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Riff on a Blueprint for Financial Services Reform: Handicapping the Needed Dialogue

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On March 31, 2008, the U.S. Secretary of the Treasury, Henry M. Paulson, Jr., responded to an industry-led clarion call to keep the U.S. markets competitive, by issuing his promised "Blueprint for a Modernized Financial Regulatory Structure." In making that release, he said that strong financial markets are equally important to Wall Street and Main Street, and that:

> **"We should and can have a structure that is designed for the world we live in, one that is more flexible, one that can better adapt to change, one that will allow us to more effectively deal with the inevitable market disruptions and one that will better protect investors and consumers."**

Motherhood and Apple Pie

I wrote in November 2006, for this publication[1], that the United States deserved to examine its marketplace as many other jurisdictions have done before any such assessment was performed for us by the international community. I argued that an unexamined regulatory structure was unhealthy and that the inability to talk about:

(1) how best to shape regulation and oversight, and

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(2) whether our techniques of regulation (be it prudential or conduct of business) have kept pace with market evolution and continue to meet our objectives

might not only prove problematic, but also could possibly isolate us from the global debate. I have not changed my mind. I support the "Blueprint idea" that the public and private sector should "jaw, jaw, jaw" and of delineating near-term, mid-term and long-term framework goals to the extent politically feasible[2]. The devilish point is talk precisely about what?

The "Blueprint reforms" reflect insights of the President's Working Group on Financial Markets (PWG)and the work conducted contemporaneously by various industry volunteers assembled to espouse and to expose a well- rounded private sector view of best practices[3]. But, the timing and setting of Treasury's response to the year-old call for reform has been outpaced by events. It is today's conditions that should set the context for what the content of any dialogue should be. Many have commented in this respect that the suggested Blueprint, announced at the height of a financial crisis deemed by some pundits to be the worst since the Great Depression, while addressing market stability generically, has nothing to offer on the issues of near panic re-pricing of debt, the corresponding impact on certainty, confidence and liquidity, the valuation issues posed by illiquid markets, and the nascent interest in enhanced transparency, and even clearing of, opaque markets[4]. Moving scenery from one stage to another among regulatory actors will not change the denouement—to change the denouement one has to go deeper and deconstruct the play itself. Others have said that the very fact that the Blueprint chose a diversionary tactic that will focus everyone on the players not the play demonstrates its brilliance; while we are moving the scenery, the market will correct itself. Some have queried whether recent experience in fact favors a more bank- driven as opposed to markets-driven regulatory response.

As assistance to your deliberations an outline of the actual Blueprint:

CHART OF MAIN BLUEPRINT PROVISIONS

Short Term	*Medium Term*	*Long Term*
Expand and enhance PWG	Transfer thrift charter to national bank charter; merge OCC and OTS	Overview/reorder structure of regulation for: market stability---prudential financial issues ---business conduct
Expand access to liquidity provisioning of Federal Reserve and enhance information available to Federal Reserve about firms with access to such provisioning	Streamline regulation of state-chartered banks with federal guarantee	Market stability overseer: Federal Reserve—with power to join examinations of prudential and business conduct regulators
Federal standards for mortgage originators; enhancement of enforcement powers of Federal Reserve	Establish Federal charter for systemically important payment and settlement systems	Prudential regulator to focus on safety and soundness of all firms with federal guarantees and with authority to deal with affiliates
	Optional federal insurance charter	Business conduct regulator to focus on monitoring of business conduct across all types of financial firms; consumer protection
	Merge SEC and CFTC	
	Expand mandate of Federally -chartered securities SRO	

But assuming, for the sake of argument, that the challenge to deconstruct how to reform financial services to assure they endure and continue to foster prosperity in the 21st Century is a real one—what should we take as a guide?

At the outset, while we need to bring some new thinking to bear on issues before us, that new thinking should be slow to discard the fundamental principles of financial regulation as it exists today.

It is, thus, fitting that our self-scrutiny begins on this 75th anniversary of the creation of the Securities and Exchange Commission (SEC). In 1930, when the securities laws were crafted as part of a move to provide "strict supervision of all banking, credits and investments," reputedly one model copied was the Business Corporations Act in England. In the 1930's the new securities laws (the Securities Act of 1933, Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Public Utility Holding Company Law) were primarily directed to disclosure, investment/enterprise structure and prevention of fraud. Clearing, insurance, market structure and market integrity reforms came later for capital market entities [5]as opposed to banks and agricultural products under the Commodity Exchange Authority. In the 1930's the industry camped out in the Mayflower Hotel and opposed every reform. But in the end, President Franklin D. Roosevelt got his SEC and the U.S. developed the most vibrant capital market in the world. In the 70's, 80's and 90's multiple U.S. agencies oversaw the development of new means for consumers and wealth managers to use the market and for the market to serve the community.

It is also fitting to think deeply about this history and to analyze why it brought us to where we are today. Would a one-size-fits-all regulator have proved a panacea or instead have the same ill effects as one-size-fits-all regulation? And, it is fitting to think carefully about the extent to which the design of the United Kingdom Financial Services Authority (UKFSA) one-stop shop[6], a twin-peaks[7] approach as in the Netherlands, Australia and (as somewhat modified) France, or the current Blueprint proposal for a whole new Alps[8] is tailored to characteristics of the markets each system serves. It is useful to think more broadly even about why conflicts law typically gives both the host and the home jurisdiction affecting enterprises a role to play.

Having made these analyses, will we find that we are out of step with the rest of the world? How does our framework fit internationally?

First, regulation is now the rule and not the exception for global financial markets. It is the accepted wisdom that financial markets are governed by rules and even private market rules must be supported by the rule of contract and the rule of law. It is also accepted that for law to rule it must be enforced. The international community of regulators has made acceptance and implementation of largely consensus- driven international standards a national imperative[9].

Second, private financial markets increasingly see appropriately configured regulation as important to the bottom line. Market failures have the potential to cause a loss of confidence with impacts well beyond the costs of any given failure. Compliance that avoids a market failure has benefits that can far outweigh its costs. Capital growth and the availability of funding are acknowledged by economic experts to depend in part on the belief of the public investor and credit provider that investment risks are disclosed, prices are fair, and the treatment of investors by corporate or market insiders is equitable. These virtues—transparency and equitable treatment of shareholders and market users— are the global rule rather than the global exception and increasingly are enlightening more opaque markets.

Third, non-U.S. financial services providers and supervisors that formerly bitterly complained about the SEC have heartily embraced creating their own bespoke version of mini or integrated SEC's. Now, almost every jurisdiction throughout the world has discovered what the U.S. already knew: that with every regulated market come a panoply of other profit-making businesses. These businesses are an outgrowth of a credible financial system[10] , whether it be sponsors of individual issues, underwriters, evaluators, lawyers, accounting firms, auditing firms, printers, transfer agents, banks, custodians, rating agencies, M& A integrators, due diligence experts, reporting services, back office and administrative functions, technology providers (both hardware and software), security background vetting personnel, consultants, etc.. Even more broadly, in the emerging markets, a regulated (or self-regulated market buttressed by the rule of law) can bring information about prices to the heartland in ways that can favorably change the conditions of competition for farmers, while creating a higher quality hedge for middlemen like warehouses and elevators and more efficient prices for, cooperatives and consumers.

The economic miracles that surround boutique markets (e.g., Singapore, Dubai, Vienna and their imitators, or NASDAQ when founded, and AIM today) and providers of outsourcing (e.g., Ireland, India, Sri, Lanka and Estonia) or accepters of foreign (in this case U.S.) issues (e.g., Israel, Portugal) often are related as much to the promotion and growth of businesses around them as to the markets themselves. Capital markets support business development and in turn, business development grows economies. Open markets increase the overall pie even where they may reduce market share.

Fourth, the international community has taken an invigorated interest in having broader public commentary/private sector input (a feature common to the U.S. administrative law system) on regulatory initiatives than even five years ago. And, while for example, the Europeans have supposedly rejected self-regulation, a raft of flourishing operator-regulated markets have sprung up alongside EU regulated markets and the MIFID (Markets in Financial Instruments Directive) places some specific requirements of oversight by and of market operators that admit issues to trading.

Fifth, while there are a litany of problems that have occurred in the marketplace and a litany of banking and investment banking liquidity crises that demonstrate the value of a buttress-contingency plan- liquidity- of- last-resort- insurance-and special insolvency response to mitigate the drastic impact of unfettered market discipline on the financial system, the market has not preferred a bank supervisory model to a capital markets oversight framework for either capital raising or risk mitigation. Nor do the proposed regulatory remedies for systemic market events originate solely from banking supervisory theories on stability. The market drove the public policy behind a safety net to protect private investment and provided such a safety net before the regulators did[11]. The international financial institutions promote capital market reform as a benefit to the real economy and as an antidote to the failure of bank financing to support innovation in the real economy or to absorb market shocks. Risk capital is more readily available from investors than from banks.

What's my point? The point is that while we now must rethink regulation domestically in an international context, many of the ideas that have been formed in the crucible of politics and occasional crisis over decades here while being reframed to fit the needs of a more global financial services community remain the basics of capital markets regulation. We should therefore be certain that our reform efforts are backed by sound analysis and not revision for the sake of revision. Instead, we can start from, and build on what has been a historically successful platform—something that needs to be updated to be sure, but still something to be proud of. Interestingly, in the last few weeks, diverse commentators have recalled the old New Deal and called for a new one. Mark Twain came up with the phrase with respect to social reform in a "Connecticut Yankee in King Arthur's Court[12]"; President Franklin D. Roosevelt used it per Conrad Black's (interestingly) glowing recollection of FDR's first inaugural[13] as "a means to make the country safe again for the wealthy"; Alan Blinder in the Sunday, May 4, 2008, issue of the *New York Times* advanced certain reforms to securitization and capital enhancements as a new New Deal.

So if the dialogue is about substance and not mainly about the structure of regulation, the embrace of another model or the termination or expansion of a particular agency's or agencies' mandate, from a lay persons perspective what should we be talking about when we reinvent our essential regulatory model, and how likely on the scale of one to ten will any real dialogue on these subjects take place. The following are some suggestions:

- *Accountability.* Accountability in the first instance for compliant performance should reside with the regulated industry and its stakeholders, not with a "Nanny" government. This requires that the public, stakeholders and the government have good information about how compliant the industry is. This in turn requires the heads of public companies, and the management of institutions to do their homework and to care about a culture of compliance as a factor of business success or failure. Accountability and transparency go hand in hand and are more important than whether rules are stated as objectives or prescriptions and how infringements are targeted and identified. *[likelihood that the notion of accountability of the industry for compliance will drive the dialogue on the design of any change in the system[14]: in a crisis: 1-2; in rising markets: 10]*

- *New product design.* Does the public want and need the government to operate as a new product committee? Yes or no? Are we satisfied with disclosure as opposed to merit-based review of, for example, complex derivative products? Is a CFTC-style self-certification of compliance with set objectives sufficient? Would we have had fewer problems with securitized mortgages, if someone had researched the history of warehouse receipts (the original asset-backed security) or remembered that there is never any extra collateral when a mortgage goes to foreclosure or that pre-payment provisions are options? In listed derivatives markets, the exchanges research the cash market for possible conventions or issues that could idiosyncratically affect the risks in the instruments and are required to stand behind their findings; is that a model? *[likelihood that the limits of a disclosure-based system will be discussed : pre sub-prime 0; post sub-prime: 5]*

- *Common sense should rule over theory.* Physicists or rocket scientists, and deltas, gammas, and sigmas should not deprive us of our common sense when approaching risk or misconduct or developing or mandating a risk management or compliance program. (Ask yourself what it means for firms that have lost billions to have had VAR-measured economic capital calculations of 100,000,000s; ask yourself if in volatile markets you would wait five days to know whether your individual transaction occurred and at what price) Sometimes the simplest, plain English statement of the issue is the most telling indicator of risks. While, recognizing that systemic risk is not the everyday or the assumed risk but rather the outlier, the surprise risk or the reversal of assumptions, we should not forget the basic maxim where rewards are greatest risk is greatest too. *[likelihood that the components of risk and risk management will be discussed as part of any framework discussion on regulatory reform: 5, though any such dialogue also is likely to defer the specifics to risk experts]*

- *Cherry pick the best ideas.* If a prudential approach makes sense in a financial emergency and a conduct of business approach makes sense when banks sell investment products to retail clients, would not the best system accommodate both approaches? If the S.E.C. keeps its audit oversight manual secret and the banks make theirs public; but the banks keep their corrective actions initially secret and the securities regulators make theirs public, should we discuss why? If the CFTC notes that the clearing mechanism is a means to protect against black swan and opaque risks, or that it is useful to know large exposures controlled by a single player across markets, or that a substituted compliance or recognition program with appropriate reciprocation can work, can any discussion avoid rejecting the idea out of hand because of the source? [*likelihood any discussion will draw ideas from multiple regulatory models, pre Blueprint: 2, post Blueprint and credit crisis 6-8, subject to turf]*

- *Think global but act local.* It is increasingly important to coordinate with non-US regulators, avoid unnecessary inconsistencies between regulatory systems, but to remain in touch with the reality of the composition and structure of each local/national market and political base. If the national market is largely persons buying bank- vended life insurance products the right regulatory regime may be different from that appropriate for the national jurisdiction where there are more retail equity security accounts than there are people. If the customer base is wholesale, the elements of any regime may be different from where the customer base is retail or involves non-discretionary retirement funds. *[likelihood that any discussion will put the U.S. market in context by looking at the structure of other markets and their participants: improving 8-9]*

- *Think global and act global.* Recognize the interdependencies of our real economies and our financial markets. Avoid the impulse to protectionist action. Think about how to bring into the net the new emerging market powerhouses. *[likelihood that any dialogue will recognize that the advent of electronic trading assures a global market, but likelihood of any dialogue favoring more open markets getting better or getting worse depending on who one talks to: 5]*

- *Mitigation of potential systemic risks.* Do we believe all products are created equal? Do we believe that the public purse should stand behind all products? If the alternative is the full taxpayer base bailing out the market, is insurance that puts the cost on the providers and users of particular products or services a bad idea? Should some mechanism for working out of an emergency or unexpected situation always be provided for? Must we be sure that prompt corrective action is possible if we are going to require it? *[likelihood that the scope of public responsibility for private failures in the financial markets will be a part of any dialogue: 10]*

- *Consider what should be the guiding objectives/principles of any restructuring effort.* How important is it for regulators to coordinate/take the same position and how important is it for them to serve individual customer bases or have product-specific expertise? How many decision-makers do you want in an emergency? How many hands do you want on deck? Have the recently combined Federal agencies, such as Homeland Security, improved the overall efficiency, quality and delivery of services? Will providing additional authority to cash market agencies (Agriculture, EPA, FTC, FERC) improve the overall performance of the financial markets? If so why; if not why not? Let answers to these questions help guide any quest for restructuring. *[likelihood that there will be a dispassionate discussion of how financial regulation might be reconstituted on an institutional basis and how best to concentrate oversight of particular activities: unrated; has some "legs" with respect to SROS, cash market agencies, and the OTS; otherwise probably hopelessly mired politically absent further crisis]*

- *Competition.* The regulated industry is a client of regulation; regulation then should promote not restrain competition, as competition means more clients. *[likelihood that the dialogue will be couched in terms of improving competition: 10, likelihood that changes will be made to foster improved competition: 5]*

- *Timing.* Will we in the U.S. grasp this opportunity to rethink how to approach regulation of the markets at a time when rethinking is not an isolated event confined to one geographic region, but when every global regulator is thinking again about the deliverables that regulators must provide to their constituency and the public. *[yes: 5; no: 5]*

And, of course:

The first and last rule always: DO NO HARM (no handicap provided).

NOTES

1. 26 *Futures and Derivatives Law Report*, No. 10 at p.1 (November 2006)
2. In October, 1993 in its report on the over-the-counter markets, the CFTC called for a reinvigoration of the President's Working Group (originally formed by Executive Order to respond to the 1987 U.S. Market Crash). That CFTC report advocated broader use of the PWG to foster communication across the multiplicity of U.S. financial services regulators and the search for common or related solutions to cross-sectoral problems. So, further institutionalization of this mechanism, as proposed in the Blueprint, to facilitate cross governmental dialogue could

enhance communication among the nation's financial regulators. The proposed new entities (such as, the Office of Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office for Thrift Supervision, among others, such as the Council on Economic Advisors) have participated informally in the past, and the dialogue should include them while it persists.

3. See, e.g., http://www.treas.gov/press/releases/hp575.htm referring to investors' and asset managers' work on hedge funds. The National Chamber of Commerce and Bloomberg and others also convened studies.
4. See, e.g., for a range of views on what needs to be done to address the credit crisis: International Monetary Fund, *Containing Systemic Risks and Restoring Financial Soundness*, "Global Financial Stability Report," April 2008, Washington, DC.
5. See, for example, the Market Reform Act of 1990, H.R. 3657 (101st Cong.) whereby the Securities Exchange Commission for the first time received the authority to obtain large exposure reports and to take emergency action to protect market integrity.
6. Integrates all financial services regulation under one regulator: not only banks, insurance companies and securities brokers, but also building societies, pension funds, etc..
7. Separates conduct of business/market regulation and prudential regulation, with various variations on this theme.
8. See, Chart above and the Blueprint itself, which would create new functions in the short term, and new regulatory entities in the long term.
9. For example, CESR (Committee on European Securities Regulators) is putting a new emphasis on enforcement of the rules that have been with such effort harmonized or converged within the European community and is itself exploring the intricacies of further converging the views of 50+ national regulators in 27 jurisdictions with a diversity of differences among them by moving from a consensus based decisional model to one that uses a qualified majority voting system among other things. Similarly, IOSCO increasingly has made imperative work toward execution of a Multilateral Memorandum of Understanding and Cooperation on enforcement assistance and work towards implementation of the IOSCO Objectives and Principles of Securities regulation.
10. Some have said the main virtue of securities regulation in the thirties was that it brought with it a full-employment program for the national denizens of the marketplace. Some politicians have thought that with respect to lawyers it did too much.
11. Prior establishment of the Securities Investment Protection Corporation in 1975, the New York Stock Exchange (NYSE) would organize work-outs to protect customers; currently futures investors are protected by segregation of customer funds, including accruals on open positions, and the clearing mechanism of futures markets.
12. Google suggests that Henry James may also have used the phrase.
13. In that speech, FDR said, albeit with respect to the Constitution, "…it is possible always to meet extraordinary needs by changes in emphasis and arrangement without loss of essential form."
14. Likelihood that on a scale of 10, a concept discussed here will prevail in any dialogue on the issue.