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## REINVENTING FINANCIAL REGULATION

by Steven Lofchie

In a market where issuers are turning away from raising capital in the U.S. public markets or listing their securities on American stock exchanges, and the financial industry and its regulators are in discredit from the apparent failures of United States financial system to avert a serious market shock, there is no shortage of proposals on how to remake the US regulatory landscape. On the heels of the sale of Bear Stearns, the United States Treasury Department issued a report that sought to set an agenda for rethinking the framework of the regulation of financial institutions (the “Paulson Report”). The report called attention to the benefits of U.S. self-examination as to the changes to the existing legal and regulatory institutions needed to maintain the preeminence of the American capital markets, and the reputation of its complex regulatory regime as an effective tool to govern markets and protect investors.

Well before the public of the Paulson Report, several studies had pointed to the importance of reforming US financial regulation to accommodate global flows of capital and information and to become more competitive and more open in the global economy. A few of the more notable recent efforts are mentioned below:

- In 2007, Mayor Bloomberg and Senator Schumer commissioned a report entitled “Sustaining New York’s and the US’ Global Financial Services Leadership”. The report advocated (a) the reform of the American financial regulatory system using a principles based approach to eliminate duplication and inefficiencies in the system, (b) the reform of securities litigation to eliminate the perception of arbitrary justice, and (c) facilitating the inflow of foreign talent to the United States.
- The Interim report of the Committee on Capital Markets Regulation had, in November 2006, prepared a report that called for sweeping changes, including to the regulatory process. The committee suggested that (a) the SEC and SROs regulate by means of principles-based rules adopted to address empirically verified risks, (b) that the litigation risk to capital market participants be mitigated, and that (c) the compliance burdens of Sarbanes-Oxley be lightened.
- Staff members in the SEC’s Office of International Affairs articulated a program of reform in the Harvard International Business Law Review<sup>1</sup> that highlighted the weaknesses in SEC requirements in view of the globalization of information and capital flows. It proposed a mechanism by which foreign stock exchanges and foreign broker-dealers could be exempted from SEC supervision and US regulation if they could prove compliance with the requirements of a

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<sup>1</sup> Ethiopis Tafara and Robert J Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 Harv. J of Int’l Bus 31 (Winter 2007).

substantively comparable foreign regulator, complemented by sharing across jurisdictions of enforcement and supervisory related information.

## Starting Point

Imagine that, instead of summarizing these past efforts, you are given the task of redesigning the U.S. financial system. How would you go about it?

**Scope.** One basic, and not at all trivial, task is defining the scope of the services or industry you want to cover. As a starting point, one would presumably include all securities activities (including presumably broker-dealers, advisers, funds, exchanges and the other SRO organizations), banking (deposit taking, trust, lending, and presumably non-bank lending activities), insurance and regulated futures.

How much lending activity would one cover? These days one would presumably include mortgage financing, but is it all consumer lending or lending that results in securitization? Perhaps some financing activities are too small and local (raising money for local business ventures such as restaurants) to include in the project.

Regulating futures is potentially very open-ended as it relates to underlying commodities of all types, not just financial commodities, but also agricultural goods, metals and energy. Indeed, energy activities are booming and of increasing importance to what one regards as the financial sector. See, e.g., “Excessive Speculation in the Natural Gas Market” (Senate Staff Report on the gas trading activities of the hedge fund, Amaranth.) If it does include energy, is it only derivatives such as futures and swaps, or is it the physical asset too? Of course, it is not always easy to tell the difference between the physical asset and the financial in our markets.

In any case, any definition of coverage that one arrives at is going to be indeterminate (hard to tell where one thing leaves off and another begins), but it is an essential starting point. What is it that we are talking about?

**Census and Description.** The next thing one might want is a census of what is out there and a general description of the professional market participants, the investors, the products, and the size of the markets.<sup>2</sup> For example, how many broker-dealers or banks are there; how big are they; is the market dominated by big firms or small; are the firms local, regional, national or global; if national or global, from where are they run; who and where are their customers; do they make money, and if so, how much and from what activities; how many people are employed, how are they paid, where are they located and what are their skills?

One would probably also like some sense of what the competition and the market looks like as a whole. Is demand for the product increasing? Profits? What does the business look

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<sup>2</sup> The recent report released by the SEC entitled “Investor and Industry Perspectives on Investment Advisers and Broker-Dealers” (the “Rand Report”) contains what looks like a pretty good try at a census of a small segment of the financial industry. It is probably only a fraction of the information that one would really want to examine the industry as a whole.

like overseas as well as in the United States? Who controls these institutions and who are the investors in them?

**Current State of Regulation.** What are the relevant laws and rules? How did we arrive at the current system? What is the history behind the current laws and regulations? Who regulates the various participants: federal or state governments or both and the role of SROs. How many people are employed in regulation and by whom? How are they paid? What is the process for adopting and implementing rules? What is the cost/benefit analysis of financial regulation? What are the politics and bureaucratic fiefdoms associated with both the current system and any potential reform?

How are rules enforced: with reprimands, fines, jail sentences, other penalties, or private litigation? For example, the SEC traditionally has relied on civil enforcement of securities firms not only to enforce securities laws but also to “send a message” to other potential law breakers. By contrast, the banking regulators have fostered a different culture of regulation and supervision. Traditionally, they rarely used civil enforcement actions, although this has changed recently especially with respect to compliance with the USA Patriot Act.

**Funding.** Perhaps an underappreciated issue is how the regulatory agencies are funded, and the costs that those funding choices place on the regulated entities. The funding of the banking regulators is all over the map – the Federal Reserve is self-funded, while the OCC is largely funded through examination and other fees based on the assets of each bank. The FDIC funds itself largely through interest from the deposit insurance funds. The state banking regulators have a varied style of funding; however, a common element is that many of them charge assessments based on asset size.

On the securities side, the issue of funding is at least as complicated. The SROs are funded through a mechanism that is distinct of taxes, but serve much the same purposes. The states fund themselves from enforcement penalties, and in fact derive far more revenue in penalties than they expend in regulation. In the case of insurance, both the revenues and expenses of regulation go to the states.

**International Survey.** It probably makes sense to look outside of the United States and see how things are being done in other parts of the world. Is Australia the model for U.S. reform? Should we look at the U.K. single regulator model and how that is being implemented around the world?

## **Evaluation**

Having described the world as it is, if we want to make improvements, we have to then assess what needs to be changed. How is the current system working, what are its strengths and weaknesses, what are its costs and benefits?

While the questions above may be difficult to answer, the question of evaluation is even more challenging because it involves establishing priorities.

Evaluating the financial regulatory system requires (i) the determination of goals and (ii) a means of measuring those goals. At a fairly trivial level, we may all be able to agree on

those goals: (i) all companies grow as the markets as a whole grow; (ii) there is full and fair disclosure that everyone understands; (iii) regulation does not impose undue costs on the system, but only serves to allow growth as it gives everyone confidence in the workings of the market; (iv) regulators work for the public good without regard to their personal or to parochial interests; and (v) risk is appropriately measured and managed throughout the system.

Further, we may be able to agree on a method of evaluation: (i) better than last year, (ii) better than yesterday, (iii) better than we could have imagined and (iv) better than people in other countries.

The problem comes in moving to specific goals and measures. What are they? Accordingly, here are some potential goals:

1. **Investor protection.** This is arguably the most important goal of the securities regulators and its significance may seem beyond dispute. However, its absolute priority is open to question. Protection also means to a good extent exclusion. When we protect investors from purchasing certain products or having access to certain markets, we also prevent them from doing so. Thus, retail investors are generally prevented from purchasing securities abroad or from buying hedge fund interests or entering into swaps. We don't think this is a bad thing, but it does entail difficult and ongoing line drawing. At times the lines exclude investors from doing things they would probably benefit from purchasing (hedge funds?) and permit them to do things they should not (take out balloon mortgages?) or the lines become outdated (the definition of "accredited investor"?). Further, with the goal of investor protection has come tremendous private right of action litigation against financial institutions. Has this been a deterrent to bad action (that is also enforced by the regulators) or just an additional cost?

There has been much less emphasis on investor protection as a goal under banking regulation. This is partially a reaction to the presence of deposit insurance, which eliminates the credit risk of buying a deposit from a bank for the vast majority of investors. It also reflects a different regulatory philosophy or emphasis in which the protection of any one customer is subordinated to the need to maintain a safe and sound system, a framework that recognized the central role of banks historically to the nation's economy. To a certain extent, it also represents a different framework of viewing financial services. Under this view, banks generally do not sell third party obligations or provide investment advice as a paid service. Rather, the traditional bank product has been a mortgage on which the banks consider themselves counterparties to borrowers instead of agent. That said, given the recent issues in the mortgage markets, and the assertion that homeowners did not know what they were borrowing, this supposedly fundamental distinction has come into question.

This difference between securities regulation and banking regulations points out that our two principal sets of regulators approach concepts of investor protection from different historic frameworks. This raises the question, what is the proper role of protecting investors under financial regulation? How much of a goal is it? How much should it be subordinated to other goals?

2. **System risk reduction.** This has been of primary concern of the banking regulators (especially the Federal Reserve). However, given recent market failures, it has quickly become the concern of the securities regulators too, though they have always had a role concerning system risk through their supervision of exchanges and clearing corporations. But not all regulators have the appropriate statutory power and practical experience to effectively perform this function – only the Fed has anywhere near close to the mandate to review all aspects of a financial conglomerate’s business. The securities regulators do not have the same power or experience to deal with this goal – they also do not have the lending power of the Fed to answer liquidity problems.

Once we establish a second goal, it becomes apparent that the various goals will conflict. In financial markets where in a single day a major firm can fail if it becomes subject to reputational or other concerns, a regulator must be mindful that its actions for the purpose of protecting individual consumers may increase the possibility that the accused entity will fail simply on the basis that its reputation was besmirched, creating a loss of confidence and a “bank run.”

3. **Growth.** As a general matter, we all want the U.S. economy to grow. This may not be synonymous with the growth of regulated financial institutions. For example, it is possible that financial institutions are fixing prices (e.g., non-competing market makers) and thus are injuring third parties. Ill-gotten profits are likely not good for the economy as a whole. On the other hand, if the economy or the regulated industry is shrinking it is possible that the costs of regulation are too high. Further, the financial services industry has been consolidating rapidly over the last two decades. While this serves to provide greater efficiencies of service and to compete more effectively with foreign competitors, it also has created giant financial institutions that may be unmanageable, unsupervisable and whose failure would be catastrophic (“too big too fail”).
4. **Good Financial Disclosure and Reporting.** Another obvious goal that seems difficult to define or achieve in practice. How do we define when risk has been shifted or removed from a firm’s books? How do we weight financial risks? How do we ensure that regulators, counterparties and investors have enough information to make informed decisions? About which entities do we want financial information? Public regulated entities only? Private funds? Rich individuals? Foreign countries?
5. **Efficiency of Regulation.** Does that mean doing away with state regulation since numerous regulators appear to be obviously inefficient? What about permitting competition between regulators? Does this lead to better regulation or just regulatory arbitrage in seeking the lowest common denominator. At what point does a particular regulation that has a beneficial effect (protecting consumers) become too expensive?
6. **Limitations on Regulatory Powers.** As a general matter, we view competition and not government regulation as the best driving force of the economy. A market is generally thought to be dysfunctional if the winners and losers are determined by regulation, rather than by sales and profitability. How powerful should regulators be? What kinds of disclosures should they be able to force? What should be the limits on their ability to protect investors by, e.g., forcing bad actors out of the industry? Should they be able to

impose a market structure? Of course, limits on regulatory powers may inhibit regulators ability to protect us. What should be the limits on powers given the SROs if they are not subject to the same limits on their exercise of powers as are governmental bodies.

7. **National Interests.** Is it a goal of our regulatory system to favor U.S. national interests or should we have it as a goal that our regulations are neutral? How do we ensure the primacy of the U.S. as a financial marketplace while maintaining the flow of capital into this country? Should we attempt to favor U.S. entities? If so, how do we define “U.S.” Should we favor U.S. investors, issuers or financial institutions given that they may have different interests?
8. **Other Potentials Goals.** There are any number of other goals that we might set. Diversification of activities to diversify risk (no “universal bank”)? Separation of commercial/manufacturing activities from banking? Equal access to governmental support to all regulated entities subject to similar regulation? Clear roles for state and federal agencies; clear preemption where appropriate? Distinctive charters for approved regulated activities? Equal regulatory capital and level pledging fields?

Having established goals, there then comes the problem of measuring success. But we can not take on this problem until we have determined goals.