Slate

The Pushover

Obama's choice to lead the SEC, Mary Schapiro, has some explaining to do.

By Eliot Spitzer
Posted Wednesday, March 31, 2010, at 6:03 PM ET

This past year has not been a good one for the Securities and Exchange Commission and its chairman, Mary Schapiro. Ignore the predictable rhetoric of a year ago about how a newly focused and vigorous SEC would identify structural problems on Wall Street and bring about systemic reform. Two years after the largest financial meltdown in history, the SEC has still not brought any cases that challenge the structural flaws of the financial industry.

Consider: In September 2009, its settlement with Bank of America over executive bonuses was rejected by U.S. District Court Judge Jed Rakoff. (Rakoff approved a larger settlement in February.) Even more amazingly, in a case filed one month earlier, the SEC took the side of the investment banks in their effort to undo the consumer and investor protections built into one of the most important settlements of the past decade. Thankfully, once again, a federal judge rejected the SEC's efforts, calling it "contrary to the public interest." Only if one understands the history of this settlement and Mary Schapiro's involvement does any of this begin to make sense.

In 2002, when I was New York's attorney general, the state sued the major investment banks alleging—and proving with explicit e-mails—that the investment banks were rendering knowingly flawed stock advice to their customers. The reason was the conflict of interest built into the structure of investment banks: They both underwrote new stock issues and made buy/sell recommendations to retail customers. Yet over the years, the banks learned not just to tolerate but to embrace this double standard. As Jack Grubman, a former analyst for Salomon Smith Barney, observed in 2000: "What used to be a conflict of interest has now become a synergy."

Indeed, the analysts who made the buy/sell recommendations at the heart of the cases had pay structures that motivated them to give bad advice. The core of the settlement was to create barriers between these two sides of the investment banks. Last summer, the investment banks went to court, with the support of the SEC, to deconstruct these critical protections. In March, their request was denied. "The parties' proposed modification would deconstruct the firewall between research analysts and investment bankers erected by the parties when they settled these actions," wrote U.S. District Court Judge William Pauley.

When the State of New York initiated these actions, the SEC, then headed by Harvey Pitt, was dismissive. (Just after he was confirmed, Pitt had lamented that the SEC had not always been a "kinder and gentler" partner for the financial industry.) Finally forced to join the suit, he was one of the parties at the table negotiating what became known as the "global settlement" with all the relevant regulators and major investment banks. Unsurprisingly, Pitt was not as aggressive as he could have been in pushing for remedies.

Also at the table was Mary Schapiro, who was then a senior executive at the NASD, the industry's supposed watchdog of market integrity. Previously, she had served as an SEC commissioner, appointed by Ronald Reagan and reappointed by George H.W. Bush and Bill Clinton. Her oft-stated perspective was that the securities industry needed "a more flexible regulatory paradigm" and that consolidated supervision of securities firms was not "necessary or appropriate."

Schapiro did get active, however, during the discussion of one point critical to restoring integrity to the markets. "Spinning" was the term used to refer to the way investment banks allocated shares of a "hot" initial public offering to executives of other clients of the bank. Because IPO shares were almost always underpriced, recipients of these shares were sure to reap a huge profit when the hot stock jumped.

Our view, backed by the courts, was that this issuance of stock was a benefit to CEOs that should have gone, if to anybody, to the shareholders of company making the IPO. It was called "spinning" on Wall Street, but in more common parlance, it is known as a bribe: Money paid to a CEO as an inducement to continue to do business with the investment bank. We therefore argued for a ban on this practice.

Schapiro took the other side, arguing that CEOs should continue to receive these benefits. Our argument prevailed, and over her objections, the final settlement banned spinning. My office later recovered significant sums from chief executives whom courts determined to have received "spinning" allocations. We claimed, successfully, that these allocations were a straightforward violation of the CEOs' fiduciary obligation to the shareholders.

Schapiro was not, to say the least, a fan of these necessary structural remedies. So it is no shock to me that her SEC would now join an effort to undo them. All this raises a series of questions:

- Did Mary Schapiro know that the SEC was going to join the industry in court in an effort to undo the settlement?
- What other settlements has the SEC tried to modify and why?
- What enforcement actions, if any, did the SEC bring under the "global" settlement?
- Why has the SEC not sought to obtain, and then make public, the e-mails from AIG that would shed light on the entire series of transactions that led to the debacle of AIG's failure?

The SEC's efforts in past months do not engender great confidence. One wonders whether, even if new financial regulation bills now before Congress become law, the SEC will have the will to use its substantial new powers very wisely. As always, the person in charge of an enforcement agency is just as important as any new powers that agency may be granted.

Eliot Spitzer is the former governor of the state of New York.