BOSTON CAPITAL

Again, states to the rescue

By Steven Syre, Globe Columnist | August 19, 2008

In an ideal world, regulators would make sure financial markets were unfailingly transparent and fair to everyone involved.

Needless to say, things work differently in the real world. Effective regulation can mean cleaning up a mess after the fact, holding responsible parties accountable, and compensating those who have been wronged. That's not as easy as it may sound.

The latest episode of markets run amok, the auction-rate securities fiasco, has become a kind of regulation case study. The executive summary: A slow start, followed by sound and fury that produced real results. State officials, sprinting ahead of federal regulators, got quick action but could end up enforcing a very uneven kind of justice.

The auction-rate securities mess first popped up in this space four months ago. Jack Allegrini, a small-business owner in Brockton, told me a story about money frozen in his brokerage account. That's very old hat now, but the story was just unfolding in April.

Allegrini took his beef about investments that were supposed to be nearly as liquid as cash to Washington, without satisfaction. He did get the attention of Massachusetts officials working for Secretary of State William Galvin, though he wasn't sure what good that would do him.

In fact, state regulators like Galvin came through for individual investors across the country. Officials in other states, most notably New York Attorney General Andrew Cuomo, were all part of the story, too. They identified culpable investment companies, and made them knuckle under by agreeing to repurchase those illiquid securities from their stranded customers and pay fines for their deeds.

Regulators were aided by the fact that big brokerages had so obviously misled their clients about auction-rate securities, protecting their own interests in the process. Inspector Clouseau could have followed the paper trail of damaging documents and e-mail produced by subpoena.

The cases turned out to be huge. Five firms soon agreed to buy back more than $40 billion of securities and eat $360 million in fines. UBS agreed to buy back nearly $19 billion of securities and pay a $150 million fine. Citigroup Inc. and Merrill Lynch & Co. agreed to buy back another $19 billion of securities combined.

Federal officials and other national regulators were interested in the same kind of cases. They were involved. But they weren't the real decision makers behind the big settlements.

Why? State regulators are much more effective when it comes to consumer protection. The Securities and Exchange Commission thinks and acts like a legal bureaucracy, which it is. That's necessary to oversee thousands of companies and brokerages in public markets. But it doesn't do the Jack Allegrinis of the world a bit of good.

People in some camps, including the Bush administration, would like to erase state securities regulators from the government landscape. Grand plans to reorganize the regulation of financial services are floating around Washington, and most of them would wipe out securities powers used by officials like Galvin.

The federal view of state securities regulators is not especially flattering. They are considered noisy headline seekers in a symbiotic relationship with the media. They bark but don't have the resources to bite very hard. All these things, while true, are not so important when you get results.

But this is important: What happens when a collection of state officials, not beholden to one another or even enforcing all the same laws, are the people who pursue an abuse that affects a market covering the whole country and even the world?

State regulators tend to divide cases like auction-rate securities up amongst themselves. Galvin gets UBS and the woman from Missouri gets Wachovia Corp. Cuomo gets plenty of his own companies to chase.

Does something consistent come out of that process?

The early cases were easy. Big brokers who managed markets for auction-rate securities clearly misled their investment clients. They needed to fix the problem and pay fines.

But what about the case brought by New Hampshire regulators, alleging that student loan issuers who had borrowed money from those same investors were victims, too?

Or Cuomo's interest in investigating discount brokers like Fidelity and Charles Schwab, who may have bought securities for clients but didn't underwrite those markets and don't get paid for giving advice to their clients? I'm not so sure about them.

A posse of state regulators is not the ideal response to problems in a global financial market. But the results of the auction-rate investigations so far look like fairly effective real-world regulation.

And where would the investors with frozen accounts be without the posse right now?

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