“What should be the Regulatory Boundary between the SEC and the Federal Reserve?”

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The tenth anniversary of the financial crisis is an especially fitting time to consider the lessons learned about the performance of financial regulation during the financial crisis and to reflect on the underpinnings of our regulatory system. The financial crisis highlighted the different roles and philosophies of banking and capital markets regulators, such as the Federal Reserve System and Securities and Exchange Commission (SEC), as well as the boundary and overlap between them and the ambiguity about such boundaries. More fundamentally, it is an opportunity to reflect on the workings of our financial system and the underlying objectives of financial regulation. Regulation is a response to potential market failure and consequently, diverse sources of market failure point to the need for differing types of regulation, depending upon the underlying circumstances. As there are a range of different types of regulation that may be needed, those actions can be operationalized potentially through distinct regulators or a single regulator. Indeed, the nature of our system of financial intermediation reflects both banking intermediation and market intermediation; the boundaries between these can lead to awkwardness in our intermediation system and the need to manage from a regulatory perspective issues that span these boundaries.
Fundamental to the effective operation of an economy is a well-functioning payments system in which significant counter-party risk does not undercut the viability of economic transactions. Many of the core manifestations of the financial crisis did reflect significant counter-party risk and the possibility of runs undercutting the viability of significant markets. These were central issues in the actual or potential collapse of Bear Stearns, Lehman Brothers, Reserve Fund, AIG, Citigroup and Bank of America, for example. The institutions involved included not only banks, but also, securities firms, a money market mutual fund and a major insurer. These situations typically involved potential solvency challenges during the financial crisis. Given the short-term (sometimes overnight) nature of much of the financing in key situations, the vulnerability to a run was considerable and the potential for rolling over financing over a short horizon was important. Many instruments that have not been heavily regulated span across these boundaries, including money-market funds, private equity and exchange traded-funds (ETFs). Of course, as is well recognized, guaranteeing the counterparty risk (such as by guaranteeing specific instruments) would avoid the possibility of a freeze in the financial system—but at the cost of encouraging risk-taking on an ex ante basis and thereby creating considerable moral hazard. Given the nature of the resources required to execute a guarantee, such an action could only be provided by an entity with access to a “significant” checkbook (funding), such as the U.S. Treasury or the Federal Reserve System, but not by a capital markets regulator such as the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC).

The examples above point to an interesting jurisdictional issue – the potential for systemic risk is not confined to banks, but includes organizations that would be regulated traditionally by non-
bank regulators. Some of the post-crisis regulatory reforms try to address this, but also leave open many issues. Dodd-Frank attempted to provide the Federal Reserve some degree of authority with respect to systemically important non-bank institutions, but the designation process has been strongly and successfully challenged. At the same time, the Federal Reserve’s expertise over firms in the securities, money market mutual funds and insurance spaces is limited and may be part of the root of objections by some firms to be designated as systemically important. In principle, one could imagine some degree of ambivalence by firms as to whether they should be designated in this manner (the tradeoff from the firm’s perspective between more oversight of the firm vs. the possible benefit to guarantees (at least for the debt holders)).

Dodd-Frank also has set the stage for an important new aspect of systemic risk by requiring that standardized derivatives contracts be centrally cleared; in effect, the clearinghouse becomes counterparty to such contracts—to the extent that there are inadequacies in the margin and collateral formulae the concentration of risk in the clearinghouse and the potential concentration of particular types of exposures from other systemic players make it an important source of vulnerability. While Dodd-Frank recognizes the potential systemic importance of clearinghouses, this again points to a key (and perhaps needless) challenge in regulatory coordination. Clearinghouses are otherwise regulated by a capital markets regulator (who would be viewed as the primary regulator), but who would not be positioned to backstop the clearinghouse, due to resource limits. One caveat to backstopping the clearinghouse being necessarily desirable would be concerns about risk-taking by the clearinghouse and incentives to have inadequate risk models; still, it is important that capital markets inherently internalize that

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1 Add reference to court decision.
2 There have been several clearinghouse failures in the past (see Spatt (2017a)).
derivatives contracts will be honored, highlighting the importance of tight supervision of the clearinghouse. This seems like a context in which oversight by the Federal Reserve rather than either a capital market regulator or joint regulation could be especially important.

These situations point to the essence of the boundary problem between regulators. Different regulators may have different tools and also possess different expertise so that the arsenal of a particular regulator may be insufficient, highlighting why a regulated firm would potentially face not only multiple types of regulation (after all different potential types of market failures necessitate multiple regulatory requirements), but because of specialized expertise and tools, it may be advantageous to have an entity regulated by multiple regulators—despite that being potentially awkward and complicated. For example, it provides for more scope for regulatory conflict and turf battles and subjects business organizations to oversight by multiple regulators. At the same time, the problem of conflicting regulators may not be simply resolved just by assigning all of the relevant regulatory powers to a single entity (that may not solve the problem of the relevant regulator otherwise not possessing all the tools, but it is not clear that would work—after all, how could the checkbook of the Federal Reserve be outsourced to the SEC or CFTC?). Furthermore, simply assigning the relevant powers to a single regulator would not necessarily resolve the expertise issue. Historically, the central tools of the Federal Reserve (besides monetary policy) have included its bank supervision role and its ability to provide liquidity with secured collateral as a “lender of last resort.”
When we look at the evolution of the financial system, we see that the activities and the roles of various parties have evolved over time. This is illustrated by the increased importance of both derivatives trading and central clearing, the reduction in boundaries and overlap in function among banks and securities firms, and the importance of money market funds. Banking and capital market activities have morphed into competitors with similar roles, but traditionally have been regulated very differently. One move towards greater harmonization is the designation of the parent companies of Goldman Sachs and Morgan Stanley as bank holding companies under the supervision of the Federal Reserve System. These designations both provided more oversight of these firms and signaled to the marketplace that these firms were under the regulatory (and protective) umbrella of the Federal Reserve at the holding company level. Of course, in the last crisis this was not part of the ex ante design (so not reflected in ex ante risk-taking decisions), but was an ex post effort to try to stabilize the system.

This discussion points to a fundamental question—should we have distinct regulators for banking and capital market activities? What do we view as the relevant boundaries between these functions or activities? To the extent that different regulatory tools are needed to address different activities (functions) and problems, do we want these housed in a single entity or different entities with distinct objectives and expertise? What are the underlying tensions and trade-offs? These are issues that have received relatively limited scrutiny historically. Indeed, these issues have become much more impactful as the activities have morphed together. The orientation of regulators, especially during the Financial Crisis and during the Dodd-Frank debate, but continuing to the present, has been a focus upon preserving their respective missions and legacies. A simple example that illustrates this is the absence of serious discussion during
the Dodd-Frank debate about the potential merger of the SEC and the CFTC, despite the

closeness in their orientation and missions. Most observers would attribute this to the

importance and value to the members of the distinct Congressional oversight committees, e.g., it

has been suggested that the members of the respective Agriculture Committees would have

blocked a merger of the two agencies because of the potential loss of jurisdiction over the CFTC

and the potential implications for fundraising by the members of Congress.

Our financial regulators have fundamentally different missions; as the crisis illustrated, in

addition to its monetary policy role, a central role of the Federal Reserve System (and to a degree

other banking regulators) is a focus upon the safety and soundness of banks, the prudential

supervision of banks and the promotion of financial stability of the economy. In contrast, the

mission of the SEC focuses upon protecting investors, maintaining fair and orderly markets, and

encouraging capital formation. In effect, the Federal Reserve focuses upon prudential oversight

and system stability, while the SEC emphasizes market integrity and the fairness of markets and

in the language of financial economics--the efficiency of markets and the quality of price

discovery. Furthermore, the distinct tools of the regulators reflect their distinct purposes.

The financial crisis and its aftermath point to the contrasting emphases and roles of these

regulators for those issues which are at the interface of the domain of these regulators, such as

encouraging sufficient liquidity provision. Of course, the collapse and restoration of liquidity

played an important role in the Financial Crisis and various narratives about it.
In understanding the distinctive roles of the Federal Reserve and SEC, it is helpful to consider a range of examples during the Financial Crisis and its immediate aftermath as well as the subsequent policy reforms. These have addressed only in a limited fashion the boundary in oversight responsibilities between capital markets and banking regulators. These issues have been largely skirted by the Dodd-Frank reforms, but remain as important issues.

At a fundamental level, financial stability regulators, such as the Federal Reserve, are heavily invested in the outcome—a crucial part of their mission is to protect the financial system and limit systemic risk—through supervision of individual institutions and the ways in which they influence the regulatory design. The Federal Reserve’s tools include a very powerful one for this purpose—a “checkbook” and some authority to use it. The philosophy of central banking (e.g., Bagehot) has highlighted the importance of central banks’ lending against good collateral.

In contrast, market integrity regulators focus upon the efficiency and fairness of the markets, thereby ensuring the attractiveness of the markets for private investment. Many instruments that have not been heavily regulated span across these boundaries, including money-market funds, private equity and exchange traded-funds (ETFs). At the core of issues of market integrity is the importance of disclosure, which is central to the quality of price discovery that would emerge. Indeed, at the heart of the SEC’s approach is disclosure regulation and enhancing disclosure on a variety of fronts. In contrast, disclosure is often anathema to central banks. This contrast in regulatory tools highlights an essential difference between regulation by the SEC and regulation by the Federal Reserve.
A central aspect of the toolkit of the SEC is a wealth of required disclosures on regulatory filings, prospectuses and forms. These include disclosures of holdings by investors (including asset managers, mutual funds and activists), prospectus disclosures (e.g., mutual funds and offerings), insider trades, option grants and exercises by insiders and registrant disclosure (both periodic and special disclosures as well as restrictions on registrants requiring Fair Disclosure (Regulation FD). Required disclosure is so important because of its central role in influencing the price discovery process. Indeed, many important SEC rules in the trading arena are designed to further enhance the quality of price discovery. Price discovery is so important because the competitive market process disciplines the valuation of financial claims; competitive forces aggregate the diverse information of different investors.

While disclosure and strengthening price discovery is a central tool employed by the SEC, disclosure and price discovery have a less central role in banking regulation. Indeed, banking regulators often will minimize disclosure because of concerns that the marketplace would interfere with the applications of the banking supervisor’s toolkit. Disclosures are limited or non-existent in a range of contexts such as bank supervisory reports, aspects of the stress tests and during the heart of the financial crisis limiting disclosure regarding many merger and acquisition transactions. The Treasury and to a degree the Federal Reserve were the primary advocates of restriction on short sales during the financial crisis, despite the resulting interference with the price discovery process. Many of these examples are relatively fundamental to the contrast in tools and techniques of the Federal Reserve and SEC, so we will discuss these situations, among others, later. It is worth emphasizing that disclosure and price discovery can lead to considerable market discipline and potentially mitigate the need for
prudential actions by banking regulators. Some of the market impact of disclosure would be to head off prudential risks in some situations by conveying greater information to the market at earlier stages. In my judgment central bankers have often viewed disclosure and price discovery as interfering with their efforts at prudential supervision, but I feel that this is a short-sighted perspective.

As we try to understand more clearly the potential differences in philosophy and tools of the regulators, it is helpful to keep in mind the types of situations that could give rise to systemic risk. During the financial crisis (2007-2009) excess risk-taking played a huge role—both leverage by financial institutions and mortgage borrowers. Indeed, while bank capital requirements have risen both domestically and internationally, there are continuing concerns about insufficient capital by financial institutions (e.g., Admati and Hellwig (2014)) as well as concerns that though consistent with Dodd-Frank, mortgage borrowers are still allowed to obtain loans with tiny down payments. Events in Europe as well as the explosion of U.S. government debt (especially in light of the ongoing normalization of interest rates in the United States and recent additions to U.S. fiscal stimulus and the potential for political gridlock) highlight the possibility of a sovereign crisis (e.g., would investors require much higher interest rates to purchase sovereign debt?). A somewhat related concern in the United States is the potential social security crisis and the inability of the political process to engage on it.3 Furthermore, while many observers gave regulators good grades for managing through the financial crisis, an important potential source of systemic risk (risk to the financial system) is a combination of the

3 A variant of this is the state and local government pension crisis; however, it seems less clear that this would lead to systemic risk unless the problem were to be unexpectedly federalized (it also is much smaller than the magnitude of the social security shortfall).
decision-making by regulators at the system level and the adequacy of the tools that they possess (e.g., Spatt, 2015). Dodd-Frank enhanced some, but restricted other, aspects of their power.

An interesting example that illustrates the potential conflict between the approaches of different regulators is the Bank of America acquisition of Merrill Lynch at the peak of the financial crisis (when Lehman Brothers collapsed). This acquisition occurred with the encouragement of the Federal Reserve, but led to subsequent conflicts about the adequacy of disclosure (which manifested itself in a variety of ways, even spilling over to both an important Congressional hearing about the Federal Reserve and the overturning of the original Bank of America disclosure settlement with the SEC by a prominent federal district judge). Delay in disclosure of the extent of trading losses in Merrill Lynch in December 2008, for example, may have influenced the Bank of America shareholder approval of the acquisition (as well as the secondary market valuation of the shares). Later in December, as Bank of America contemplated invoking the Material Adverse Changes (MAC) provision to exit from the transaction prior to its closing, the Federal Reserve made clear that such a course would lead to the removal of the CEO and board if Bank of America needed further relief (see youtube link to Congressional testimony in June 2009 by Federal Reserve Chairman Ben Bernanke). The Federal Reserve’s position was that the Bank of America shareholders would themselves be worse off if the deal collapsed with the resulting spillover to the financial system (and that from a legal perspective that Bank of America would not be able to invoke the MAC, which is a difficult issue for an outsider to judge).

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4 http://www.youtube.com/watch?v=Exm6pROz6kk
The transaction was important for financial stability, but the handling points to the tensions between different regulatory objectives. One can interpret Bank of America’s handling of the disclosure as transferring financial stability costs from the Federal Reserve to its shareholders, by interfering with an informed choice on the merger. As the link at http://www.youtube.com/watch?v=Exm6pROz6kk highlights that the Federal Reserve felt that the merger was not primarily an SEC issue and that it was not responsible for keeping the SEC in the loop, despite Bank of America’s ongoing disclosure obligation. Indeed, the legal responsibility for disclosure is the firm’s, not its prudential supervisor. Still, the appreciation of the benefits of disclosure would be dramatically different by the SEC and the Federal Reserve. Interestingly, the Securities and Exchange Commission later brought an enforcement action against Bank of America for its failure to disclose the extent of bonuses. Rather than fighting the SEC, Bank of America initially settled for $ 33 million for failure to disclose. However, federal district judge Jed Rakoff (Southern District of New York) rejected this settlement as inadequate (including the limited underlying disclosure), though later did approve a $150 million settlement for failure to disclose the extent of both bonuses and underlying losses. This example illustrates the tension associated with whether the regulator is invested in the outcome or simply trying to protect investors. If one doesn’t have a fairness regulator and government is viewed as manipulating the outcome due to its size and role, this affects the willingness to participate in the markets—especially in crisis times, which is actually quite problematic.

Another important example from both the financial crisis and the post-crisis era is the case of money market fund regulation, which at its core is related to liquidity in the financial system. A crucial mechanism is the extent to which artificial (non-market value) pricing ($1 NAV) can lead
to “runs” and the collapse of liquidity (while the context is somewhat different, the “runs” of short-term “deposits” in Diamond and Dybvig (1983) also leads to the collapse of bank liquidity). This has certainly been one of the most contentious issues among regulators (the Fed and SEC have very different perspectives about liquidity regulation), leading to a relatively strong jurisdictional conflict between the Financial Stability Oversight Council (FSOC) and the SEC. The explicit tensions in this context help highlight crucial challenges in the design of the regulatory system. Some of the roots of the tension on money market regulation go back to the collapse of the Reserve Fund and failures in the SEC’s pre-crisis regulatory regime (some would even point to the earlier form of Regulation Q, which indirectly encouraged the development of money market funds). Money market funds also have special significance because these instruments, though securities, have check-writing and money-like features (amplifying some of the tensions between banking and securities regulators), and support important portions of short-term liquidity in the economy, such as the commercial paper market.

An interesting twist on the money market fund example is the recent increase in borrowing from the home loan bank system to circumvent the liquidity coverage ratio (see Anadu and Baklanova (2017)) and to accommodate the greater funding now available in government money market funds as a byproduct of the SEC’s implementation of money market fund reforms. In some respects this is reminiscent of earlier borrowings from the home loan bank system (as a “hidden discount window” that undercut the discount window and the claims available to protect the FDIC). This type of situation involves scope for regulatory consideration by both the Federal Reserve and SEC. Though not as central in the past, the focus on closing prices for mutual fund valuation more generally, also can lead to an illusion of liquidity (see Spatt (2014)) and the
potential for runs when the economy faces liquidity challenges (see Zeng (2017)). The awkwardness associated with money market reforms is illustrated by the regulatory changes adopted by the SEC in 2014 that became effective in 2016. These changes essentially led to the elimination of “prime” (non-governmental) money market funds for retail investors with stable value ($1) pricing. Most of the accounts disappeared as investors were perceived as not being interested in floating NAV money market accounts and so the industry didn’t promote such accounts. Instead, most of these retail funds relatively quickly shifted to governmental money market funds of the stable value ($1) pricing variety.

Indeed, the relationship of the FSOC, which is chaired by the Secretary of the Treasury, to other regulators is one of the underlying challenges associated with Dodd-Frank implementation. Perhaps most fundamentally it relates to the nature of the goals of the FSOC as a coordinating mechanism. Indeed, press accounts have suggested considerable tension between the Office of Financial Research (which provides support to the FSOC) and the Treasury, which houses it. The FSOC does not supervise the other agencies, but the nature of the model can lead to considerable awkwardness in the coordination.

Recently, there has been new attention to both the corporate bond and Treasury markets, particularly with the renewed focus and special attention to the Volcker Rule and the impact of reduced market-making upon liquidity provision. Again, this is a domain in which many regulators are involved and the division of responsibilities can undercut the effectiveness of the markets—at the same time it is important to consider the diverse perspectives and skills of the various regulators, while ensuring that an effective overall picture arises.
A particularly important example from the post-crisis era in which the different regulatory lenses point to different treatments is the regulation of clearinghouses, which involve the SEC, CFTC and the Federal Reserve. Governance, risk management and resolution are all very important issues given the possibility of the collapse of a clearinghouse. Indeed, the resolution regime for clearinghouses is still largely unsettled. Given the importance of the viability of the clearinghouse and the potential importance of the resources of the Federal Reserve, it may even make sense for the oversight to be more concentrated inside the Federal Reserve. Clearinghouses are under joint supervision of the SEC/CFTC and the Fed—basic supervision and too big to fail guarantees (and resolution, etc.). We saw in the last crisis that institutions are much more responsive to those regulators who have the resources to provide emergency funding (such as the Federal Reserve).

Short-sale regulation is yet another important feature in which the perspectives of financial stability regulators and those focused upon market integrity diverge. Financial stability regulators (the Federal Reserve and Treasury) pushed the SEC to ban short-selling of 900 financial stocks during the debate on the Troubled Asset Recovery Program in 2008. This led to various problems—it created less predictable regulation in the long-run (and especially by the SEC), it signaled to investors that perhaps the market situation was more problematic than anticipated in 2008, and it forced the SEC to exempt options market makers (and giving them monopoly power on the short side) to prevent the temporary closing of the options markets. Short selling protects long investors against buying overpriced stocks.
This example highlights the importance of expertise in dividing regulatory responsibilities. Indeed, when SEC Chairman Cox was asked by the Washington Post in his “exit” interview at the end of 2008 as to the worst mistake that the SEC had made during the financial crisis, he said that it was listening to his colleagues on the Presidents Working Group and agreeing to ban short selling on 900 financial stocks at the peak of the financial crisis, as the TARP legislation was being debated. The push by the Treasury and Federal Reserve to ban short sales during the difficult times in 2008 illustrated the lack of appreciation by these entities of the importance and centrality of the quality of the price discovery mechanism. While concern had been expressed by the leadership of several major financial institutions that their prices were driven down by short sellers, prices declines are not driven by short selling but because buyers are no longer willing to pay what they previously would to purchase a company’s shares. In the case of the major financial services firms these were several reasons that occurred, including declining assessment of both the quality of leadership at these firms and the economic value of the assets owned by these highly leveraged firms.

As one addresses the connection between regulatory approaches one should assess former Governor Tarullo’s call for prudential oversight of market institutions. What are the limitations of such a perspective? These have addressed only in a limited fashion the boundary in oversight responsibilities between capital markets and banking regulators. These issues have largely been skirted by the Dodd-Frank reforms, but remain important. Indeed, the reverse—market oversight of prudential arrangements—greater transparency of balance sheets, supervisory outcomes and the C-CAR also are important and reflect the boundary between the various types of regulators. An important aspect of prudential supervision that a lack of market orientation does not capture
is the notion that identical regulatory models (such as under Basel) push everyone towards the same treatment and enhanced systemic risk. Of course financial stability and prudential supervisors are not all knowing. Indeed, in earlier work (Spatt, 2015) I’ve highlighted the importance of government and regulatory policy as a source of risk to the financial system (systemic risk).

This suggests that the framework and the underlying examples described and analysis for examining the boundaries between the key regulators should address the meaning of financial stability and prudential supervision. Theoretical principles, such as the importance of moral hazard and time consistency, also can help provide additional insight with respect to the boundaries and overlap between regulators. As we put together a framework to help assess the boundaries between regulators and the opportunities for greater co-operation between them, it is important to understand the different lenses that these regulators bring to put these together and help assess the balancing on particular issues. There are more opportunities for co-operation among regulators given their statutory mandates, especially if one takes an elastic view of the regulatory goals. However, at the same time, it is important to respect the missions of the various regulators and to acknowledge the potential subtle benefits of commitment, as boundaries are important for accountability.
References


