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Public enforcement of securities market rules: Resource-based evidence from the Securities and Exchange Commission☆

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ABSTRACT

We empirically investigate whether increases in the U.S. Securities and Exchange Commission's (SEC) budget have an effect on firms' compliance behavior with securities market rules. Our study uses a dataset on the SEC's resources and its enforcement actions over a period beginning shortly after the Second World War and ending in 2010. We find that increases in the SEC's resources both improve compliance and lead to an increased activity level of the SEC. The higher level of compliance is reflected by a decrease in the numbers of enforcement cases. The increased activity level is reflected by a surge in the number of investigations conducted by the SEC.

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1. Introduction

In an effort to restore investor confidence in financial markets the Securities and Exchange Commission's (SEC) budget was doubled between 2007 ($830 million) and 2010 ($1.6 billion). Given this significant increase in funding we investigate whether investors in the U.S. financial market can expect firms to improve their compliance with securities laws enforced by the SEC. This question about the effectiveness of public enforcement of securities laws has provoked a substantial debate in the literature.[1] La Porta et al. (2006) and Djankov et al. (2008) find no evidence that public enforcement impacts standard measures of financial market development (such as stock market capitalization in relation to GDP, trading volume, the number of domestic firms, or the number of IPOs). Consequently, the World Bank (2006), La Porta et al. (2006) and Djankov et al. (2008) have argued that financial market development is solely aided by private rather than by public enforcement of securities market rules. From their point of view, resources should be devoted primarily to promote private enforcement institutions.[2] Jackson and Roe (2009) do not share this view. They replicate the analysis by La Porta et al. (2006) but use a different measure of regulatory intensity. La Porta et al. (2006) employ an index based upon regulators' formal powers. Jackson and Roe (2009) use regulators' resources to proxy regulatory intensity.[3] In contrast to La Porta et al. (2006), Jackson and Roe (2009) do find a significant and positive impact of public enforcement on financial market development.

Interestingly, the channel through which public enforcement affects market development has not been analyzed yet. We fill this gap in the literature by studying firms' compliance behavior in reaction to increases in the SEC's resources. We investigate if and how increases in the resources available for public enforcement of securities markets rules impact the compliance of securities market participants. In practice, before enforcement can lead to better financial markets, i.e. markets where investors demand relatively lower returns on their capital as they do not have to be afraid of being defrauded, that enforcement must initially influence firms' decisions to comply with securities market rules. By focusing on the incentives for firms' disclosure behavior provided by the SEC's enforcement, our study closes this gap. It is those changes in compliance that – over time – can lead to improved financial markets.

Our study uses a dataset on the SEC's resources and its enforcement actions over more than 60 years starting shortly after World War II and ending in 2010. We expect that increases in the SEC's resources result in an improved level of compliance. A decreased number of enforcement actions filed by the SEC captures this improvement in compliance. Following Jackson and Roe (2009), we use the SEC's budget to proxy the resources available for public enforcement.[4] We measure compliance, or rather misbehavior, using the number of SEC's enforcement actions aimed at stopping ongoing misbehavior. The SEC's primary tools for stopping such misbehavior are injunctions (see Section 3 for more details). We even analyze the number of administrative proceedings and two measures for the SEC's investigative activity.[5] By using vector autoregressions as our econometric tool (VAR), we are able to cope with the problems known from the economics of crime literature, i.e. the fact that the two central variables, the level of misbehavior and the resources targeted at law enforcement, respectively, are determined simultaneously.

We find evidence that increases in the SEC's resources deter financial market participants from misbehaving and lead to a higher compliance in the medium-term. This higher level of compliance is reflected by a decrease in the number of enforcement cases. We establish our results in the following manner: First, using Granger-causality tests we establish that there is a significant link between the SEC's resources and corporations' contemporaneous misbehavior.[6] Second, we find that the result of an increase in the SEC's resources is a decrease in (reported) ongoing misbehavior. The results from the VAR analysis suggest that a positive budget shock leads to an aggregate decrease in the number of ongoing misbehavior, this is reflected by a decrease in the number of injunctions by 11% within five years and by 14% years within ten years, respectively. This is clear evidence for the compliance hypothesis with firms being more compliant and explains Jackson and Roe's (2009) finding of the effectiveness of public enforcement.

Our results are robust when we extend our measures of SEC enforcement to include administrative proceedings. Administrative proceedings are another enforcement measure that the SEC may employ (see Section 3 for details). We also find support for our results when we examine the SEC's investigative powers. In addition to enforcing financial market rules using

[1] As the results of Brown et al. (2013) suggest, this question is likely to have effects on the real economy.

[2] Some researchers at the International Monetary Fund and the European Central bank seem to share this assessment of the limited value of public enforcement (Berglöf and Claessens, 2006 and Hartmann et al., 2007, respectively).

[3] Actually, Jackson and Roe (2009) measure public enforcement using regulators' budget and staff. La Porta et al. (2006) use a self-composed index of the regulator's formal qualities (such as independence from the executive, its investigative powers, its capacity to issue remedial orders, and the range of criminal sanctions available) to quantify public enforcement.

[4] The SEC, being a federal agency, receives its budget from the federal government. It nevertheless also generates its own revenue. This revenue stems from fees, securities registrations and tender offers, etc. However, the SEC can only spend the amount agreed upon by the federal government. Since 1982, these revenues have always exceeded the SEC's budget and the SEC has thus positively contributed to the federal budget. The SEC's annual report for fiscal year 2001, e.g. states that the agency collected $2.06 bn in fees SEC (2001). 48 % of that sum was generated from securities registrations; 50% came from securities transactions. The remaining 2% were from tender offer, merger, and other items. The agency's 2001 budget was $430 million. Lohse and Thomann (2015) show that positive stock market returns and have a tendency to reduce the SEC's funding.

[5] The question how corporate fraud can be detected before being sanctioned by institutions such as the SEC is analyzed in detail by Dyck et al. (2010). Del Guercio et al. (2013) investigate how spending on the SEC impacts insider trading.

[6] Granger causality is a statistical concept that is concerned with the question of whether past values of one variable can be used to forecast another variable.