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Yale Program on Financial Stability

Lessons Learned

Erik Sirri

By Mercedes Cardona

Erik Sirri served as director of the Division of Trading and Markets at the US Securities and Exchange Commission (SEC) from 2006 to 2009. In his post, he was responsible for matters relating to the regulation of stock and option exchanges, national securities associations, brokers-dealers, clearing agencies, transfer agents, and credit rating agencies. Before joining the SEC in 1996, he was an assistant professor of finance at the Harvard Business School from 1989 to 1995. Sirri served as the SEC's chief economist until 1999, before returning to academia. He is currently a professor of finance at Babson College. His research interests include the interaction of securities law and finance, securities market structure, investment management, and capital markets. This Lesson Learned is based on an interview with Sirri held in May 2021; [the full transcript may be accessed here](#).

Consolidated agency oversight of economically similar financial activities will improve each regulator's ability to evaluate risk and recognize vulnerabilities.

In the years leading to the 2007–2009 Global Financial Crisis, US financial regulators (of which there are five at the federal level) generally lacked a consolidated view of the significant amount of risk and leverage that accumulated outside of the commercial financial institutions. The Gramm–Leach–Bliley Act in 1999 did not provide for consolidated supervision of investment bank holding companies. The SEC lacked the supervisory authority by statute that would have allowed it to see some of the warning signs of the coming crisis; its oversight was limited to broker-dealers and did not extend to their holding company parents, which may have had questionable holdings or unreasonable leverage within other subsidiaries.

The collapse of Bear Stearns showed how quickly liquidity can vanish from a firm that has trouble at one of its affiliates, but Sirri noted that a year and a half before its demise, Bear Stearns had its most profitable year ever. From the SEC's limited vantage point, the financial system seemed to be in good shape, not a teetering framework, he said.

In retrospect there was a regulatory hole there, and Congress should probably have filled it. You didn't want firms as big as our investment banks running around without consolidated supervision, or certainly without the ability for someone to . . . look holistically at the risks and the amount of liquidity across the whole entity. There was no one to do that, and these were big, important firms.

The Office of Thrift Supervision was the only regulator that had statutory supervision over any holding companies, namely those that also owned a thrift institution. But it failed to exercise that oversight in the lead-up to the crisis.

Lacking statutory consolidated supervisory authority, the various agencies needed to work together to provide that holistic view of risk. Agencies including the SEC, the Federal Reserve

System, and the Treasury Department, among others, failed to communicate effectively across the fragmented regulatory regime that also included the Treasury's Office of the Comptroller of the Currency and the Office of Thrift Supervision.

The authority was divided, and they did not all play ball well. I think that was one thing that was unfortunate. But this is politics. Regulatory entities want to defend their own turf, so that's somewhat to be expected.

To be effective, oversight must be based in statutory authority, have real legitimacy behind it, and include the power of enforcement.

The SEC gained some broad-based supervisory authority of broker-dealers and their holding companies through rulemaking, rather than statute, with mixed results, said Sirri. A 2004 SEC rule established a voluntary oversight program of consolidated supervisory entities (CSEs)—holding companies that agreed to increased supervision by the SEC. This was meant to fulfill consolidated supervision requirements that firms had to comply with to do business in the European Union. In exchange, the SEC offered them a carrot. He said,

What the 2004 rules did was a trade-off. The SEC gained oversight and some transparency into the risks at the holding company level. That was something that it did not have before. It didn't do it by statute; it did it by rule. It could look at the risks and see the risk controls at the level of the holding company of the big investment banks. The 2004 rules also let the SEC require a pool of unrestricted liquidity at the holding company level. The SEC had not been able to implement these regulations before. In exchange, it gave the investment banks an alternate method for computing the required level of broker-dealer capital that they held.

That trade-off of a computation method for broker-dealers in exchange for oversight over the holding company gave rise to the notion that the SEC had lifted limits on leverage across financial firms, leading to the crisis. Sirri explained,

It allowed for the computation of actual broker-dealer capital using a different measure. That's all it did, and in particular, it did not change the required broker-dealer capital. At these firms, their broker-dealers didn't fall out of capital compliance. They didn't run into a situation where they ran out of capital. The problems arose at the holding company level, where the SEC had a window into what was going on, but we didn't have statutory oversight. Then people started thinking the SEC allowed a ton of leverage to occur in these firms at the parent level. We couldn't have stopped them from taking holding company leverage. We didn't have the authority to do that.

The CSE program tried to create a holistic supervisory system over holding companies, but it didn't have enough authority. Sirri pondered: If the SEC not stepped in with rulemaking, might Congress have felt the need to act, or might the Federal Reserve have assumed supervision? Having only supervisory authority over broker-dealers, once the crisis exploded, the SEC's role was limited. It couldn't provide the necessary liquidity to affected firms, as the Fed was able to do, and its assigned functions couldn't stabilize the markets.

Dated: December 2022

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