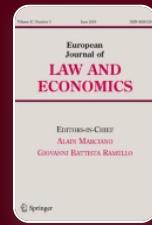


[Home](#) > [European Journal of Law and Economics](#) > Article

Are bad times good news for the Securities and Exchange Commission?

| Published: 09 August 2014

| Volume 40, pages 33–47, (2015) [Cite this article](#)[Save article](#)[View saved research >](#)

[European Journal of Law and Economics](#)

[Aims and scope →](#)[Submit manuscript →](#)

[Tim Lohse](#)^{1,2} & [Christian Thomann](#)  ^{3,4,5}

 465 Accesses  10 Citations [Explore all metrics →](#)

Abstract

There exists a considerable debate in the literature investigating how stock market upswings or downswings impact financial market regulation. The present paper contributes to this literature and investigates whether financial market regulation follows a regulative cycle: does regulation, and consequently investor protection, increase as a result of a stock market downturn [as argued by, e.g., Zingales (J Account Res 47(2): 391–425, [2009](#))] or—contrary to the regulative cycle hypothesis—as a result of an upswing [as claimed by Povel et al. (Rev Financ Stud 20(4): 1219–1254, [2007](#)), or Hertzberg [2003](#)] Following Jackson and Roe (J Financ Econ 93(2): 207–238, [2009](#)), we use funding data on the world's most

important financial market regulator, the U.S. Securities and Exchange Commission (SEC), as a proxy for the politically desired degree of regulation. We apply time series analysis. Using more than 60 years of data, we show that the SEC's funding follows a regulative cycle: A weak stock market results in increased resources for the SEC. A strong stock market results in reduced resources. Our findings underline the downside of regulation as the regulative cycle amplifies the technical procyclicality inherent in regulation.



This is a preview of subscription content, [log in via an institution](#) to check access.

Access this article

[Log in via an institution](#)

Subscribe and save

Springer+

from €37.37 /Month

- Starting from 10 chapters or articles per month
- Access and download chapters and articles from more than 300k books and 2,500 journals
- Cancel anytime

[View plans](#)

[Buy Now](#)

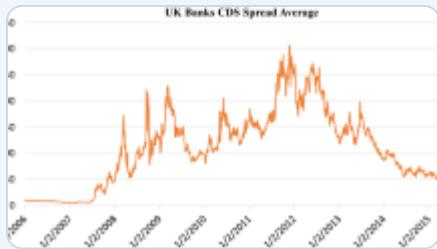
[Buy article PDF 39,95 €](#)

Price includes VAT (Poland)

Instant access to the full article PDF.

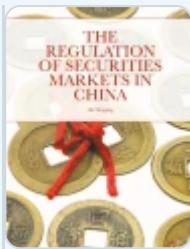
[Institutional subscriptions](#)

Similar content being viewed by others



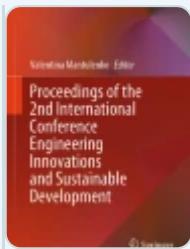
What do we know about the stock markets' reaction to regulatory announcements regarding financial...

Article | 04 August 2022



Theories of Securities Markets Regulation

Chapter | © 2018



Identification of Factors Reducing Effectiveness of Institutional Regulation of Financial Capital Market

Chapter | © 2023

Explore related subjects

Discover the latest articles, books and news in related subjects, suggested using machine learning.

[Capital Markets](#)

[Financial Law](#)

[Financial Economics](#)

[Public Finance](#)

[Regulation and Industrial Policy](#)

[Regulatory networks](#)

Notes

1. Zingales (2009) is not the only paper claiming that there exists such a tendency. Rajan and Zingales (2003), Leuz and Wysocki (2008), Jackson and Roe (2009), Brunnermeier et al. (2009), Benmelech and Moskowitz (2010), Bertomeu and Magee (2011) and Wagenhofer (2011) suggest that regulation follows a cyclical pattern.
2. Povel et al. (2007) suggest that the incentives for firms to commit fraud are greatest in relatively good times. It is in such times that investors will rely on publicly available information, which a fraudulent firm might manipulate, to detect “bad” firms. Once times are not too good investors have stronger incentives to monitor and firms manipulating their public information are likely to be caught. However, during very good times investors will assume

that a firm which, according to public data, does not perform is having a bad day. Thus, there will be no incentive to manipulate during such times.

3. There exists a substantial literature (e.g. Loebbecke et al. [1989](#); Beasley [1996](#); Bell and Carcello [2000](#)) establishing that an individual firm's financial results might impact its probability of fraudulent reporting. The relation between stock-market wide conditions and a firm's probability to commit fraud is, however, unclear.
4. Bebchuk and Neeman's ([2010](#), p. 1110) prediction 4 states: "Investor protection will be higher in growing economies in which the value of the new capital that needs to be raised from outside investors is largely relative to the value of the capital already in the hands of existing public firms."
5. Brown et al. ([2013](#)) study the impact of shareholder protection on (young) firms' spending on research and development. Martinsson ([2013](#)) discusses how financial regulation might even impact the demand for skilled labour. In a similar manner, Peev ([2015](#)) shows that firm-level growth in transition economies is positively affected by measures of country governance.
6. Our results hold if we extend the series 2010. See Sect. [3.3](#).
7. Seligman ([2003](#)) provides a comprehensive review of the SEC's history.
8. SEC ([2001](#)) states that during the fiscal year of 2001 it collected \$2.06 bn in fees. 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.
9. Class action litigation as a rather important means of private enforcement is discussed in detail, e.g. by Ulen ([2011](#)). The more sophisticated question

whether or not a “one size fits all” regulation should be uniformly applied to all equity trading platforms within a country is analyzed by Boyle and Meade ([2008](#)). In respect to the SEC as a public enforcement institution, a recent study by Lohse et al. ([2014](#)) shows that increases in the SEC’s resources improve compliance with financial market rules. Even Del Guerico et al. (Del Guerico et al. [2013](#)) show that there is a deterrence effect associated with SEC enforcement.

10. The data is on fiscal year basis. Since 1976 the federal fiscal year ends in October. Prior to that, the fiscal year ended in June.
11. In order to avoid our results being driven by the financial crisis or the Madoff scandal, we consider only data up to 2007. We provide a robustness check for the time until 2010 in Sect. [3.2](#). The number of observations we use is comparable to Jackson and Roe ([2009](#)) who use, at most, 55 observations. Furthermore, the normalization procedure used in Jackson and Roe ([2009](#)) is comparable to the one employed in this paper.
12. Data on the number of stocks traded on the NYSE is obtained from NYSE ([2009](#)). We use the Bureau of Labor Statistic’s consumer price index (Bureau of Labour Statistics [2009](#)) to inflate the SEC’s budget to 2007 dollars. It should be remarked that the results of our empirical analysis can also be derived independently of this normalization. We discuss this is issue in Sect. [3.2](#).
13. The intuition behind this normalization is that two firms with each \$1 bn market capital are likely to create more work for the SEC than a single firm with a market capitalization of \$2 bn.
14. We also try other indices, e.g. the SP 500. Yet, the results are not materially affected by the choice of the index.

15. The univariate SBC are calculated as $SBC = T \log(\text{sum of squared residuals}) + n \log (T)$ where n is the number of parameters estimated and T is the number of usable observations.
16. Dickey-Fuller-tests indicate that *sec_stocks** is stationary. The finding that *sec_stocks* has a unit root can be explained by a number of factors. First, a rising complexity of the firms supervised and, second, a growth of the average market capitalization of the firms traded on the NYSE.
17. The results are very similar if we detrend *sec_budget* using a second degree polynomial. Lohse et al. ([2014](#)) use this approach.
18. The multivariate SBC are calculated as
$$SBC = T * \log |\varOmega| + k * \log T$$
 where T is the number of usable observations; $|\Omega|$ is the determinant of the variance/covariance matrix of the residuals; and k is the number of parameters estimated.
19. In this paper we follow the suggestion of Sims and Zha ([1999](#)) and obtain confidence bands by Monte Carlo integration.
20. ARCH stands for autoregressive conditional heteroskedasticity.
21. These fractiles correspond to one standard deviation. The econometrics package RATS provides a procedure for estimating error bands according to Sims and Zha ([1999](#)).
22. This data is from CRSP.
23. These results are available from the authors upon request.

References

Bank for International Settlements. (2010). *Basel Committee on Banking Supervision: Basel III: A global regulatory framework for more resilient banks and banking systems*. Basel: Basel Committee on Banking Supervision.

[Google Scholar](#)

Beasley, M. S. (1996). An empirical analysis of the relation between the board of director composition and financial statement fraud. *Accounting Review*, 71(4), 443-465.

[Google Scholar](#)

Bebchuk, L. A., & Neeman, Z. (2010). Investor protection and interest group politics. *Review of Financial Studies*, 23(3), 1089-1119.

[Article](#) [Google Scholar](#)

Bell, T. B., & Carcello, J. V. (2000). A decision aid for assessing the likelihood of fraudulent financial reporting. *Auditing: A Journal of Practice & Theory*, 19(1), 167-182.

Benmelech, E., & Moskowitz, T. J. (2010). The political economy of financial regulation: Evidence from U.S. state usury laws in the 19th century. *Journal of Finance*, 65(3), 1029-1073.

[Article](#) [Google Scholar](#)

Bernanke, B. S. (2009). The financial crisis and community banking, March 20, 2009,

<http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm>. Accessed 30 August 2013.

Bertomeu, J., & Magee, R. P. (2011). From low-quality reporting to financial crises: Politics of disclosure regulation along the economic cycle. *Journal of Accounting and Economics*, 52(2), 209-227.

[Article](#) [Google Scholar](#)

Boyle, G., & Meade, R. (2008). Intra-country regulation of share markets: Does one size fit all? *European Journal of Law and Economics*, 25(2), 151-165.

[Article](#) [Google Scholar](#)

Brown, J. R., Martinsson, G., & Petersen, B. C. (2013). Law, stock markets, and innovation. *The Journal of Finance*, 68(4), 1517-1549.

[Article](#) [Google Scholar](#)

Brunnermeier, M., Crockett, A., Goodhart, C., Persaud, A. D., & Shin, H. (2009). The fundamental principles of financial regulation. *Geneva Reports on the World Economy*, 11, 16-48.

[Google Scholar](#)

Bureau of Labour Statistics (2009). *Consumer price index..*
<http://www.bls.gov/data/#prices>. Accessed 30 August 2013.

Del Guercio, D., Odders-White, E., & Ready, M. (2013). The deterrence effect of sec enforcement intensity on illegal insider trading. Available at SSRN 1784528.

Dewatripont, M., & Tirole, J. (1999). Advocates. *Journal of Political Economy*, 107(1), 1-39.

[Article](#) [Google Scholar](#)

Enders, W. (2004). *Applied econometric time series* (2nd ed.). Hoboken: Wiley.

Hertzberg, A. (2003). *Managerial Incentives, Misreporting, and the Timing of Social Learning: A Theory of Slow Booms and Rapid Recessions*. Working paper, Northwestern University.

Jackson, H. E. (2013). *Public enforcement: An update of literature on resource-based evidence*. Unpublished Manuscript.

Jackson, H. E., & Roe, M. J. (2009). Public enforcement of securities laws: Resource-based evidence. *Journal of Financial Economics*, 93(2), 207–238.

[Article](#) [Google Scholar](#)

Kim, I. (2008). Securities laws 'facilitating' private enforcement. *European Journal of Law and Economics*, 25(1), 17–38.

[Article](#) [Google Scholar](#)

La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (2006). What works in securities laws? *Journal of Finance*, 61(1), 1–32.

[Article](#) [Google Scholar](#)

Leuz, C., & Wysocki, P. (2008). Economic consequences of financial reporting and disclosure regulation: A review and suggestions for future research. *MIT Sloan School of Management Working Paper*.

Loebbecke, J. K., Eining, M. M., & Willingham, J. J. (1989). Auditors' experience with material irregularities: Frequency, nature, and detectability. *Auditing: A Journal of Practice & Theory*, 9(1), 1–28.

[Google Scholar](#)

Lohse, T., Pascalau, R., & Thomann, C. (2014). Public enforcement of securities market rules: Resource-based evidence from the Securities Exchange Commission. *Journal of Economic Behavior and Organization (forthcoming)*. doi:[10.1016/j.jebo.2014.06.010](https://doi.org/10.1016/j.jebo.2014.06.010).

[Google Scholar](#)

Martinsson, G. (2013). Financial reform, demand for skilled labor, and growth. *Swedish House of Finance Research Paper No. 13-04*.

NYSE (2009). Facts and Figures, NYSE Historical Statistics, <http://www.nyxdatalink.com/nysedata/NYSE/FactsFigures/tabid/115/Default.aspx>. Accessed 30 August 2013.

Peev, E. (2015) Institutions, economic liberalization and firm growth: evidence from European transition economies. *European Journal of Law and Economics*. doi:[10.1007/s10657-014-9450-3](https://doi.org/10.1007/s10657-014-9450-3).

Povel, P., Singh, R., & Winton, A. (2007). Boom, busts, and fraud. *Review of Financial Studies*, 20(4), 1219–1254.

[Article](#) [Google Scholar](#)

Rajan, R. R., & Zingales, L. (2003). *Saving capitalism from the capitalists*. New York: Random House.

[Google Scholar](#)

SEC (2001). *Securities and Exchange Commission annual reports*, www.sec.gov. Accessed 30 August 2013.

SEC (2011). *Securities and Exchange Commission annual reports*, www.sec.gov.

Accessed 30 August 2013.

SEC (2012). *Securities and Exchange Commission annual reports*, www.sec.gov. Accessed 30 August 2013.

Seligman, J. (2003). *The transformation of wall street* (3rd ed.). New York: Aspen.

[Article](#) [Google Scholar](#)

Shleifer, A. (2005). Understanding regulation. *European Financial Management*, 11(4), 439-451.

[Article](#) [Google Scholar](#)

Sims, C. A., & Zha, T. (1999). Error bands for impulse responses. *Econometrica*, 67(5), 1113-1156.

[Article](#) [Google Scholar](#)

Ulen, T. S. (2011). An introduction to the law and economics of class action litigation. *European Journal of Law and Economics*, 32(2), 185-203.

[Article](#) [Google Scholar](#)

Wagenhofer, A. (2011). Towards a theory of accounting regulation: A discussion of the politics of disclosure regulation along the economic cycle. *Journal of Accounting and Economics*, 52(2), 228-234.

[Article](#) [Google Scholar](#)

Wang, T., & Winton, A. (2012). *Competition and corporate fraud waves*. *Unpublished Manuscript*.

Wang, T., Winton, A., & Yu, X. (2010). Corporate fraud and business conditions:

Zingales, L. (2009). The future of securities regulation. *Journal of Accounting Research*, 47(2), 391-425.

Acknowledgments

The authors thank two anonymous referees, Johan Eklund, Martin Eling, Razvan Pascalau, Lars Petterson, Daniel Wiberg, participants of the workshop on Regulation, Entrepreneurship and Firm Dynamics in Stockholm, the German Finance Association meeting and seminar participants at Humboldt University Berlin, the Universities of Hannover, Potsdam, and Ulm and the Social Science Research Center Berlin (WZB) for valuable comments on earlier versions of the paper. Tim Linderkamp provided very valuable research assistance. All errors and omissions are our own.

Author information

Authors and Affiliations

Berlin School of Economics and Law, Alt-Friedrichsfelde 60, 10315, Berlin, Germany

Tim Lohse

Max Planck Institute for Tax Law and Public Finance, Marstallplatz 1, 80539, Munich, Germany

Tim Lohse

Centre of Excellence for Science and Innovation Studies (CESIS), Royal Institute of Technology (KTH), Lindstedtsvägen 30, 100 44, Stockholm, Sweden

Christian Thomann

Center for Risk and Insurance, Leibniz Universität Hannover, Hannover, Germany

Christian Thomann

Ministry of Finance, Stockholm, Sweden

Christian Thomann

Corresponding author

Correspondence to [Christian Thomann](#).

Rights and permissions

[Reprints and permissions](#)

About this article

Cite this article

Lohse, T., Thomann, C. Are bad times good news for the Securities and Exchange Commission?. *Eur J Law Econ* **40**, 33–47 (2015). <https://doi.org/10.1007/s10657-014-9455-y>

Published	Issue date
09 August 2014	August 2015
DOI	
https://doi.org/10.1007/s10657-014-9455-y	

Keywords

[Financial regulation](#) [Procyclicality](#) [Securities and Exchange Commission](#) [Stock market](#)

JEL Classification

[G28](#) [G18](#) [C32](#)

Search

Search by keyword or author



Navigation

[Find a journal](#)

[Publish with us](#)

[Track your research](#)