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SAME SONG, SAME DANCE: EVIDENCE OF PATTERNS IN SECURITIES AND EXCHANGE COMMISSION FUNDING

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ABSTRACT

The actions of Congress and the Securities and Exchange Commission subsequent to a financial crisis appear to follow a predictable set of steps. Each tries to position itself to gain the resources it needs to survive by couching its actions in terms of legitimacy. One outcome is a predictable dance that culminates with the annual funding process. The events surrounding the financial collapse of Lehman Brothers and the resulting scrutiny of the Securities and Exchange Commission are hardly unique. In fact, they appear to be the predictable result of a period of boom and bust. These predictions are based on the historical behavior of politicians in funding the Commission. This paper uses an institutional theory perspective to examine the funding patterns in the wake of the collapse of Enron in 2001 and the global financial crisis precipitated by the collapse of Lehman Brothers in 2008. Implications for the Securities and Exchange Commission are provided.

JEL: M41, M48, M49

KEYWORDS: SEC, Institutional Theory, Regulation

INTRODUCTION

What experience and history teach is this-that people and governments never have learned anything from history, or acted on principles deduced from it. Hegel, (2004) Those who cannot remember the past are condemned to repeat it. Santayana (2011) A large Wall Street firm collapses. A post-bankruptcy investigation reveals the firm to be a house of cards. A public outcry threatens the very fabric of the accounting profession. Are these headlines from today's financial press? Hardly! The events being described occurred in the late 1930's. The collapse of the firm of McKesson, Robbins, Inc. sounds eerily familiar to those following recent financial headlines. The McKesson's collapse elicited a public outcry that placed the Securities and Exchange Commission (SEC) and the accounting profession under the spotlight of a Congressional investigation. In the end, however, the SEC emerged from the affair with renewed legitimacy.

Today's financial scandals have once again focused attention on SEC oversight. Congress and the public are outraged over events such as the bankruptcy of Lehman Brothers and the bailouts given to many large banks. What will be the result of the public outcry? Will the SEC survive or be replaced with another watchdog? While no one knows the ultimate outcome, lessons can be learned from historical events. This paper uses an institutional theory perspective to examine the budgetary interactions between the SEC and the Congress. The end result is hypothesized to be an outcome that has the SEC positioning itself in terms of taking steps to "improve" itself and hence, being able to do a better job at oversight of the financial industry. At the same time, politicians will attempt to garner favor from the voters since they have acted to protect the public from financial frauds. In short, the relationship among the parties is in

reality a highly predictable set of behaviors that will allow all of the participants to demonstrate their legitimacy to their external constituents. The result will allow each party to secure future resources.

The remainder of this paper is organized as follows. The next section reviews work in the area of institutional theory, with specific applications to SEC behavior, shortly after its creation. Following the literature review, a discussion of SEC funding and how it adheres to the institutional theoretic framework is presented. The paper ends with some concluding comments about possible future behaviors on the part of both the SEC and those responsible for funding the agency.

LITERATURE REVIEW AND BACKGROUND

A basic premise of institutional theory is that an organization's survival requires it to conform to social norms of acceptable behavior. It follows that the better an organization is able to gain legitimacy in the eyes of its external funders, the more resources that it will secure. Tschopp, Wells and Barney (2011) state, "Unlike efficiency-based theories that focus on profit maximization and the interactions between markets and governments, Institutional Theory considers a wider network of variables that influence the decision making process." Eisenhardt (1988) found that institutional theory is applicable to complex, dynamic settings. A regulatory agency, such as the SEC does not operate in a vacuum. It must interact with its external constituents in order to survive. In this respect, specific organizational practices and structures may be displayed as symbols to external groups, in order to demonstrate that it is acting in a highly rational, stable and predictable manner. These legitimating activities takes place in order to gain support from external constituents, particularly in highly institutionalized settings, such as in agencies of the state (DiMaggio and Powell, 1983). Scott (2008) found that organizations are not passive actors and can respond to reshape institutional pressures. This result has been supported by authors, such as Phillips and Malhotra (2008) and Suddaby and Greenwood (2005), who have found that rhetoric plays a key role in creating, maintaining and repairing legitimacy.

Ritti and Silver (1986) specifically examined a regulatory agency's use of a predictable set of actions in its interactions with the industry it regulates. The resulting interactions between agency and funder allowed the regulatory agency to gain budgetary resources from its governmental funders, while the regulated entity submits to the regulation so that it may emerge as being "improved". Bealing (1994) and Bealing, et al. (2001) have quantitatively examined the applicability of the institutional perspective to the SEC. The results of these studies appear to bolster the idea that the SEC's behavior is consistent with an organization seeking to gain legitimacy from external constituents in order to gain resources.

Bealing, et al. (1996) specifically examined early SEC behaviors and found them to be consistent with the institutional perspective. Other authors, such as Meyer (2010), Drori, Meyer and Hwang (2006) and Drori, Meyer and Hwang (2009), have found that institutional rules may act as scripts defining the roles of actors with legitimate actions and purposes for particular social domains. That is to say, actor identities emerge in particular historical contexts. It is against this backdrop that the origins of the SEC will be examined. The call for strict federal regulation of the securities markets ebbs and flows with the times and appears to be somewhat predictable. During good economic times, there is little incentive for strict regulation. However, bad times bring renewed efforts at "protecting the investor". For instance, the Volstead Bill of 1919 and the Denison Bill of 1922 were designed to prevent the sale of fraudulent securities. Times were good and both measures failed to pass.

There were virtually no voices raised until after the debacle of 1929 to contest the virtues of participation in this best of all possible markets. As one writer pointed out, big business was not an object of distrust when the purchaser held its soaring stock. (de Bedts, 1964, p. 7). Contrast this to aftermath of the stock market crash of 1929. In a direct response to the crash, the Democratic party's 1932 platform called for the protection of the investing public. Shortly after his election, Democrat, Franklin Roosevelt, sent to

Congress a message urging passage of legislation that included the principle of "let the seller beware". This message was accompanied by a bill that, after several modifications, eventually became the Securities Act of 1933 (Cherrington, 1942).

The Act of 1933 was to be administered by the Federal Trade Commission (FTC). However, nine months after its creation, the 1933 Act was soundly criticized by someone who eventually would become a future SEC Chairman. William O. Douglas called the Act a failure because, "it presupposes that the glaring light of publicity will give investors needed protection" (Karmel, 1982, p. 42). As it turned out, the Securities Division of the FTC only enforced the provisions of the Act between May 27, 1933 and September 4, 1934. On the later date, administrative responsibilities were transferred to the SEC, which was created by the Securities Exchange Act of 1934. This newly created agency faced many strong adversaries. President Roosevelt named Joseph P. Kennedy as the agency's first Chairman.

The justification for this appointment was that Kennedy understood the questionable practices of the trade and could get the job done because he was a Wall Street operator. Kennedy's objectives were to make the SEC acceptable to Wall Street and restore investor confidence in the capital markets (Karmel, 1982, p. 47). In the 1930's, the firm of McKesson & Robbins, Inc. (McKesson) was acquired by F. Donald Coster. Coster, was the alias used by twice convicted swindler, Philip Musica. One of the first actions taken by Musica after the acquisition of McKesson was that of selecting auditors for the firm. He knew that in order to acquire financing for his planned "expansion", the firm would need some credibility. Coster made several inquiries of various bankers and financial acquaintances as to the "finest auditors in the country". He finally settled on Price, Waterhouse & Co. (PW) (Brief, 1982).

PW was widely recognized to be the largest public accounting firm in the United States and indeed, the world. In addition to its size, PW enjoyed one of the best reputations of all accounting firms. Several directors of MR referred to PW as, "the Blue Ribbon firm of America", "they were tops", and "I just took it that when you put Price, Waterhouse on the bottom of the statement, it was Sterling Silver and everything went". (Brief, 1982). On December 6, 1938, the NYSE suspended trading of McKesson securities due to rumors that the firm would file for receivership. On December 8, 1938, McKesson became the first major corporation to enter reorganization under Chapter X of the Chandler Act . (Keats, 1982) The McKesson scandal made front-page headlines from coast to coast. There were six federal probes into the affair, one of which was undertaken by the SEC. The agency filed charges against several officers for violating Section 32 of the Securities Exchange Act of 1934: filing false financial information with the SEC. During the SEC investigation, it was determined that approximately $19,000,000 of the assets included in the 1937 financial statements audited by PW, were entirely fictitious. The fictitious items were comprised of approximately $10 million of non-existent inventory and $9 million of bogus accounts receivable. The SEC eventually concluded that the work of PW was deficient. The SEC stated,

While the appointment of Price, Waterhouse & Co. and the method of determining the scope of the engagement in this case was in accord with generally accepted practice, we do not feel that it insures to the auditor, in all cases, that degree of independence which we deem necessary for the protection of investors (Brief, 1982, p.5).

In response to the fact that the accounts receivable balance contained approximately $9 million of fictitious items, the Commission indicated that PW had conformed to generally accepted auditing procedures in effect at the time of the audit, even though confirmation of receivables was not carried out. With respect to the conduct of the audit of inventory, the SEC concluded that PW's audit program basically conformed to generally accepted practice at the time of the audit. However, as a result of the hearings, several previously "optional" auditing procedures became required. The SEC now considered observation of inventory and confirmation of receivables to be part of generally accepted auditing standards. Both of these procedures had already been put into place by the accounting profession during

the course of the McKesson investigation. The end result of the McKesson debacle was that the SEC severely reprimanded the accounting profession, but allowed the accounting profession to continue to determine appropriate auditing standards rather that have the Commission usurp this responsibility.

The SEC's ability to oversee the accounting profession was now beyond question. The accounting profession made mandatory, several previously optional auditing procedures. As a result, the profession was also able to proclaim itself as improved by virtue of its ability to conduct more thorough audits. The outcome was mutually beneficial to both the regulator and the regulatee.

Enron came into existence in 1986. It was the result of shareholders voting their approval for a name change by the Houston Natural Gas Corporation. Jeffrey Skilling would become the chief executive officer of Enron Corp. in 2001. Six months later, he would resign this position and have his responsibilities assumed by Kenneth Lay. In December of 2001, Enron would file for Chapter 11 bankruptcy bringing with it a massive public uproar. As a result of the public outcry over the bankruptcy of such a large public corporation, politicians seek to gain legitimacy in the eyes of their external constituents, the voters. Predictably, Congressional hearings into Enron's collapse (the WorldCom and Global Crossing debacles also took place during this time period) began less than two weeks after public disclosure of its bankruptcy filing and within six months, Congress had enacted H.R. 3763, the Sarbanes-Oxley Corporate Accountability Bill, widely referred to simply as the Sarbanes-Oxley Act of 2002.

Also predictably, the SEC engaged in its own legitimacy seeking behavior after the collapse of Enron. In March 2002, the SEC announced plans for completing reviews of auditor independence as well as establishment of controls over the "Final Four" accounting firms. It had effectively begun seeking legitimacy from its external funders (Congress) in order to justify the $776,000,000 of additional resources in fiscal year 2003 granted to it in conjunction with the Sarbanes-Oxley Act of 2002 (Law, 2002). One of the main ways the SEC can demonstrate legitimacy is by "getting tough" in its oversight of the accounting profession. A tough stance is seen by Congress as a legitimate response to the financial scandal. The SEC can expect additional resources to strengthen its oversight capabilities, while Congress (politicians) can expect to bank political capital by being seen by voters as funding efforts to protect the small investor. This scenario is very predictable and consistent with findings by Ritti and Silver (1986).

Discussion

In the wake of the perceived closer scrutiny of the Sarbanes-Oxley era, the SEC itself changed. Starting in 2004, the SEC began submitting its financial statements to the audit process. What better way for the agency that is responsible for the oversight of the financial industry to gain legitimacy than to submit to the same process it requires of all the publicly traded companies it oversees? According to William H. Donaldson, the Chairman of the SEC, Because we oversee the accounting and auditing profession, in order to avoid any perceived conflict of interest, the U.S. Securities and Exchange Commission (SEC) chose to have its financial statements audited by the U.S. Government Accountability Office (GAO). I am pleased to report that the GAO has affirmed that the SEC's financial statements were presented fairly in all material respects, in conformity with U.S. generally accepted accounting principles. This outcome is an impressive achievement considering that this was the first-ever audit of the SEC's financial statements. (SEC, 2004, p2) There was one slight problem. The SEC's auditor, the Governmental Accountability Office (GAO) has reported a material weakness existed in the SEC's system of internal controls. Hence, the GAO concluded,

"…SEC did not have effective internal control over financial reporting (including safeguarding of assets), but had effective control over compliance with laws and regulations that could have a material effect on the financial statements as of September 30, 2004…". (SEC, 2004, p105) For most of the public companies the SEC oversees, such a finding would prove devastating. Not so for the SEC. The agency

was given lemons and it made lemonade. The agency stated it was, "…taking appropriate steps to begin to address all weaknesses that GAO and we have identified, including three material weaknesses in internal controls." (SEC, 2004) "It is quite an achievement for the SEC to receive an unqualified audit opinion on its financial statements as this is the first time the agency has prepared statements, a full PAR (Performance and Accountability Report), and undergone a financial statement audit." (SEC, 2004, p76) The SEC also revamped the format and title of its annual report beginning the very same year (2004). For fiscal years 2003 and prior, the document produced by the SEC was simply entitled, "Annual Report". Beginning in fiscal year 2004, the name changed to, "Performance and Accountability Report". The SEC began reporting more than twenty new "performance measures" in 2004. According to the agency,

Many of the measures presented in this report were derived from the SEC's "dashboards" initiative. These "dashboards" comprise a set of internally-generated indicators, which provide information regarding the SEC's timeliness in completing certain tasks, its changing priorities, and the scope and breadth of its activities. (SEC, 2004, p 54) In addition, the agency indicated that it had "improved". Its 2004 report states, The SEC has initiated efforts to improve its ability to "look over the hills and around the corners" for the next emerging problem by creating a new Commission-wide risk assessment and management program, featuring a new Office of Risk Assessment, as well as a new program of comprehensive risk identification throughout the agency. (SEC, 2004, p 3). The funding result for the SEC? "For FY 2004, the SEC received the authority to spend $811.5 million and maintain 3,550 full-time equivalents (FTEs) and 4,090 positions. These figures represent an 83 percent increase in dollars and a 21 percent increase in FTEs from FY 2001 levels." (SEC, 2004, p 12)

Funding levels rose approximately 13% again FY 2005. Not a bad outcome given investor outcry over the failures of companies such as Enron, WorldCom and Global Crossing. Politicians legitimate themselves by acting to "protect" investors by funding the watchdog agency. The SEC, even while admitting problems of its own, legitimates itself by undergoing a financial audit for the first time and touting itself as an improved agency. Between 2004 and 2007 the financial markets had stabilized, along with SEC funding levels. The S&P 500 index increased approximately 9%, 3%, 14% and 5% during this time period. Corresponding SEC funding levels for fiscal years 2005-2008 actually declined by approximately 3%, 2% and 3%. Apparently there is less need for Congress to take visible actions to "protect the investing public" when markets are rising.

But what became of the agency's promise to be able to "look over the hills and around the corners" for potential problems? It clearly did not foresee and prevent the financial crisis which occurred when the financial markets collapsed in 2008. What became of the SEC and its funding in the wake of the financial market meltdown? The music may have had a new beat to it, but it was the same old song and dance on the part of Congress and the SEC. Congress immediately responded by taking actions that demonstrated it was protecting investors. Probably the most prominent example of this was the introduction of "The Wall Street Reform and Consumer Protection Act of 2009". This legislation was later passed and signed into law by President Obama in 2010. It is most commonly referred to as the Dodd-Frank Act. This highly visible piece of legislation helped to legitimate politicians in the eyes of their constituents. As a result, lawmakers can be thought to be more likely to receive resources (votes) they need to win re-election. Notice the pattern? There is some sort of crisis in the financial markets. Congress then takes steps to legitimate itself in the eyes of its "funders", the voters, by passing Dodd-Frank. It return, the SEC can now say to Congress, we need more funding to do your bidding. In response to the calls of a few Congressional budget hawks to be fiscally responsible and cut the SEC budget, none other than Barney Frank who came to the defense of the SEC when he stated,

This is a serious threat to financial reform…What you get is a disproportionate assault on our ability to regulate the financial industries. (Wyatt, 2012)

Even President Obama got involved in the legitimation dance. Under fire for the lack of significant prosecutions related to the 2007-2009 financial and housing market meltdowns, he has supported adding about $55 million to the Justice Department's proposed budget to prosecute financial crimes.

In the aftermath of the financial market collapse in 2008, the SEC wasted no time in its attempt to legitimate itself in the eyes of both the public and its Congressional funders. None other than SEC Chairman, Christopher Cox paid homage to its Congressional funders and delivered the agency's case in the Message from the Chairman portion of the agency's 2008 performance report when he stated,

The mortgage meltdown and ensuing global credit crisis during the past year have confronted our markets with unprecedented challenges. The government's response to the financial turmoil has been equally unprecedented: the Federal Reserve and the Department of the Treasury have together committed over one trillion dollars in taxpayer funds to support insurance companies, banks, thrifts, investment banks, and mortgage giants Fannie Mae and Freddie Mac.

The Emergency Economic Stabilization Act (EESA) signed into law in October 2008, gives the Chairman of the SEC a formal oversight role with respect to the Troubled Asset Relief Plan administered by the Department of the Treasury. In addition, the Housing and Economic Recovery Act of 2008 gives the SEC Chairman similar oversight and advisory responsibilities with respect to the conservatorship of Fannie Mae and Freddie Mac supervised by the Federal Housing Finance Agency. These duties come in addition to the new responsibilities the SEC is already discharging as the statutory regulator of credit rating agencies, and the mandate that the EESA has given the agency to report by January 1, 2009, on the results of a congressionally-mandated study of fair value accounting. (SEC, 2008, p2) Later in the same message, Chairman Cox made the SEC's case when he said,

I told the Congress that when SEC regulation is backed up with statutory authority, it is strong and successful—and that voluntary regulation of businesses the SEC does not regulate by statute does not work. (SEC, 2008, p 4) Predictably, SEC funding levels increased in years following the crisis. They rose by 6% from the previous year in FY 2009 and soared by 22% FY 2010, largely due to provisions contained in the Dodd-Frank Act. SEC legitimating actions appear to be independent of its Chair. After Christopher Cox stepped down as SEC Chairman, he was replaced by Mary Schapiro. Chairwoman Schapiro was quick to point out that the agency needed even more resources in order to carry out the provisions of the Dodd-Frank Act, which was passed by Congress in response to a public outcry for more oversight of financial institutions. Confidence in the markets is important to economic growth and demands a strong investor protection agency. This additional funding will allow us to continue strengthening our enforcement and examination programs.

(Schapiro-contained in Doering and Lynch, 2012) There is one interesting fact about the budget of the SEC that makes the preceding "legitimation dance" all the more interesting. The agency has a long history of being a <u>net contributor</u> to the United States Treasury. In 2010, it collected $300 million more fees from the financial industry than it cost to run the SEC…the difference went into the Treasury (Wyatt). If funding of the SEC were merely a rational process, Congress would simply let the agency keep all the money it collects and bypass the budget appropriations process entirely. Under the present situation, cutting the SEC's budget has no effect on the deficit and wouldn't save any taxpayer money. It could, however, cost millions in terms of lost fees and penalties. Even the Dodd-Frank Act contained a provision that prevents the fees collected by the SEC from exceeding the amount budgeted to it! (Wyatt, 2012). In the world of governmental budgeting, appearance (legitimacy) is everything.

To demonstrate to external constituents that it is fulfilling its role as a public watchdog, the SEC appears to be focused on taking cases where it has a high probability of success. During the 2012 fiscal year, the SEC filed 734 cases and obtained 714 settlements. Out of the 15 cases it took to trial, it lost only two.

(Raymond, 2013) However, despite the SEC's claimed 85% success rate in trials during 2012, critics have said the commission's win rate has been poor when it comes to the financial crisis. The SEC's habit has been to allow defendants to settle cases without admitting or denying wrongdoing. This may be changing. In June, 2013, SEC Chair, Mary Jo White, said the agency is moving toward requiring defendants to admit liability. This increases the likelihood of a high profile trial and verdict. In July of 2013, one of the first high profile verdicts was handed down when a Goldman Sachs trader nicknamed "Fabulous Fab" Tourre was found liable in six of seven SEC fraud claims. (Hays, 2013) In a second highly visible case involving a "big fish", J.P. Morgan agreed to pay $920 million in penalties and admitted violating securities laws. This settlement was the result of the investigation into the so called "London Whale". While it may appear that the SEC has embarked on a new regulatory course, the agency may simply have put a new spin on an old regulatory style. One of the basic tenets of institutional theory states that both the regulator and the regulatee will engage in highly visible actions. The outcome of which will allow both parties to eventually emerge claiming they are "new and improved".

Thus both parties now have a legitimate claim to further resources. This is similar to Price Waterhouse's claim after the SEC got involved in the matter of McKesson & Robbins back in the 1930s. It is looking increasingly likely that it will be the same today. Specifically, there is a distinct possibility that the large fine against J.P. Morgan may lack any real bite. While J.P. Morgan engaged in a "pattern of misconduct" by maintaining poor internal controls, the fines may eventually be deemed to be tax deductible to the bank. This is because some fines and penalties may be "viewed as remedial (and thus deductible) rather than penal in nature." (Woods, 2013) Even the idea of not allowing defendants to "neither admit nor deny" any allegations against them may not be what it seems. In November 2013, JP Morgan reached a record $13 billion settlement with the government over, among other things, its packaging and reselling of mortgages to investors. According to Bloomberg,

The Justice Department wasn't about to go down that path when it unveiled its big, not-really-$13 billion deal this week… So the government made a few sly tweaks. The result is a mutant offspring of the no-admit genre that may be even less satisfying than the parent. JP Morgan didn't have to admit to any violations of the law. And here's the rub: The Justice Department didn't allege any, either. According to the settlement agreement, the bank will pay a civil penalty "pursuant to" a statute called the Financial Institutions Reform, Recovery and Enforcement Act. However, the Justice Department didn't lodge any claims against JP Morgan for breaking that law or any other. …The agreement did incorporate an 11-page statement of facts that explained in vague terms what JP Morgan did. Yet none of the acknowledgments by JP Morgan in that document hurt the bank. JP Morgan didn't admit liability or even any mistakes. That's no better than the old "neither admit nor deny" boilerplate. (Weil, 2014) And so it goes, the more things change, the more they stay the same. Different circumstances, different SEC chairman, but the same old song and dance.

CONCLUDING COMMENTS

Letting past history be our guide, several predictions can be made. Past response to financial scandal and Congressional hearings has been the passage of additional accounting standards or financial regulations. In the wake of the McKesson, Robbins affair, it became mandatory for auditors to observe inventory and confirm accounts receivable. The Moss, Metcalf, and Dingle hearings of the 1970s and '80s yielded similar outcomes. The Dingle hearings, which grew out of the collapse of the Savings & Loan industry, resulted in a package of accounting standards known as the response to the "Expectations Gap". The failures of Enron and WorldCom yielded the Sarbanes-Oxley Act which contained many provisions aimed directly at problems related to auditor independence and CEO responsibilities. In the aftermath of the failure of Lehman Brothers and the ensuing great recession, the Dodd-Frank Law was enacted. The pattern appears to be clear. During times of prosperity and a growing economy there is little incentive to upset the status quo…let the good times roll. However, during times of a perceived crisis, the various

actors all assume their familiar positions on the dance floor of public perception and do the steps they know so well. Indeed, when it comes to the funding of the SEC, the music may sound different, but the beat is the same. During periods of good economic health, there is little in the way of regulatory oversight actions. During challenging economic times, the SEC will engage in symbolic actions which legitimize the agency in the eyes of its various constituent groups. At the same time, those organizations submitting to SEC oversight may claim that they have emerged from the process as being stronger and "improved". The result appears to be the same song, and the same dance.

This paper has used an institutional theoretic approach to analyze SEC funding patterns and behavior. Institutional theory was selected because several authors had previously applied it to explain the behavior of governmental regulatory agencies. Specifically, amounts allocated to the SEC during the federal budgetary process were identified and analyzed in light of SEC advocacy efforts. The result was a pattern that is consistent with the basic premise of institutional theory. That is, the SEC will try to legitimate its existence in the eyes of its external funders (Congress and the President) in order to obtain resources.
There are several limitations with respect to generalizability of results. First, only one agency, the SEC, was selected for analysis using one framework for analysis, institutional theory. As a result, the findings of this paper, while consistent with previous findings, may not be applicable to other settings. Second, there may be other theories which could be used to explain SEC funding patterns. To enhance the possible generalizability of this paper's results, future research is needed. Institutional theory could be used to analyze the funding patterns of other regulatory agencies.

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