that Bear Stearns was stable, "the commission appears to have been caught badly off-guard by the seriousness of the situation," said Sen. Jack Reed (D., R.I.), a member of the Senate Banking Committee.

In an interview, Mr. Cox defended his agency by saying Bear's problems stemmed not from its capital structure but from the unwillingness of other financial institutions to lend to the company. "This was not a lack of capital. It was a lack of confidence," he said. He acknowledged that the traditional ways of measuring liquidity -- having enough money on hand to handle transactions -- need updating. "These are unique problems that challenged the bank supervisory model that has relied on capital and liquidity standards," he said. "It is unprecedented, but it is not to say it could not happen again unless regulation is adjusted."

The SEC has limited power in financial crises. Its mission is to maintain orderly markets and protect investors and customer accounts at brokerage firms. The Fed, for its part, is focused on maintaining the soundness of the financial system. Unlike the Fed, the SEC has no funding powers. During the Bear meltdown, the SEC's staff was on site, reviewing the firm's funding levels. It granted technical exceptions to rules to remove potential blocks to the deal with J.P. Morgan. And Mr. Cox said customer accounts at Bear were protected.

According to data released by the SEC last week, Bear had cash and cash equivalents of $18.1 billion on March 10, which fell to $11.5 billion on March 11 -- the day of Mr. Cox's statement. The figure rose to $12.4 billion on March 12 before falling to $2 billion on March 13, the day the Fed provided emergency funding. The SEC estimates that Bear's net capital remained well in excess of federal supervisory requirements, including on March 16, when it agreed to be taken over by J.P. Morgan.

That isn't likely to placate critics who charge that the SEC and other regulators didn't do enough leading up to the credit crunch.

"It does not appear the risk management was adequate, so why wasn't the SEC intervening?" asked Barbara Roper, director of investor protection at the Consumer Federation of America, a consumer-advocacy group. She doesn't think the SEC holds the largest responsibility among financial regulators, she said, but "If the SEC had been sending strong messages that [investment banks] needed to clean up their act, it would have been hard for the big investment banks to ignore them."

The SEC says it encouraged firms to increase their liquidity, which they did. The agency also says all financial firms' risk-management systems assume that they can get secured funding, or lines of credit backed by assets. In the case of Bear Stearns, the SEC said, other firms' refusal to provide secured funding "placed enormous stress on the liquidity of the firm."

Lawmakers have begun discussing how to revamp financial-market oversight, and some of the ideas could weaken the SEC's role. Harvard Law School Professor Hal Scott, who heads a nongovernmental bipartisan committee on capital-market regulation, says one solution might be to fold the SEC into a broader agency that has responsibility for the overall stability of the financial system. That is the model followed by the United Kingdom's Financial Services Authority.

Mr. Paulson on Wednesday backed the notion of giving the Fed temporary scrutiny of investment banks to which it lends money, which could diminish that role at the SEC.

"Anytime that you give another agency jurisdiction over your constituents in any way you are weakened," said Peter Wallison, a senior fellow at the American Enterprise Institute, a conservative think tank. "That's where the securities industry will focus their attention because that's where their business will be affected."

Mr. Cox identified banks' movement of risk to off-balance-sheet entities as a key problem and said the Financial Accounting Standards Board, which sets U.S. accounting rules, will revisit the accounting for off-balance-sheet entities by the end of the year. He declined to comment specifically on changes.

As the SEC is addressing whether there were gaps in its information, it is debating whether it would have been useful to have data about short-term, or "repo," financing from the banks that clear trades and hold collateral for the securities firms under the agency's review, a spokesman said. It is possible that could have been useful in identifying the problems at Bear. Currently, the Fed has access to the information, but the SEC doesn't.