The Future of Financial Regulation:

Meet the New Regulators, Better Than the Old Regulators?

August 12, 2013

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In May 2008, Cadwalader hosted a conference on the Future of Financial Regulation. The premise of the conference was that our regulatory structure was broken. Just before, the Treasury Department under Secretary Paulson had published its Blueprint for a Modernized Financial Regulatory Structure ("Paulson Report"). Publication of the report had obviously been accelerated in response to Bear Stearns' failure, so its quality was uneven. Nonetheless, its main point was clear: an urgent need to overhaul regulation of the financial system was the official wisdom.

The Paulson Report said the United States requires an efficient regulatory framework geared to the markets and products that exist now in place of our current Jackson Pollock canvas with its multilayered, multidirectional messiness. An efficient regulatory scheme would entail both more regulation and a realignment of regulatory power. Recent events have reinforced the need identified by the Paulson Report. Certainly, the clamor for action is there.

But the discussion is going wrong: too much “more”; too much “get tough.” Not enough asking questions: what does the market look like today; what are the products; who are the

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1 Cf. Peter Townsend (THE WHO), Won’t Get Fooled Again, WHO’S NEXT (1971).
2 The papers delivered at the conference and other related papers are posted at: http://www.cadwalader.com/view_events_resources.php?page=213.
4 The Paulson Report was certainly flawed and, given the pace of events, it has already become somewhat outdated. Since the report’s publication, the GSEs have been guaranteed by the government (contrary to the report’s premise); money market mutual funds have “broken the buck” and received a federal guarantee (contrary to the supposed separation of banking and securities); Lehman and a number of thrifts and banks have gone under; and Madoff has been uncovered.
participants; what regulations; which regulators; for what purpose; at what cost; what will be the effects; how will success be measured?6

The discussion is nostalgic. There are longings for the return of Glass-Steagall. But our current reality is that banking and securities activities are inseparable. Similarly, attacks on hedge funds and derivatives seem a reaction to the shock of the new detached from empirical considerations.

The realignment of regulatory power called for by the Paulson Report would necessarily require that some governmental entities lose power. The “losers” would include (i) the states, (ii) certain existing federal agencies and (iii) implicitly, Congressional committees that supervise any federal agencies that lose power. Unfortunately, this call for realignment of government is being drowned out by the shouts for “more.” But a further smattering of rules won’t turn Jackson Pollock into Mark Rothko.7

Rather than a questioning of what works, there is the editorial demand that regulators “get tough,” as if neither the front page nor the sports page had enough violence. But financial institutions are not inflatable punching bags that can be expected to wobble back up after every good wham in order to be given another good wham. Nor do they simply re-inflate after paying $100 million fines to fill the enforcement coffers. They are essentially fragile Samsons, prone to collapse in the case of any shearing off of their counterparties’ confidence. What we need is not a culture of tough enforcement, but rather one of informed regulation and oversight, one based on economic and psychological theory, and moral tenets,8 and one that can be tested in practice—what works, what doesn’t.

Given that we are now at the dawn of the new regnum, the time is right to return to the issues raised by the Paulson Report in light of subsequent events. As the issues covered in this memo range broadly, I have organized them somewhat roughly through the structure of looking at past, present and future.

6 I suggested some of the questions that we should ask about our financial markets in the papers for our May 2008 conference. See Steven Lofchie, Reinventing Financial Regulation (Cadwalader Conference Paper, May 2008), available at http://www.cadwalader.com/docs/lofchie/RegReform2.pdf. Those questions included reasonably basic facts such as who are the participants in the market and what do they look like.


8 Even a basic economics has to incorporate some view of psychology or of human nature, e.g., greed. It is, in theory, possible to have an economics which incorporates psychology, but not a value system. Such an economics would be purely descriptive. On the other hand, regulation must inherently incorporate values, since it is intended to control and direct human behavior to some end. Cf. JOSEPH SCHUMPETER, HISTORY OF ECONOMIC ANALYSIS (1954) (Chapter on Scope and Method, Economics and Philosophy).
In the past section, I try to briefly make the point that we cannot return to a golden past—there was no Atlantis. I also express my skepticism as to three of the supposed villains of the crisis: (i) the SEC (for allegedly going soft on capital regulation); (ii) derivatives; and (iii) Wall Streeters.

In the current section of the memorandum, I discuss three realities that we ought acknowledge: (i) financial institutions are inherently fragile; (ii) banking and securities activities cannot be separated; and (iii) the paradoxes of internationalization.

Finally, in the future section of this memorandum, I discuss three issues: (i) whether hedge funds should be regulated and for what purpose; (ii) how power should be realigned between governmental entities; and (iii) what should be the culture of the SEC (should it be tougher than Amir Sadollah?).

In summary, I am concerned that:

(i) the analysis of our problems is short-circuited by finding easy or convenient villains;

(ii) by personalizing blame, and by demonizing failure, we downplay systemic regulatory flaws;

(iii) supposed “solutions,” such as the separation of banking and securities activities, are neither realistic nor, even worse, founded in any sound theory;

(iv) calls for “more” regulation are divorced from discussion of what is to be achieved by the regulations;

(v) calls for “more” regulation may cut short a necessary dialog about how to improve the regulatory structure; and

(vi) calls for “tough” enforcement against our crippled financial institutions is largely besides the point; their stockholders are sufficiently punished. The real long term issue is oversight and prevention.

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9 Even if there had been an Atlantis, given the current state of the financial markets, it would now be deep under water.

10 The upset winner of Ultimate Fighter competition No. 7 – see www.ufc.com/AmirSadollah.
I. The Past: Who Are the Villains

*Stabilizing an Unstable Economy* by Hyman Minsky,\(^{11}\) begins as follows:

As we approach the last decade of the twentieth century, our economic world is in apparent disarray. . . . [Beginning] in the late 1960s, the order of the day became turbulence—both domestic and international. Bursts of accelerating inflation, higher chronic and higher cyclical unemployment, bankruptcies, crunching interest rates, and crises in energy, transportation, food supply, welfare, the cities and banking were mixed with periods of troubled expansion.

The book’s initial chapters describe a number of then recent financial crises, those of 1981-2, 1974-5 and 1969-70. (There have been, of course, several more since the book’s initial publication.)\(^{12}\) Mr. Minsky then posits that financial crises will steadily become worse for a variety of systemic reasons, which he explains in good detail. Since the book’s *1986 publication*, his predictions seem largely borne out, culminating now. Mr. Minsky’s economics are beyond my level, but his description of the market feels accurate. That is, what we seem to have is an ordinary collapse. By saying “ordinary,” I do not mean the consequences are not serious, and even this time extraordinary (as we are now effectively nationalizing significant parts of the banking system), but rather that the causes are routine and fundamental, and these were so in 1986 and before that as well.\(^{13}\) I have quoted Mr. Minsky’s 1986 book liberally throughout this memo to demonstrate how old-news all of today’s new-news is.

In fact, we own an extensive literature as to financial crises of the past. Accordingly, we should not settle for the facile notion that it is the introduction of some financial novelty into the previously stable markets that has caused the downturn and so imagine to resolve our problems by unbiting the apple. By ascribing blame to the novel, we ignore problems that are both basic to and of longstanding in our system.\(^{14}\)

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\(^{11}\) HYMAN P. MINSKY, *STABILIZING AN UNSTABLE ECONOMY* 4-5. The book by Hyman Minsky, an economist at the University of Chicago, received a brief flurry of attention in the press recently, which caused me to buy it. (Some of the press referred to our downturn as a “Minsky Moment,” which sounds catchy, but has nothing to do with the substance of the book, which is about long term policy.)


\(^{13}\) See MINSKY, supra note 11, at 57 (quoting speech by then Fed Chairman Arthur Burns as to concern for the banking system in light of weakness of banks’ regulatory capital, reliance on volatile funds, heavy loan commitments and deterioration in asset quality.

\(^{14}\) See MINSKY, supra note 11, at 5: “A theory that denies what is happening . . . , sees unfavorable events as the work of evil outside forces rather than as the result of characteristics of the economic mechanism, may satisfy the . . . , need for a villain or scapegoat, but such a theory offers no useful guide to a solution for the problem.”
We should also be mindful that villain-finding may be done by those who have an interest in what is found or concealed. Michael Lewis (author of Liar's Poker) recently published an anthology on recent financial crises entitled Panic: The Story of Modern Financial Insanity. In it, he makes the point that, at the time of the 1987 market crash, the SEC identified financial futures as the major cause of the crash. Of course, at that time, the SEC was in a regulatory battle with the CFTC and trying to take control of financial futures from the smaller agency. Just as we can look back at that 1987 SEC report with cynicism, so we should regard some of the current finger-pointing with at least skepticism.

A. Supposed Villain 1: The SEC Went Soft on Capital Regulation.

The SEC Inspector General recently issued two reports (the “OIG Reports”) damning the SEC staff’s supervision of Bear Stearns. The OIG Reports begin with the declaration that the SEC’s job was to regulate Bear Stearns, that Bear Stearns failed and, therefore, the SEC failed. It is the simplistic easy-out set forth in these reports (does the OIG really believe that the SEC staff was so powerful as to be able to prevent the crisis?) that originally motivated me to write this memorandum. In the interests of space, I have scaled back my critique of the reports, but I make two observations below that relate to my overall themes.

i. Failure to Collect Information. The OIG Reports highlight the SEC’s failure to collect from numerous firms the information required by Exchange Act Rule 17h, which generally requires that every investment bank with over $20 million in capital submit very extensive financial information regarding its affiliates. There was a problem here—but not that the SEC failed to collect Rule 17h information. Rather, the problem was that the SEC did not repeal or scale back this Rule. Consider, in the scale of the U.S. economy, how small $20 million is. It is not even enough money under management to qualify a firm to register as an investment adviser with the

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16 See Report by the Division of Market Regulation, U.S. Securities & Exchange Commission, The October 1987 Market Break at 3-3 to 3-9 (February 1988). The Division of Market Regulation asserted that “futures trading and strategies involving the use of futures were not the ‘sole cause’ of the market break. Nevertheless, the existence of futures on stock indexes and use of the various strategies involving ‘program trading’ were a significant factor in accelerating and exacerbating the declines.” Id. at xi.


18 Exchange Act Rule 17h-2T.
There is simply no use for so much information that is so trivial. However, rather than reexamine the Rule and either repeal it or moderate its uselessness, the SEC left it to accrete along with the other outdated SEC rules that serve no policy beyond being an enforcement threat to the unwitting.20 (I will return to a discussion of the enforcement culture of the SEC in Section V.)

ii. Liberalization of the Capital Rules. According to the OIG CSE Report, the SEC liberalized the capital rules, permitting the level of leverage at broker-dealers to soar by 12x as a result of deregulation, in supposed contrast to the conservative capital regulation of banks.21 This assertion is at best misleading and at worst untrue as the report obfuscates the difference between capital at the broker-dealer and consolidated holding company levels.

In fact, prior to the rule amendments that created the so-called “CSE” capital program, the capital of non-bank-related broker-dealer holding companies was completely unregulated. There was no “deregulation” of such firms, because they had never been regulated. To the credit of the Europeans, they recognized that the absence of holding company regulation was a danger to the global financial system, and threatened to impose such regulation on U.S. financial institutions that were operating in Europe without a regulated holding company. Rather than force the U.S. investment banks to be subject to European regulation, Congress granted the SEC limited authority to supervise investment bank holding companies that opted for consolidated regulation as part of Gramm-Leach-Bliley.22 When the SEC adopted the CSE program to implement this legislation, it offered the broker-dealers a carrot—contingent permission to use internal models to calculate risk haircuts for capital purposes—in part in order to increase its leverage over the holding companies, as Gramm-Leach-Bliley had not provided the SEC with significant enforcement powers at the holding company level. Unfortunately, the ability to revoke the use of models-based capital was an extremely blunt instrument.

As to the comparison of broker-dealers' capital requirements with that of banks, my instinct (and I do not know for sure) is that SEC capital regulation was equal to that of the banking regulators. Most of what one reads in the newspaper are simple numeric comparisons of

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19 The National Securities Markets Improvement Act (“NSMIA”) amended the Investment Advisers Act such that advisers having less than $25 million in assets under management generally do not qualify to register with the SEC. Investment Advisers Act of 1940, § 203A(a)(1)(a).

20 In this case, the unwitting victims of the SEC “enforcement” culture happened to be the SEC staff.

21 OIG CSE REPORT at 19.

debt-equity ratios: 6-1, 12-1, 30-1. These numbers mean nothing without information as to the asset types or the collateral quality or as to the expected sources of repayment or as to the accepted accounting conventions. If the financial institutions are exposed to financial risk that is not accounted for in off-balance sheet vehicles, the fractions might as well be division by zero. There could be an analysis done of bank capital and securities firm capital to equate the numbers, but I have not seen anything beyond the repetition of apple-to-orange ratios.

B. Supposed Villain 2: Derivatives and Other Weird Stuff.

Warren Buffett famously described derivatives as “financial weapons of mass destruction.” This remark echoes more than a yodel. Googling “Warren Buffett” and “derivatives” produces more than 390,000 hits.

I had always assumed that Mr. Buffett was either (i) somewhat playing to the love of the press for one-liners (after all, he makes his money selling insurance, he invests heavily in financial product companies, and he is known to trade derivatives—so he is not exactly in the bricks and mortar business himself) or (ii) making a clever observation that was taken too literally. In fact, what Mr. Buffett said in full had far more substance than the oft-quote. In somewhat greater detail, what Mr. Buffett said was: (i) our accounting system does not deal with derivatives in a very accurate manner, and thus companies are likely mis-marking derivatives on their books and showing false profits; (ii) derivatives can be a form of leverage that, in combination with other leverage in the

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25 See id. at 13-15. The specific point that Mr. Buffett makes is that two parties can enter into a derivative, mark the derivative as having different values, and thus each show a profit, even though only one of them can ultimately make money, a process he calls “mark to myth.” Id. at 13. His implicit view is that a profit should not be shown until profit actually comes in the door.

While his view as to derivatives may be right or wrong, the critical observation that he is making supposedly about derivatives is in fact a more general critique of profit recognition under ordinary accounting principles. Suppose, for example, that a company buys a piece of machinery for $10 million, not a derivative, paying for it full, and in the first year of using that machine, the company makes $2 million of cash flow profit from using that machine. Let’s suppose that the accounting depreciation on the asset is $1 million; in that case, the company will show a $1 million profit. However, if in 4 years, the machine breaks or its output no longer has any value, the company will have ended up losing a lot of money on the machine, notwithstanding that it seemed to show a positive cash flow on the basis of accounting rules.

See also MINSKY, supra note 11, at 228: “In a world in which accounting practices can be creative and in which corporations are complex combinations of different types of operations, the book value of capital assets can have little relation to the value of the capital assets in production.” In short, problems of accurate accounting are endemic to any business that holds assets that cannot be readily marked to market (which is pretty much every business), and are not particularly specific to derivatives.
economy, greatly increases the risk of a bubble popping; and (iii) it is very dangerous for a company to enter into derivatives that tie collateral requirements to its credit ratings, as that subjects it to the risk of needing to post massive amounts just as it enters into a weakened credit position. All of these observations are perfectly reasonable, they are just not so “google-able.”

(Interestingly, what Mr. Buffett has to say about large physical assets—“now let’s move to the gruesome”—is much more negative than what he has to say about derivatives.)

The discomfort with the new or the eccentric extends, I think, to transactions as basic as short selling and to hedge funds (which I will discuss in Section III on the future). As to short selling, I will just say that the SEC and academic studies continue to show that it is a positive for our economy, that it tends to prevent asset bubbles. Now, I have no problem with the SEC regulating short sales (or most anything else) if there can be some empirical demonstration of a problem, followed, hopefully, by an empirical review to determine whether regulation has ameliorated the problem in a cost-efficient manner. I am, however, a skeptic as to faith-based regulation.


I read in the newspapers that one of the automobile executives was quoted as saying something to the effect that “Washington hates Detroit.” This made me feel somewhat better; it is not only those who work in the financial industry who are corrupted.

The problems with the people who work on Wall Street, as I understand them, are numerous. They are (i) unable to assess risk or make decisions accurately, particularly as to “black swan” events; (ii) greedy; and (iii) short-term oriented. Unfortunately, modern science indicates...
that these problems are endemic to the human species. Accordingly, as a society, we are unlikely to do better by throwing the Wall Street bums out and replacing them. There is not, out there, some better, smarter, more decent class of human beings—either raised on the high plains of the West or in the great corn fields of the Midwest—ready to step in and take over Wall Street in place of the bums we throw out. If we want change, we have to change the structure in which we operate and change the rules, because the contestants will look the same in the mirror.

It may seem that I am being cavalier with these remarks as to human nature. I do not intend to be. Any theory of financial regulation, or of any type of regulation, must be based on some view of human nature: of how we are motivated, what we fear, and how we make decisions. Demonization and ridicule of individual financial executives who have made huge mistakes, and sometimes gotten very rich making mistakes or even acting in their personal interests, may be good fun and make for exciting press (and in some cases be cause for enforcement actions against those individuals), but it largely risks ignoring systemic problems that, unlike human nature, may be transformed.

I do note that a good part of the personal criticism has been directed at executive compensation. Now I would be surprised if none of this criticism were fair—it is after all a very standard agent/principal problem that the agent takes advantage of the principal’s assets to the agent’s benefit. However, as with the problems of human nature, excessive executive compensation is not a Wall Street-specific problem.

I think also we need to be mindful of the distinctions (i) between failure and crime; (ii) between failure and inability and (iii) between individual failure and systemic failure. To fail, even to go bankrupt, is not the same as theft. Nor does it mean that the person who failed will not succeed tomorrow, or vice versa. As that great philosopher, SEC, once said, “Past performance is not necessarily indicative of future results.” Many of today’s bums were yesterday’s demigods, and the same may be true of today’s wonders.

30 Notably, the man that we generally think of as the father of capitalist economics, Adam Smith, was primarily a moral philosopher. See, e.g., ADAM SMITH, THE THEORY OF MORAL SENTIMENTS (1759).
33 See MINSKY, supra note 11, at 286 (generally describing the incentive of managers of banks to take on increasing risk and grow so that they may profit as holders of stock options). Likewise, failures associated with leverage, short-term thinking and the like are evident in numerous other non-financial business and in government, and certain of these failures may be found in consumer budgets as well. It is not surprising if we regard them as typical human failings.
II. The Present Realities, Some Harsh

The following discussion highlights three realities that I think we ought acknowledge to redesign the financial system: (i) financial institutions are fragile; (ii) banking and securities activities are inseparable and not easily indistinguishable; and (iii) internationalization can bring about certain paradoxes.

A. Panic Faster: Financial Institutions Are Really Fragile.

President Franklin Delano Roosevelt is famously quoted as saying, “The only thing we have to fear is fear itself.” I think that this remark was intended to mean that (i) if none of us worried that banks would fail and pulled our money out, (ii) the banks would not fail and (iii) we would all be fine. Just like the movie, “It’s a Wonderful Life.”

i. There Are No Long Slow Deaths. As a lawyer who works in the financial industry, I was intrigued when the CEO of General Motors announced that if he did not receive government financing, GM would be out of business in five months.34 If the head of a financial institution had made the same statement, the institution would have been out of business before the testimony concluded. The practical reality of managing money is, in fact, the opposite of President Roosevelt’s advice. In the Oz of financial markets, the king is the Cowardly Lion.

The “lesson” of Bear Stearns to money managers was: Panic! When you see that a financial institution is in trouble, get out. The value of Bear Stearns disappeared at a somewhat fantastic clip—unless of course you compare it to the declines experienced by Drexel Burnham, E.F. Hutton, Barings, Refco. That is the way financial institutions fail: hard, fast and completely.

As fast as Bear Stearns fell, its bond holders and customers did not lose money. Thus, the lesson of Bear Stearns were discounted. When Lehman crashed, this time, not only the stockholders lost. Creditors and customers were bereft. The lesson of Lehman was, thus, “You Fools, Didn’t Bear Stearns Teach You to Panic?! Now Panic Faster!!!” This time, the market got it. There was a run of confidence on virtually every financial institution.35


35 See generally Minsky, supra note 11, at 63 (a run will quickly take place on a bank known or believed to be in difficulty).
ii. Financing Structures and Vulnerability to Default. One of the criticisms made of the failed financial firms was that their capital structures were deficient; that their assets were too long-dated as compared to their liabilities. This may be a reasonable concern, but it is not readily correctable.

The notion of a matched asset-liability structure generally assumes that a financial institution can be confident that one half of its counterparties (the borrowers) can be expected to do business with the financial institution in spite of its weaknesses, because, after all, why should they care: they borrowed money. Then, the financial institution just needs to worry about the other half of its counterparties, the lenders. If the financial institution can just match the term of its commitments from its lenders with the term of its commitments to its borrowers, its asset-liability structure will match up, and it will be OK in a crisis.

But just locking up the lenders does not work in the securities markets. When a financial institution makes a loan on securities (very liquid and salable collateral), it faces an additional problem. In short, when a financial institution lends out money and receives in securities having a market value in excess of the loan, it then turns around and uses this liquid collateral as collateral for its own borrowing to fund the financial institution itself. In effect, the financial institution, by taking in liquid collateral and reusing that collateral, is borrowing from the borrower. The borrower has become a lender—or, to be more exact, both sides to the transaction are borrowers, and both sides are lenders. In this situation, the “borrower” is actually very fearful (notwithstanding Franklin Roosevelt’s words of strength) that the financial institution may suddenly collapse, because the borrower has delivered securities collateral to the financial institution in excess of the amount of cash that it has borrowed from the financial institution, and this excess collateral is at risk in the financial institution’s failure.

Thus, in the financial markets, where the underlying collateral is liquid assets, both borrowers and lenders are ready to panic if the financial institution should wobble. As a result, even if the financial institution locks up the lender side of its balance sheet, the borrowers are nonetheless likely to flee, and because the borrowers are also effectively lenders to the financial institution, their fears can pull the institution down.

iii. Ramifications for Enforcement. Acknowledging that financial institutions are fragile has a number of very significant regulatory implications. As to enforcement (a topic that I will discuss in more detail later), I think one must question whether the United States can tolerate an enforcement regime where any one of over fifty regulators (e.g., the State regulators) has the power to threaten disciplinary proceedings that could put the institution out of business by threatening investor confidence in the institution, even before a case went to court. This is not a “free market” argument against regulating financial institutions: on the contrary, the regulatory regime requires a strict approach to oversight so as to maintain market discipline and protect
consumers. However, penalties for violations must be reasonable and proportionate; and they
ought be delimited in a manner that does not give power to numerous local government officials to
destroy national financial institutions and threaten the national financial system. (I take up the issue
of State regulation again in Section IV.D.)

iv. Ramifications for Prudential and Systemic Risk Regulation. The size and
interconnectedness of today’s financial institutions increase systemic risk. The fragility of our
financial institutions makes that risk particularly difficult to address. Because our financial
institutions are both huge and fragile, there is little time for regulators to design a response once a
problem has surfaced and confidence has been shaken. By the same token, the governmental
regulation of risk taking by the private sector in order to prevent risk that is “excessive” for the
market is something that no real-world regulator is likely to get right all of the time (thus we should
consider how much the government is capable of before we impose on it more than it can do). And
efforts by the government to buffer the market from such risk-taking (either before or after a crisis
develops) creates the moral hazard that market participants will rely overmuch on the government’s
inherently imperfect oversight.

I believe the regulatory response should include creation of an overall capital
regulator for financial institutions (as discussed below), much more day-to-day contact and
information sharing between oversight-oriented regulators and financial institutions, and the further
development of non-bankruptcy liquidation procedures for financial institutions based on our
experience of what happened at Lehman Brothers. Little of this will be helped by getting “tough.”
Instead, we need to take the opportunity to explore, in the manner of social scientists, exactly how
the problems developed at Bear Stearns, Lehman Brothers, AIG, Wachovia, the Reserve Fund and
other financial institutions and how similar problems developed at other institutions and spread
through our financial systems.

B. Banking And Investment Banking Are Not Separable.

Policy Justification. The common reason for the separation of banking and securities is
given by Joseph Stiglitz, 2001 Nobel laureate, in a recent article in *Vanity Fair*:

Glass-Steagall had long separated commercial banks (which lend money) and investment banks (which
organize the sale of bonds and equities); it had been enacted in the aftermath of the Great Depression
and was meant to curb the excesses of that era, including grave conflicts of interest. For instance, without
separation [of commercial and investment banking], if a company whose shares had been issued by an
investment bank, with its strong endorsement, got into trouble, wouldn’t its commercial [banking] arm, if it
had one, feel pressure to lend it money, perhaps unwisely? An ensuing spiral of bad judgment is not hard to foresee.36

**Can It Be Tested?** At first read, this defense of Glass-Steagall seems plausible. But ultimately, it is an empirical question. If true, there should be plentiful examples of situations in which commercial banks made bad loans to support their investment banking operations. Further, one would expect that the large European banks would suffer from a tremendous amount of such loans since they do not separate investment and commercial banking.

Until there is some empirical research and demonstration in support of the proposition, my guess is the opposite of that of Mr. Stiglitz. For starters, seldom is a particular corporate issuer so identified with a particular investment bank that, if the issuer were to fail, the investment bank would be stigmatized. Its hard to see why an investment bank would pressure its affiliated commercial bank to, for example, make a $1 billion loan, for some tenuous reputational boost.

My intuition is that Mr. Stiglitz's description of banking (banks “lend money”) and investment banking (investment banks “organize the sale of bonds”) implies a greater distinction than now exists. His implicit description of banking is that banks make loans and hold those loans on their books until maturity. But, in our market, banks make loans and then syndicate (sell) the risk, or a good part of the risk, on those loans to buyers such as other banks or investors such as money market mutual funds, insurance companies or hedge funds.37 This syndication may be through the sale of whole loans, through loan participations, through pooling the loans in securitized investment vehicles or through derivatives that have a similar effect, such as credit default swaps. Meanwhile, advances in the technology of asset-based lending have allowed securities firms, money market mutual funds and other financial intermediaries to become “shadow banks.” I believe it would be a more accurate description of our financial markets to say that (i) commercial banking is the business of organizing the sale of loans and (ii) investment banking is the business of organizing the sale of bonds. To me, those businesses are very close.38

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37 I note that my questioning of Mr. Stiglitz’s hypothesis is in fact consistent with (or I flatter myself that it is consistent with) Mr. Stiglitz’s general approach to economic thinking. Mr. Stiglitz is known as an economist who has strongly rejected oversimplified “model” based economics in favor of dealing with the world as we know it. See Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, NOBEL PRIZE LECTURE (Dec. 8, 2001), available at http://nobelprize.org/nobel_prizes/economics/laureates/2001/stiglitz-lecture.pdf. In fact, his views on the cost of information are central to the direction I believe regulation should take going forward.

38 And here is what Mr. Minksy has said:

The clear distinction between commercial banks and investment banks that rules in the United States over the post-World War II era was a creature of the reforms that followed the Great Depression. This distinction is currently breaking down [remember the book was published in 1986], and it never really existed in other capitalist economies, such as Germany’s. Furthermore, as the financing of activity and asset holdings as well
**Does It Matter?** Even if you believe that “Enlightened Policy” requires the separation of banking and securities activities, such a separation is no longer a practical option in light of the actual structure of the market in the United States. There is no remaining major independent securities firm not affiliated with a bank. Nor, in a world where securities firms have grown large enough to create systemic risk, is it easy to imagine how such a major independent firm could come into existence. Banking firms have two funding advantages that securities firms do not: (i) access to federally insured deposits;39 and (ii) an ability to borrow from the federal government.40 This means that banking institutions can survive financial panics. Large stand-alone securities firms may, perhaps, be able to, but no big institution is ever likely to make that experiment again.41

**C. Internationalization, Competition and That’s Gratitude for You.**

**Cooperation and Competition.** It is a necessity of a sound global financial system that the United States cooperate with other jurisdictional regulators. For example, control of insider trading clearly depends on our ability to obtain information as to trading in U.S. securities that takes place overseas.

At the same time that we cooperate, we must also recognize that we are in a global competition to construct a better financial system that will increase employment and investment in the United States. As we impose regulations, we have to be aware that the imposition of the regulations affects our competitiveness and our ability to create jobs. This does not mean the adoption of regulation is inconsistent with job creation. Sound regulation that increases financial stability will over the long run increase investment and jobs. Inefficient regulation and wasteful litigation will have a damaging effect on our long run ability to create jobs. As we adopt more rules, we ought not forget that the larger goal is increasing social welfare.

**Businesses and Gratitude.** In a global capitalist economy, the executives of large companies generally do not see themselves as serving domestic national interests. Their overriding and proper purpose is to make money for their shareholders (within the limits of applicable

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39 The Federal Deposit Insurance Corporation ("FDIC") currently guarantees up to $250,000 per depositor at insured banking institutions.

40 Banking institutions that are members of the Federal Reserve System may borrow funds from the Federal Reserve at the “discount window.” Non-banks, as well as banks that are not members of the Federal Reserve System, do not have this privilege – which is coveted because of the lower funding costs associated with borrowing from the Federal Reserve. See generally The Federal Reserve Discount Window (March 17, 2008), available at http://www.frbdiscountwindow.org/discountwindowbook.cfm?hurlID=144dltID=43.

41 Interestingly, Minsky (at 355) makes the argument for the complete repeal of Glass-Steagall so that regional banks could enter into the underwriting business. Though outside the scope of this memo, his arguments ring sensible to me.
Further, they must be able to raise money in all jurisdictions, purchase capital assets where they are cheapest, find talented help around the world, and attract customers globally. If these corporate executives were to be perceived as favoring the interests of one national jurisdiction over another, their corporation and global business prospects would undoubtedly suffer. One can imagine that American customers would be less likely to buy the products of a French company if its executives were to announce that they tended to favor French interests in all their decision making, and vice-versa.

However, the extent to which companies are truly “international” is not unlimited. It is understood that certain national economies and national interests are more significantly intertwined with the interests of particular financial institutions. Accordingly, when UBS required a capital injection, it obtained that injection from the Swiss government. The UK government is making capital available to Abbey, Barclays, HBOS, HSBC, Lloyds TSB, Nationwide, Royal Bank of Scotland, and Standard Chartered. The French government has made capital available to BNP Paribas, Société Générale, Crédit Agricole, Caisse d’Epargne, Banque Populaire, and Crédit Mutuel. The Irish government guaranteed the general obligations of its banks. The United States has invested equity in over 200 banking institutions, all American organized. One question that we must therefore face is how do we regulate and support financial institutions (and other companies) whom we regard as domestic and so whom we may favor, but who do not (and really can not) particularly favor the country back.

I do not know the answer to this question. But I would make some basic observations:

U.S. regulation inherently must to some extent serve U.S. interests. This means developing a regulatory structure that encourages the creation of jobs in the United States, and corporate investment here, and the location of corporate transactions here.

Over the long haul, we will have a hard time sustaining investment if we continue along the track of maintaining high regulatory walls around the country to “lock in” U.S. investors and prevent them from sending capital abroad. Institutional investors (mutual funds, private funds, large corporations, insurance companies, rich individuals) are unlikely to have significant problems avoiding any lock-in requirements; they all have overseas investment arms. At the same time, we can no longer assume that our market is so attractive to outside companies that they will scale high walls to get in. If it is not attractive to invest in the United States (and create jobs here) people will

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not invest. This means that we have to compete by being better (which includes providing better investor protection). More regulation is fine, but it has to produce results in line with the costs.

III. The Future of Financial Regulation (Issue Number 1): Hedge Funds

As we prepare to expand the scope of regulation, we should consider the costs and benefits of what we want to accomplish and whether we can in fact accomplish our goals. Talking about “hedge funds” is, I think, a good way to take on these general questions.

Why regulate hedge funds? As the term “hedge fund” is not legally defined, I will create my own: “a legal entity that (i) pools money from 2 or more rich individuals for the purpose of making the 2 rich individuals even more money by investing in financial assets and (ii) is managed by a 3rd rich individual.”

So what is it about these 3 rich individuals that requires protection (either of us or of them). There are three potential answers: First, we want to protect the 2 rich individuals from being disadvantaged by the 3rd. Second, we want to protect the public markets from illegal trading arranged by the 3rd for the benefit of the first 2. Third, we want to know what the legal entity is doing so that we can make national economic policy decisions on a fully informed basis.

Identifying a purpose for hedge fund regulation is essential as that identification will define the rules that we adopt and how those rules are implemented, as well as how their success can be measured. It will also define the types of hedge funds that we regulate. For example, if the purpose of regulating hedge funds is to protect investors, the relevant rules might include revised limits on the types of investors and regulations governing such matters as communications with investors, custody and valuations. Very likely, it would also require regulating smaller hedge funds since I believe that such frauds are more likely at small organizations. If the goal, on the other hand, is to protect the markets against crime by hedge funds, the regulations might focus on obtaining information about the positions that hedge funds take in publicly-traded securities and their

See Steven Lofchie, SEC Issues Proposed Amendments to Rule 15a-6 (Cadwalader July 2008), at 21-22, available at http://www.cadwalader.com/assets/client_friend/070908SECAmends15a-6.pdf: “For all its failings, and there are many, the U.S. regulatory system provides numerous protections to investors, and the SEC should provide a means by which U.S. firms can vigorously compete outside the United States by offering non-U.S. investors access to the protections that U.S. regulation affords.”

See, e.g., Peter Drucker, Managing the Public Service Institution, in PEOPLE AND PERFORMANCE (2007), at 137.

Achievement is never possible against specific, limited clearly defined targets. . . . Only if targets are defined can resources be allocated to their attainment; priorities and deadlines be set, and somebody be held accountable for results. But the starting point for effective work is a definition of the purpose and mission of the institution—which is almost always “intangible,” but nevertheless need not be vacuous.

See also MINSKY, supra note 11, at 9 (need to establish political and social objectives).
derivatives. If the goal is to obtain information that may be relevant to the economy as a whole, then we would be more concerned with information as to investment strategies and aggregate levels of investment and potential disinvestment. If protection of the economy is the goal, we would focus on the regulation of large funds.

Whichever of the three purposes we decide to prioritize, we should also have some sense of the costs, who is going to bear those costs, how effective the regulations are likely to be, and whether the money used will be taken away from a better cause (in effect, I think we should assume that regulatory oversight is an expensive good and we cannot purchase an infinite supply of oversight).45

**Protecting Investors and Preventing Madoff?** Whatever regulations we adopt as to hedge funds, and for whatever purpose, we should have a sense of whether they are likely to be effective. This is particularly the case where government regulation may result either (i) in an increase in hedge fund investment on the assumption that government regulation will protect investors or (ii) a lessening of care by private investors based on a belief that the government will protect them.

For example, it is certainly not inconceivable that, in the wake of the disinvestment in hedge funds caused by the Madoff fallout, an increase in government regulation could encourage greater investment in hedge funds by investors (pension plans, charitable foundations, rich orphans) who would otherwise be scared off. Similarly, investors who might otherwise decide that extensive due diligence is necessary prior to a hedge fund investment decision may relax their care in light of the calming effect of increased government regulation (the so-called moral hazard problem).

My personal view is that it will not be easy for the government to monitor hedge funds for the purpose of protecting investors. Their capital structures and the investments that they are permitted to make are far more complicated than are those of 1940-Act registered investment companies (“RICs”).46 That is, open-end RICs generally buy publicly traded securities and hold them at a custodian. RICs may to a limited extent engage in short selling, and in other reasonably

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simple financial transactions, such as repurchase agreements or securities loan agreements. In
terms of complexity, RICs do Finance 101.

There are hedge funds that also follow the Finance 101 model. But there are many that do
not, that are at Finance 501. These funds invest in everything from public securities to actual real
estate to bonds issued by Polish nursing homes. Further, these funds may have complicated
hedging strategies; e.g., buy Polish nursing home debt and hedge with a credit default swap on
Polish government securities and a long term non-deliverable forward on zlotys.

Assuming that we are not going to make Finance 501 illegal, the question is, do we really
believe that the government will be effective in overseeing the financial risk of large numbers of
hedge funds engaged in Finance 501. Before we put this on the SEC’s plate, we should be
comfortable that we have the resources for the SEC to regulate broker-dealers doing Finance 501.
I think for the SEC to take on Hedge Fund 501 effectively (there are far more hedge funds than big
broker-dealers), and maintaining their ability to do so, would be enormously expensive. It would
mean a tremendous increase in the size of the SEC staff, the amount of training that would have to
be given to that staff, travel costs, and the like. Is this a good regulatory expense?

To put this in military terms (and to exaggerate for color), the difference between inspecting
hedge funds and inspecting RICs is like the difference between invading Iraq and invading
Grenada. It may be worthwhile to invade Iraq, but it will be complicated and expensive. Further, as
to hedge funds, we can never call the inspectors home; they will have to be constantly deployed,
retrained, supported and replaced. Also, as we are invading, we should bear in mind that this will
not be a one-front regulatory war. There will have to be more efforts with respect to mortgage
lenders, mutual funds, banks and broker-dealers, not to mention rating agencies, accountants and
ordinary corporate issuers.

In short, taking on hedge funds is going to take a lot of firepower. And resources sent to
one front will be lost to another.

I also note that there already is an industry of companies out there that oversees hedge
funds, the “fund of funds” industry. Obviously, some of those entities failed with respect to Madoff,
but so did the government. Why is it that, following Madoff, we would expect that the government
would improve its regulation of hedge funds, but the fund of funds industry would not also improve?

**Ramifications of Regulation of Hedge Funds to Prevent Madoff.** My own instinct (and I
don’t want to say that it is more than that) is that the comprehensive regulation of hedge funds for
the purpose of protecting hedge fund investors is not a prudent expense of the government: it is
too complicated and expensive and it diverts attention that should be paid to other goals. Even if I
am to be judged wrong, I would prefer that I be judged wrong after a real study of the issue. This
means that—rather than just decide that hedge funds “should” be regulated—the government should consider what such regulation would entail. That is, (i) what would be the costs of the regulation, (ii) for how long would those costs have to be sustained (presumably forever); and (iii) how effective would such regulation be at preventing fraud or misconduct, and fraud of what types?47

The government should also make a reasoned judgment as to whether such regulation would likely result in an increase or decrease in hedge fund investment. If, for example, the added safety of government regulation has the effect of increasing investment in hedge funds at the expense of investment in mutual funds or direct investment in corporations, is that an effect that the government wants?48

Ramifications of Regulation of Hedge Funds to Monitor Systemic Risk. On the other hand, I do believe that there is benefit in the government monitoring the largest hedge funds so that the government can attempt to understand the effect that these funds have on the economic system. Such a scheme would not have as its end-goal investor protection, but economic understanding.


It is an unfortunate fact that regulatory power is not a zero-sum game. That is, one regulator’s gain of authority is not another regulator’s loss. We can have duplicate regulation, overlapping regulation, regulation that is inconsistent, regulation that incorporates other regulation, regulatory coordination, and regulatory turf wars. We have regulators that examine other regulators and regulators that are examining themselves.

In the first part of this section, I would like to establish some general principles of designing a regulatory system. In the next section of this memorandum, I would like to take up some of the specifics of who should be the regulators: e.g., the need for an overall capital regulator, the role of the SROs and the role of the states. In fact, it is probably the overarching thesis of the

47 See generally MINSKY, supra note 11, at 268 (questioning, as to banks, how effective banking examination is at a complex financial institution).

48 Rather than regulate hedge funds more closely, an alternative that might be considered is liberalizing the investment restrictions that currently apply to registered investment companies. There are many types of investments in which RICs cannot compete with hedge funds because the law does not allow it, thereby giving hedge funds something of an open field.
Paulson Report that regulation be more centralized, meaning that the number of regulators be reduced.49

A. General Principles.

Assuming that you were starting from scratch, how would one set up the regulatory system? I would begin with some basic principles:

First, I would want a relationship between (i) responsibility and (ii) power. At its most basic, this means that if there is a federal insurer that is responsible for overseeing that banks do not take on too much risk, the agency must be accountable for its failure to monitor or control risk appropriately. However, before such an agency can be held responsible, they must have the power to carry out the task. Conversely, it also means that I want to reduce “free rider” regulators, by which I mean regulators who feast on enforcement revenues without being responsible either for actual regulation or for bearing the cost of the failure of a regulated institution.

Second, I would want efficiency of regulation, reducing the amount of overlapping and duplicative regulators. To begin, if we have ultimately only one federal insurer of banks, then it is inconsistent with that unitary responsibility to have multiple regulators and overseers of bank capital. Beyond that, where multiple regulations apply, it is enormously expensive to even track them, let alone, to institute systems for their compliance.

In the same vein, I want to minimize regulatory arbitrage. I concede that weighing against the advantages of minimizing regulatory arbitrage is that we may lose the benefit of having a “marketplace for regulation” allowing us to see which method of regulation appears to work best. That would be a real loss, although I actually think there are very few places in our regulatory scheme where we are able to evaluate whether Regulator A does a better job of regulation than Regulator B. On what basis can we compare the securities regulation in North Dakota with that in West Virginia or California? Who makes such comparisons?

Regulatory competition only exists if (i) it is possible for an entity to choose its regulator; (ii) that regulator takes responsibility for the success and failure of the entity; and (iii) the jurisdiction empowering the regulator bears the costs of failed enforcement.

B. Single Capital Regulator.

I believe we need a single financial (capital) regulator able to deal with systemic risk.50

But Not Because the SEC Screwed Up. The common view is that the SEC should be divested of prudential regulatory authority because it has done a bad job regulating capital—liberalizing leverage excessively in comparison to the more conservative banking regulators.51 As I said above, I am not aware of any basis for this beyond the apple-orange ratios in the newspapers.

My view as to the single capital regulator also has nothing to do with giving the government better control of the money supply. (Although this may be a good reason, I am not qualified to express any opinion on it.)

The Confidence Factor. Rather, the reason I believe that there should be one ultimate capital regulator for the major bank/broker-dealers is that both banks and broker-dealers are inherently fragile, subject to sudden meltdown in the case of any loss of confidence in their stability. What follows from this, based on my observations following the fall of Lehman and other institutions, is that (i) no broker-dealer could survive the failure of a large affiliated bank and (ii) no bank could survive the failure of a large affiliated broker-dealer. Accordingly, the affiliated bank and broker-dealer are inherently linked to each other through the shared risk of confidence failure, even if there is no obvious credit relationship or dependence between the two of them.52 Since each is at risk for the other’s failure, there is no benefit in having separate financial regulators for the two of them; it simply results in the regulated entities attempting to arbitrage the system, putting each type of asset or position in the particular regulated entity that has more liberal regulation as to that particular asset or position.

As Applied to Money Market Mutual Funds. I think a similar argument might be made that a bank cannot survive, or would at least be severely weakened by, a money market mutual fund that the banking organization manages “breaking the buck.” It is certainly notable that quite a number of banking organizations purchased assets at (presumably) above market values from their affiliated money market mutual funds. This suggests that either the bank or the banking regulators believe that the failure of the money market mutual fund would severely damage the bank (or the general credit system).

50 The Paulson Report proposed the “Prudential Financial Regulatory Agency” to take on this role. See PAULSON REPORT at 157-70.

51 Cf. OIG CSE REPORT at 10-13.

52 The Paulson Report also recognizes the importance of oversight over affiliates of the entity subject to prudential regulation. See PAULSON REPORT at 162-64.
In any case, the crisis has made clear that money market mutual funds serve as quasi-banking institutions.\textsuperscript{53} That is, customers buy fund shares (which are apparently the moral equivalent of deposits) and the mutual fund uses the “cash deposits” to lend money on a short-term basis. The interest that the mutual fund makes on its loans is then returned to its shareholders. One supposed difference between banks and mutual funds was that the banks’ deposits were federally insured up to $100,000 (now raised to $250,000) and the mutual funds’ “shareholders” were not. This distinction in insurance treatment has now been partially erased by reason of the New York Fed’s Money Market Investor Funding Facility (“MMIFF”), which is providing liquidity to money market mutual funds that do not receive FDIC deposit insurance coverage.\textsuperscript{54}

\textbf{Another Seat at the Table.} One of the minor themes of the Paulson Report is the need for the various regulatory bodies to coordinate their activities. In this regard the Paulson Report mentioned the Federal Financial Institutions Examination Council, which facilitates coordination among the banking and thrift supervisors, as well as the “President’s Working Group on Financial Markets,” which loosely facilitates policy coordination among the Fed, CFTC and SEC. Missing from this alphabet soup is the IRS.\textsuperscript{55}

It has always struck me as odd that the financial regulatory agencies in Washington seem to operate separately from the taxing authority. To a great extent, our financial instruments and structures are driven by tax considerations. For example, the deductibility of interest expense obviously favors debt financing over equity financing, which means that any rational business person should borrow to the hilt (although rational business persons may differ as to how high the hilt). Therefore, it is of no effect to decry the stupidity of leverage if the tax system rewards leverage. The degree of financial risk that we accept in our economy is as much a factor of our tax structure as it is of our regulatory structure.

C. Self-Regulation.

I believe self-regulation is a pretense, even if it is thought a practical one for hiding regulatory expenses, with which I think we should be uncomfortable and certainly should not spread. Either the self-regulatory organization (“SRO”) is (i) captured by the industry in which case it cannot do an effective job of regulation or (ii) captured by government, in which case it may be an


\textsuperscript{55} See \textit{Paulson Report} at 43-44; 75-77. The Paulson Report recommended “expansion” of PWG membership, but did not include the tax authorities.
effective regulator, but we are disguising the hand of the government in a way that I think inappropriate.56

My point is demonstrated by the events of the last several weeks. First, Mary Schapiro, the head of FINRA, the most significant SRO, is nominated to be Chairman of the SEC, the most significant securities regulatory organization.57 Ms. Schapiro is well-respected within the securities industry - that is, she is a well-respected and experienced regulator, and she is moving from one regulatory job to another, not from the “industry” to a regulatory agency.

On the other hand, Mr. Madoff, one of the leading industry representatives in FINRA (formerly NASD), is under house arrest. Conceding that this is an anomaly, my point is that you cannot reasonably expect one business to supervise another. Businesses are engaged in trying to make profits. It is reasonable to expect them to obey the law and not to collude in others’ criminality. It is naïve to expect them to police each other except to the extent that each of them thinks it is likely to gain some advantage by impeding the other’s business.58

The above paragraph may seem to suggest that I believe FINRA is a weak regulator, as it has been captured by the industry. That is not true. FINRA is a very strong regulator; it has been captured by the government. I just believe that if the government is going to do something, it should not operate through a hidden hand.59

Paulson Report and the Benefits of “Self” Regulation. The Paulson Report, in contrast to my own views, recommends the extension of the “self” regulatory system to investment advisers.60 It does this while it hardly says a single word about either the success or failings of the


58 “People in the same trade seldom meet together even for merriment or diversion, but the conversation ends in a conspiracy against the public and in some contrivance to raise prices.” ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS bk. I, ch. 10, para. 82 (1776).

59 It is a very imperfect analogy, but I will make it anyway: the Government Sponsored Enterprises.

The Paulson Report asserted that the market is under a “misapprehension” that the GSEs are really government entities and their debt is guaranteed by the government. Of course, there was no misapprehension; the GSEs were really government entities and now their debt is explicitly the taxpayers’. Just so, the SROs are really government entities, even if profitable ones.

60 See PAULSON REPORT at 122.
self-regulatory system. In fact, the most substantive discussion of SROs in the Paulson Report says that the SEC regulates securities exchanges with too heavy and slow a hand. That just demonstrates governmental control of the supposed self-regulatory system, it does not argue for an actual self-regulatory system.

The Paulson Report explains the benefits of pseudo-self-regulation as follows:

Although a federal regulator typically oversees SROs . . . , the industry directly bears the costs of regulation, which results in significant savings to taxpayers. An SRO can raise revenue through . . . fees paid by its members. This private source of funding for SROs may be even more flexible than that for government regulators, which typically depend upon Congress and an annual appropriations process.

Self-regulation is not free of criticism. . . . Self-regulation is also susceptible to a wide range of conflicts of interest, including the potential that the SRO may have a financial interest in its members or their business activities. Many of these potential problems, however, may be practically dealt with by . . . requiring that a majority of an SRO’s board members or policymakers are from outside the industry (i.e., independent) and that consumer and investor interests are well represented.

Translated into plain English, I read this as, (i) self regulation does not work, (ii) but we don’t advocate for actual self regulation since the supposed “self” regulators are controlled by supposed “independent” people; i.e., government regulators who cannot otherwise get enough funding from Congress, and (iii) this allows the government to get away with hiding the costs of what is essentially a user tax on the securities industry by keeping it off the government's books.

D. State Regulation.

One of the most notable aspects of the Paulson Report is its skepticism about state regulation, due in good part to the lack of accountability. The Paulson Report suggests a variety of mechanisms through which the states may make themselves heard without being able to put financial institutions out of business. For example, the Paulson report recommends that (i) “state authorities could be given a formalized role in [the federal] rulemaking process" and (ii) "states could also play a role in monitoring [emphasis supplied] compliance and enforcement.”

The Power of the States and Mr. Spitzer. I would posit that any discussion of state regulation may begin and end with the career of Elliot Spitzer. He is, to my mind, both the paragon of its successes and the devil of its dangers. As between the two, I think the dangers are greater.

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61 Id. at 111-12.
62 Id. at 123.
63 See generally Karmel, supra note 56, at 39-44.
64 PAULSON REPORT at 21.
(Perhaps there is some middle ground that can be reached, which is what the Paulson Report suggests.)

It is necessary to begin by giving credit to Mr. Spitzer. He raised two issues as to certain firms in the securities industry that had not been surfaced by the federal regulators (although interestingly both issues had been raised by academics): the production of research allegedly subject to conflicts of interest and late trading in mutual fund shares. These issues gave Mr. Spitzer tremendous press and publicity, which perhaps creates a different kind of conflict of interest for someone as ambitious as Mr. Spitzer.

I believe what ultimately drove Mr. Spitzer was political ambition, not a sense of appropriate conduct. At the height of his acclaim, he not only rose to become Governor of New York, he was touted as a Presidential candidate. To further this ambition, he was motivated to impose fines that could not be realistically challenged and to impose rules on the production of research that I believe were not well considered.

When I say that Mr. Spitzer’s penalties could not be challenged, what I mean is that any financial institution challenging Mr. Spitzer would have risked having him seek an injunction or criminal action against the firm, which could have put the firm out of business, even if Mr. Spitzer’s legal action had not ultimately succeeded.

To further explain, it is illustrative to read the story that former SEC Chairman Arthur Levitt tells about himself in his book. According to Mr. Levitt, when he sought to change the rules governing the interaction of accounting firms and securities firms, the accounting firms were initially strongly resistant. However, as a result of violations that the SEC had uncovered at one of the accounting firms, Mr. Levitt was basically able to tell that firm that either it went along with what Mr. Levitt wanted or he could put the firm out of business. Now, as to the general issue on which Chairman Levitt was fighting, I am inclined to believe that Mr. Levitt was in the right. However, it is not easy to feel comfortable with that degree of power in one person, even when that person is the


68 ARTHUR LEVITT, TAKE ON THE STREET (2002). An excerpt of the book is available online at http://www.businessweek.com/magazine/content/02_39/b3801097.htm.
Chairman of the SEC and he is not angling to be elected to a higher job. I am even less comfortable when that person is 50 different state attorney generals, each potentially currying favor with the press, and each potentially with further political ambitions.

I would liken this dispersion of power to nuclear proliferation: there are a lot of officials out there who can drop the bomb on a securities firm. (That is overdramatic, but this is a long memo!). Even if none of them actually drops the bomb, there is a constant threat that is unhealthy for the financial system.69

V. The Future of Financial Regulation: (Issue Number 3) The SEC and the Culture of War

*It Plays Well in the Press.* Recently, the N.Y. TIMES ran an editorial about Bernie Madoff in which the editorial board announced its opposition to frauds and ponzi schemes.70 According to the N.Y. TIMES, Madoff was an object lesson that the Bush administration’s deregulatory plan had been a failure and that the SEC had to get tough on wrongdoers. This sounds like “real world” thinking. It is not. That the SEC missed the Madoff fraud demonstrates that individuals at the SEC made mistakes and that systems at the SEC should be improved. To say it brings to light that the SEC deregulated fraud or went soft on fraudsters is just wrong.71

Yet effectively the same editorial is written by the SEC’s former Chairman, Arthur Levitt. In his testimony before Congress on October 18, 2008, Mr. Levitt bemoaned “a lessening of corporate penalties against wrongdoers, a reduction in the corporate penalty numbers of the past year, and a demoralizing of the enforcement staff undermining their efficacy.”72 Mr. Levitt’s complaints were picked up by the N.Y. TIMES in a story that said that the SEC was not bringing enough enforcement actions or charging heavy enough fines.73 Further, the N.Y. TIMES reported, many of the staff were dissatisfied with the SEC’s level of review of their ability to bring enforcement actions, and that higher level review had caused morale problems in the SEC enforcement staff.

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71 Interestingly, recent news articles have indicated that the SEC might potentially have had information on Madoff for close to twenty years, evidencing that the failure to catch him was essentially human error, not a change in philosophy.


But Is It Right? As a regulatory and transactional lawyer, this view of the world strikes me as a strange prism.

First, I have no idea whether the level of corporate fines now, recently or at any time in the past is too high, or is too low, or is just right. But there is no logic to expecting fines or enforcement actions to climb constantly as if they were numbers on a sales chart for iPods. Hopefully, penalties are proportionate to the amount and severity of crimes that have been uncovered. Thus they should go both up and down, perhaps in a somewhat random way, unless one believes that the world is in a constant downward trend of moral decay.74

Personally, I want the SEC enforcement staff to be under severe internal restraints in their ability to bring cases. For the SEC enforcement staff, it is their job to bring cases, and it is rewarding for them to have fun (sometimes) doing their jobs, just as I (sometimes) have fun doing mine. On the other hand, for the accused who is the subject of an enforcement case, just being the subject will very likely cost them their job and, unless they are pretty rich (even in the financial industry, most people are not), it will cost them most or all of their savings to respond to the SEC. Until the case is closed (assuming it is closed in their favor), they will have a very difficult time, if not an impossible time, getting another job in the financial industry, since no financial institution wants to hire an individual who is potentially the subject of charges. Even “victory” (meaning likely the closing of the case without a trial) by the accused does not mean that their lives will resume a normal course. Their money may be gone; they may not have worked in the ordinary professions for a significant period; and they will continue to be subject to a taint.

So I think restraint by the SEC enforcement staff is good. I am in favor of it. Nor is this an isolated view.75 It is just favoring decency in the use of power.

In passing, I note that I read a recent editorial by Michael Lewis in the N.Y. TIMES76 that I thought made a variety of good points, but one I thought he got entirely wrong. He observed that many former heads of enforcement at the SEC had gone on to become general counsels of major financial institutions. And he posited that the reason they had been able to secure these jobs is that they had implicitly gone soft on financial institutions during their tenures. And he posited that the reason they had been able to secure these jobs is that they had implicitly gone soft on financial institutions during their tenures. This is exactly wrong.

74 This is of course a defensible view. If you are really in the mood to be depressed by constant and unstoppable decline, I recommend the Cormac McCarthy trilogy (or I consider it a trilogy) of Blood Meridian (the inevitable conquest by death); No Country for Old Men (the inevitable conquest of evil); and The Road (world end).


They each built up the reputations that made them desirable general counsels by being aggressive. The “conflict of interest” that SEC enforcement lawyers generally face is not the inclination to go soft on business; the “conflict of interest” is to be too hard in light of the benefit that enforcement lawyers may gain by building a reputation with big cases “fought” against institutions that may be put out of business if the institutions mount a defense.

**How Should SEC Success Be Measured?** Ideally, one would like corporate penalties to be, not a very high number, but rather, zero, just as one would like (even if not expect) the number of people in jail to be zero. That is, we do not view the number of people in jail as a testament to the success of our system. A more substantial success than putting people in jail is reducing the number of crimes committed. That is why successful police departments tout their jurisdictions’ crime rate.

I think the SEC should be the same way. Of course, it should bring enforcement actions, just as the police should put people in jail. But the SEC should have a fuller measure of its success that reflects its role as a regulatory agency.

As applied to the SEC, this means that I would rather that it took pride in understanding the financial markets and products, adopting good rules while repealing outdated ones, and clarifying rules that are uncertain. In this regard, I think it essential that the SEC have theories as to why particular rules governing matters such as short sales, hedge funds, trade reporting and most anything else are desirable. Without theories, all the SEC can do is follow popular opinion. Further, the SEC must attempt to follow up on the rules that it adopts and measure their effect. Although I do not follow UK regulation closely, my impression is that the Brits have it all over us in their follow-up on rule-making.

On the enforcement side, the SEC should attempt to focus on matters that are of importance and to bring enforcement actions, where necessary, that are appropriate in size and type to the violation. Bringing the largest number of enforcement actions and obtaining the largest settlements is not an indicator of success. In fact, it could be an indicator that problems were missed until their size was too great.

**Who Should Staff the SEC?** A good part of the reason, I believe, why the SEC is so focused on enforcement is that it is so heavily staffed by lawyers. Lawyers have some useful skills, but it is a limited set. We tend to do well in school and to be good with words. Thus, playing to our strengths, we make a lot of detailed rules, and then we severely punish those who break them.
But, if it were my job to create and staff a new financial regulatory agency, I would not staff it so largely with lawyers. Nor do I think that I would have lawyers predominate. I would have greater numbers of accountants, economists, research analysts (who better to look at corporate disclosure), and information specialists. (Of course, I do not go as far as Dick The Butcher—you do want some lawyers to write it all down.)

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77 Economics have come into some disrespect, along with everyone else, with the financial crisis. As for me, I would argue for far more consideration of economic theory in the promulgation of regulations. There is a lot of really interesting work in economics today that takes account of real world factors. For example, the work of Joseph Stiglitz with respect to the economics of information is the type of study the SEC should draw up as it implements rules with respect to research, disclosure, transparency, rating agencies and like matters. See also ERIC D. BEINHOCKER, THE ORIGIN OF WEALTH (2006) (interesting general survey of modern economic thought).

78 WILLIAM SHAKESPEARE, THE SECOND PART OF KING HENRY THE SIXTH act 4, sc. 2.