Shining a Light on Regulators

Lydia I. Kang*

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Once we realize that imperfect understanding is the human condition, there is no shame in being wrong, only in failing to correct our mistakes. ---George Soros

Now, approximately two years after the height of the economic crisis that reached the outer corners of the world, from America to Iceland to Greece to Dubai, Congress's attention has turned to overhauling the regulatory system governing financial institutions. In a sense, the bill currently being debated in the Senate is the American government's attempt to correct the mistakes that led to the most severe economic meltdown since the Great Depression.

Many have analyzed the causes behind the crisis, and while there is no universal consensus, most agree that several players were asleep behind the wheel when the economy crashed. Despite differences of opinion on who was most blameworthy and what are the solutions, most agree that there was not one but several bad actors - banks and other financial institutions, the

* Assistant Professor, Sogang University Law School

mortgage companies, the borrowers, Congress, and regulatory agencies.[1] Banks made dangerous bets with a short-sighted pursuit of immediate profit and without proper risk management controls, mortgage companies made bad loans to people who were clearly a credit risk, ratings agencies were conflicted and offered stamp of approval to many products, despite reservations, in a bid for more business. Congress, with deregulatory zeal, was behind the eight ball regarding the real estate bubble, the extent of toxic mortgages being packaged and sold, and the explosive growth of the derivatives markets, effects of which were largely hidden by moving them off the books in what has been called "the shadow banking system."[2]

1) Although many also have castigated the ratings agencies as overstating the quality of many mortage securities that ended up tanking once the housing market collapsed, a recently opened investigation by New York Attorney General Cuomo suggests that at least some believe that misinformation was given to the ratings agencies leading to their inflated ratings. Louise Story, Prosecutors Ask if 8 Banks Duped Rating Agencies, N.Y. Times, May 12, 2010.

2) The shadow banking system refers to the non-bank financial institutions that lend businesses money by way of intermediating between borrowers and investors. A very good description of the shadow banking system is offered in Secretary Timothy Geithner's June 9, 2008 speech to The Economic Club of New York, available at http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html (The structure of the financial system changed fundamentally during the boom, with dramatic growth in the share of assets outside the traditional banking system. This non-bank financial system grew to be very large, particularly in money and funding markets. In early 2007, asset-backed commercial paper conduits, in structured investment vehicles, in auction-rate preferred securities, tender option bonds and variable rate demand notes, had a combined asset size of roughly $2.2 trillion. Assets financed overnight in triparty repo grew to $2.5 trillion. Assets held in hedge funds grew to roughly $1.8 trillion. The combined balance sheets of the then five major investment banks totaled $4 trillion. In comparison, the total assets of the top five bank holding companies in the United States at that point were just over $6 trillion, and total assets of the entire banking system were about $10 trillion.

This parallel system financed some of these very assets on a very short-term basis in the bilateral or triparty repo markets. As the volume of activity in repo markets grew, the variety of assets financed in this manner expanded beyond the most highly liquid securities to include less liquid securities, as well. Nonetheless, these assets were assumed to be readily sellable at fair values, in part because assets with similar credit ratings had generally been tradable during past periods of financial stress. And the liquidity supporting them was assumed to be continuous and essentially frictionless, because it had been so for a long time. The scale of long-term risky and relatively illiquid assets financed by very short-term liabilities made many

Finally, regulators were conflicted, incompetent, and too cozy with the same institutions they were supposed to supervise.

While people have fiercely debated what the lessons are regarding the roots of the crisis and what must be done to prevent or mitigate a similar meltdown, Congress has steadily moved closer to passing a sweeping overhaul of the regulatory system. This bill,[3] proposed by Democrats, with the support of President Obama's administration, is currently being considered in the Senate.[4]

The legislation encompasses varied issues but primarily targets the risk "too big to fail" banking and nonbanking institutions[5] pose, creates a resolution fund to dissolve a bank should it be necessary, adds a new consumer protection bureau, empowers regulators to impose higher capital requirements on the banks, mandates that most derivatives be traded through a clearinghouse and incorporates the so-called "Volkner rule" banning proprietary trading[6] of banks. Although any analysis of the bill should be

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of the vehicles and institutions in this parallel financial system vulnerable to a classic type of run, but without the protections such as deposit insurance that the banking system has in place to reduce such risks.)

3) Restoring American Financial Stability Act of 2010 Wall Street Reform Bill - As Filed S. 3217 April 27, 2010.

4) See Sewell Chan, Republicans Offer Alternative Financial Overhaul, N.Y. Times, April 27, 2010. Chan offers a comparison of this bill with alternative bill offered by Republicans. While both would try to combat the "too big to fail" risk and impose some regulation over derivatives, the Republican proposal would provide consumer regulators with less power and limit the ability of regulators to supervise activities of large financial institutions.

5) "Too big to fail" banks or financial institutions refers to the idea that the biggest and most interconnected firms are so large that a government cannot allow them to fail because a collapse of the firms would have a catastrophic effect on the overall economy. This idea is associated with the moral hazard that once the firms consider themselves "too big to fail," based on an assumption that the government would ensure its survival, the bank would be tempted to take dangerous risks in the hope that they could gain large profits with the risky bet, and, should the bet fail, that the taxpayers would bail them out.

6) Deal Book, Financial Debate Renews Scrutiny on Banks' Size, N.Y. Times, April 21, 2010 describes a proposal by Mr. Volcker which would ban banks that take customer deposits from proprietary trading (making speculative bets with their own money.) It would also limit the

understood with the caveat that modifications to any and all provisions may occur before final bill is passed, the bill, as it stands currently, represents a solid first step in regulatory reform.

Provisions of the bill address the excessively risk-taking culture prevalent in most banks and financial institutions before the crash. By banning proprietary trading and forcing most derivatives contracts to be traded by way of clearinghouse, the bill prevents the temptation to gamble with federally insured deposits and guarantees more transparency and better risk management. By providing for a resolution authority to dismantle a financial institution in an orderly way, it combats any moral hazard that institutions would take imprudent risks, knowing they could depend on future government bailouts so long as they were deemed "too big to fail." Moreover, the bill pushes for companies to consider shareholders' views on executives' compensation, in support of the idea that firms should properly align management's incentives with the long-term health of banks and firms.[7)]

The bill, therefore, appears focused largely on changing the culture of banks and financial institutions, disincentivizing any short-term chase of profits despite accompanying risks, and promoting transparency and risk management within the firms. This article notes that these are laudable goals; however, if the bill suffers from weaknesses, one in particular stands

share of all financial liabilities that any one institution can hold – besides deposits – but it would be up to regulators to set the limit.

7) Summary of the bill calls this part a "Vote on Executive Pay: Gives shareholders a say on pay with the right to a non-binding vote on executive pay. This gives shareholders a powerful opportunity to hold accountable executives of the companies they own, and a chance to disapprove where they see the kind of misguided incentive schemes that threatened individual companies and in turn the broader economy." Available at http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf; see also Douglas O. Edwards, AN UNFORTUNATE TAIL : RECONSIDERING RISK MANAGEMENT INCENTIVES AFTER THE FINANCIAL CRISIS OF 2007-2009, 81 U. Colo. L. Rev. 247, 255, Winter 2010 ("Accordingly, we should restructure risk-management incentives through corporate reporting and compensation reform to incentivize those responsible for systemically critical decisions to be more cognizant of the low-probability, high-impact events that occasionally plague the financial system.")

out – neglecting an equally pressing need to reform regulatory bodies and their culture, thereby making regulators more effective.

Despite generally being castigated by Congress and the public as incompetent, conflicted, and excessively close to financial institutions, regulators, except for short vague provisions about providing more information and restructuring how the President of the New York Federal Reserve is selected, are largely ignored in the bill. In fact, the bill not only pays scant attention to the reform needs of regulators, it arguably gives them more power.

Thus, looking at regulatory reform legislation through this lens makes it clear that the bill currently being considered in the Senate is missing a vital piece. There has been little attempt to correct the past mistakes and passivity of regulators, or align their incentives, examine their culture, and clarify their priorities.

The following argument proceeds in four parts. First, Part I analyzes the bill currently being debated and how, despite the merits of many of the provisions being considered, there is marked absence of attention to reforms related to regulatory agencies. Part II describes regulators – particularly the Securities and Exchange Commission (SEC) and the Federal Reserve – as well as their authority, tools, and culture. Later, Part II assesses arguments about their inefficacy, conflict of interest, and lack of transparency. Part III presents a modest proposal regarding how to better address the past mistakes of regulators. Among other aspects, limiting the discretion of regulators is recommended as well as promoting more transparency and thereby accountability on the part of regulators. There has been much discussion about shining a light on the shadow banking system. The arguments for more transparency in the derivatives markets apply with equal force to shining a light on regulators. Part IV concludes by briefly highlighting the need to recognize that real regulatory reform cannot be fully effective until there is international cooperation.

I. The Bill and Insufficient Attention to Regulators

Real financial regulatory reform in America often has only come about as a result of a crisis or scandal of enormous proportions. After the stock market crash in the late 1920s that led to the Great Depression, Congressional hearings in the form of the Pecora Commission provided a window to Congress and the public into stories of fraudulent bond sales, preferred shareholder lists, insider trading, and journalists promoting stock to boost prices. In the aftermath of the hearings, two new agencies were born - the SEC, charged with administering federal securities laws[8)] and the Federal Deposit Insurance Corporation (FDIC), that would insure deposits. Around the same time, the Glass-Steagall Act of 1933, the New Deal legislation that separated commercial banking and investment banking was made law.

Similarly, in the 1970s, in the wake of breaking scandals that American companies were making questionable payments to foreign officials, Congress enacted legislation requiring public companies to maintain accurate books and records.[9)] In the summer of 2002, a few days after the bankruptcy filing of WorldCom and a series of other spectacular accounting frauds, including Enron's had come to light,

Sarbannes-Oxley was enacted, mandating that management certify the adequacy of its internal controls and that an outside auditor attests to management's certification.

Only the Depression was comparable in scale to the panic of 2008. The

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8) See generally Joel Seligman, Transformation of Wall Street, (2003).

9) Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended at 15U.S.C.ss78dd to dd-3 (2006)).

2008 economic crisis led to the taxpayer-funded bailouts of some of the country's biggest financial companies, including Bear Stearns, Fannie Mae, Freddie Mac, the American International Group, Citigroup and Bank of America. Responding to the public's outrage, in June 2009 President Obama proposed financial regulatory reform legislation. In December the same year, Democrats in the House passed a bill similar to the President's proposal. The Senate Democrats have now proposed a bill that is being debated as of this writing[10]. This article focuses on the legislation put forward by Senator Chris Dodd[11], D-Conn. It consists of about 1,400 pages of regulations that change the way the financial system is managed. It will likely incorporate some if not all of the proposed amendments, and the Senate and House will then have to resolve any differences before a final vote. When this bill passes in some form or another, as many predict it will,[12] the financial system will experience the greatest overhaul since the 1930s.

The key points of the bill are the following:

- Consumer protection. A new agency, the Consumer Financial Protection Bureau, is created and given the mandate to help consumers understand their mortgages, credit cards and other financial products. The Bureau would prevent and punish unfair, deceptive, or predatory practices. In the Senate bill, the Bureau would be housed within the Federal Reserve, though it would have its own budget.[13]

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10) The U.S. Constitution requires the approval of both chambers of Congress and the President in order to pass a law; each chamber's rules route bills through subcommittees and then full committees before they can reach the floor for a vote; and under the Senate rules a supermajority of sixty votes is required to invoke cloture and limit debate on legislation.
11) Christopher J. Dodd, Democrat of Connecticut and the chairman of the Senate Banking Committee.
12) A pox on your swaps - Banks face up to a tougher derivatives regime than many had expected, The Economist, April 29 2010.
13) The House version of the bill creates an independent agency.

- Preventing "systemic" threats. The bill creates a Financial Stability Oversight Council to look for significant threats to the financial system and to recommend regulations to rein in large financial institutions. The Federal Reserve would be given new powers to regulate nonbank financial companies.[14] The bill would allow the council to designate specific companies as systemically important, subjecting them to more supervision by the Federal Reserve. Companies that largely escaped consolidated federal regulation before the 2008 financial crisis, like insurance companies and investment banks, would now come under the Federal Reserve's purview. The Federal Reserve would be directed to impose higher capital and liquidity standards on these companies. To help the Council's determinations, the Office of Financial Research within the Treasury Department is created to collect financial data and conduct research and analysis.

- Resolution authority. This part of the bill aims to address the "too big to fail" problem.[15] If a large, interconnected firm is teetering on

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14) Paul Krugman, Financial Reform 101, N.Y. Times, April 1, 2010 (What ended the era of U.S. stability was the rise of "shadow banking": institutions that carried out banking functions but operated without a safety net and with minimal regulation. In particular, many businesses began parking their cash, not in bank deposits, but in "repo" – overnight loans to the likes of Lehman Brothers. Unfortunately, repo wasn't protected and regulated like old-fashioned banking, so it was vulnerable to a pre-1930s-type crisis of confidence. And that, in a nutshell, is what went wrong in 2007-2008. So why not update traditional regulation to encompass the shadow banks? We already have an implicit form of deposit insurance: It's clear that creditors of shadow banks will be bailed out in time of crisis. What we need now are two things: (a) regulators need the authority to seize failing shadow banks, the way the Federal Deposit Insurance Corporation already has the authority to seize failing conventional banks, and (b) there have to be prudential limits on shadow banks, above all limits on their leverage.)

15) The size of big banks and investment companies gives them unfair advantage in competition for funds (vs smaller institutions) because creditors know that they will be bailed out when a crisis occurs. David M. Herszenhorn and Sewell Chan, Financial Debate Renews Scrutiny on Banks' Size, N.Y. Times, April 21, 2010 (The banking industry has become much more concentrated as it has grown in recent years. In 1995, the assets of the six largest banks were

collapse, the Treasury Department, the FDIC and the Federal Reserve would have to agree to liquidate it, using a special fund created with payments from the largest financial firms. The legislative language says the fund must be used to dissolve failing firms. This provision is meant to prevent any moral hazard of financial companies returning to their excessively risk-taking ways because they know they will be bailed out should they fail because they pose systemic risks. Moreover, regulators are empowered to impose new capital and leverage requirements that make it undesirable to get too big.

- Derivatives.[16] Most but not all derivatives would be traded on an exchange. During the financial meltdown, derivatives exacerbated losses, especially in the housing market, and since derivatives have long been unregulated, investors weren't sure who was taking the biggest losses, leading to a freeze in the markets. The new regulations are aimed at making clear who is trading in derivatives.[17]

- Hedge funds. Generally speaking, hedge funds are investment management funds for selected groups of elite investors. Under the new regulations, hedge funds which have a certain size would have to register with the SEC and report their activities. Some exemptions are provided for venture capital funds and private equity fund advisers.

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equivalent to 17 percent of G.D.P.; now they amount to 63 percent of G.D.P. Meanwhile, the share of all banking industry assets held by the top 10 banks rose to 58 percent last year, from 44 percent in 2000 and 24 percent in 1990.)

16) http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf(The over-the-counter derivatives market has exploded – from $91 trillion in 1998 to $592 trillion in 2008. During the financial crisis, concerns about the ability of companies to make good on these contracts and the lack of transparency about what risks existed caused credit markets to freeze. Investors were afraid to trade as Bear Stearns, AIG, and Lehman Brothers failed because any new transaction could expose them to more risk.)

17) Warren Buffett has called them "financial weapons of mass destruction."

- Executive Compensation. Shareholders of publicly traded companies can vote on executive pay, though the vote is nonbinding on the company.

- Credit ratings agencies. The bill creates an Office of Credit Rating Agencies and puts in place rules for internal controls, independence, transparency and penalties for poor performance.[18)]

The regulatory legislation currently also includes some tough provisions, put forward by Senator Blanche Lincoln, Democrat of Arkansas and chairwoman of the agriculture committee. Mrs. Lincoln's proposal imposes new requirements that all derivatives be traded on a public exchange and processed, or cleared, through a third party. Parties to derivatives contracts, including existing contracts, would be required to post collateral to help protect against potential default.

Another amendment proposed would ban commercial banks who receive Federal Reserve loans from risky trading for their own accounts. This rule would prohibit banks from engaging in proprietary trading (trading the bank's money to turn a profit). Nonbank financial institutions supervised by the Federal Reserve will also have restrictions on proprietary trading and hedge fund and private equity investments.[19)] Other amendments attempt to reform ratings agencies[20)] and be incorporated into sweeping financial

18) http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf

19) The Senate bill would direct a council of regulators to conduct a six-month study of the matter and empower it to make recommendations. It then gives bank supervisors nine months to turn the council's recommendations into a final rule. Finally, after another two years, the Volcker Rule would come into effect.

20) David Herszhenhorn, Senate Acts on Credit-Rating Agencies, N.Y. Times, May 14, 2010. In recent weeks, the Senate approved more amendments to the bill, including two amendments to the financial regulatory bill aimed at the credit ratings agencies, including one proposal that would force federal officials to come up with alternative methods for evaluating securities and other investments as a way of preventing the reliance on companies like Moody's Investors Service and Standard & Poor's. One amendment, sponsored by Senators George LeMieux,

regulatory legislation that Senate Democratic leaders hope to complete next week.[21] The bill has been toughened up to require all contracts that can be centrally cleared to be traded on exchanges.[22]

Thus, the entirety of the bill, inclusive of amendments, betrays an over focus on banks, hedge funds, and consumer product companies such as credit card and mortgage lending companies.[23] The legislation does not discuss in-depth the weaknesses and needs of the regulators[24] except a vague paragraph about SEC and how to address its lack of competence in subtitle F[25](with bill providing that there be a report on internal supervisory controls

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Republican of Florida and Maria Cantwell, Democrat of Washington, would remove references to the credit agencies in major financial services laws, including the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Federal Deposit Insurance Act. Mr. Franken's proposal, which was approved by a vote of 64 to 35, would create a board, overseen by the Securities Exchange Commission, that would make the randomized assignments. Mr. Franken said his proposal would help eliminate potential conflicts of interest in which issuers of securities choose that rating agency to grade their product. Senator Christopher J. Dodd, Democrat of Connecticut and the primary author of the financial regulatory legislation, opposed both proposals. Senate also approved a proposal that would direct the Federal Reserve to impose new limits on the fees that banks can charge businesses to process transactions using credit and debit cards.

21) David M. Herszenhorn, Senate Amends Financial Overhaul Bill, N.Y. Times, May 13, 2010.

22) A pox on your swaps Banks face up to a tougher derivatives regime than many had expected, The Economist, Apr. 29, 2010 (In a memo circulated this week, the Fed complained that the bill's language is too "hard wired", leaving insufficient room to tweak rules as markets evolve. It also thinks the legislation unnecessarily restricts data-sharing among regulators.)

23) It is worth noting that even criticisms of the current bill being considered tends to focus on banks and how to, for example, deal with problems of their size and complexity. See, e.g., Baxter, Lawrence G., How Big Became Bad: America's Underage Fling with Universal Banks (March 31, 2010). Available at SSRN: http://ssrn.com/abstract=1582453 (suggesting three ways in which regulators could slow growth of large, interconnected banks).

24) Bill also demonstrates lack of attention to Fannie Mae and Freddie Mac. These are the two government-created companies that back many mortgages. They were supposedly private companies but often thought of as public. Then the financial crisis happened, and the Federal Housing Finance Agency placed them in conservatorship because they were out of money. The federal government now is likely on the hook for huge losses sustained by Fannie and Freddie when the housing bubble popped. The current bill doesn't address Fannie and Freddie's losses in any significant way.

25) The Madoff scandal demonstrated the extent to which the SEC is in need of reform. The SEC

and management at the SEC). Even in this opaque paragraph, however, more attention is paid to how to get people outside of SEC to help SEC (by offering nonbinding recommendations for example) than how to internally reform or improve SEC. There is an equally vague paragraph on “strengthening” the Federal Reserve.[26)]

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has failed to perform proper oversight and is unable to understand some of the very companies it is supposed to regulate.

SEC and Beefed Up Investor Protections

- Encouraging Whistleblowers: Creates a program within the SEC to encourage people to report securities violations, creating rewards of up to 30% of funds recovered for information provided.
- SEC Management Reform: Mandates an annual assessment of the SEC’s internal supervisory controls and a GAO study of SEC management.
- New Advocates for Investors: Creates the Investment Advisory Committee, a committee of investors to advise the SEC on its regulatory priorities and practices as well as the Office of Investor Advocate in the SEC, to identify areas where investors have significant problems dealing with the SEC and provide them assistance.
- Funding: The self-funded SEC will no longer be subject to the annual appropriations process. Available at http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf

26) The Federal Reserve will oversee the larger, more complex holding companies with assets over $50 billion and other systemically significant financial firms, where their expertise in capital markets will come into play. With this new role will come new responsibilities, but also new transparency and efforts to eliminate conflicts of interest.

Strengthening the Federal Reserve

- Transparency: GAO will have authority to audit any emergency lending facility set up by the Federal Reserve under section 13(3) of the Federal Reserve Act.
- Oversight Accountability: Creates a Vice Chairman for Supervision, a member of the Board of Governors of the Federal Reserve designated by the President, who will develop policy recommendations regarding supervision and regulation for the Board, and will report to Congress semi-annually on Board supervision and regulation efforts.
- Eliminates Conflicts of Interest in Reserve Bank Governance: No company, subsidiary or affiliate of a company that is supervised by the Federal Reserve Board will be allowed to vote for directors of Federal Reserve Banks; and their past or present officers, directors and employees cannot serve as directors. Currently the member banks elect directors, who choose the Federal Reserve Board president. Federal Reserve supervisory functions are carried out through the Federal Reserve Banks.
- Increases Accountability at the New York Federal Reserve Bank: The president of the New York Federal Reserve Bank will be appointed by the President of the United States, with the advice and consent of the Senate. The New York Federal Reserve president is a permanent member of the Federal Open Market Committee, the Bank executes open market operations

A close reading of the legislation makes clear that generally regulators have held onto much of their power and some have even expanded their authority. For example, on May 12, 2010, the Senate approved an amendment to the financial regulatory bill that allows the Federal Reserve to retain its supervision of state-chartered banks and bank holding companies with less than $50 billion in assets that are now in the Federal Reserve system rather than transfer authority to the Federal Deposit Insurance Corporation.[27] A Financial Stability Oversight Council, provided for in the bill, will be composed of Secretary of Treasury, Chairman of Federal Reserve, and Chairman of SEC, among others. This Council, with a 2/3 vote including the Chairperson's vote, can recommend that the Federal Reserve have supervisory authority over a US nonbank financial company.[28] Moreover, the

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and is an important source of information on capital markets, and the Bank supervises many important bank holding companies. However, the president of the New York Federal Reserve Bank is currently chosen by the Bank's directors, 6 of whom are elected by member banks in that district. [changing current system in which Each Reserve Bank is headed by a president appointed by the Bank's nine-member board of directors. Three of the directors are elected by the commercial banks in the Bank's region that are members of the Federal Reserve System. The other directors are selected to represent the public with due consideration to the interests of agriculture, commerce, industry, services, labor and consumers. Three of these six directors are elected by member banks and the other three are chosen by the Board of Governors. Available at http://www.newyorkfed.org/aboutthefed/whatwedo.html]

27) The vote, 90 to 9, was a big victory for the Fed. David M. Herszenhorn, Senate Beats Back Efforts to Ease Regulation Bill, N.Y. Times, May 12, 2010 (Under the amendment, sponsored by Senators Kay Bailey Hutchison, Republican of Texas, and Amy Klobuchar, Democrat of Minnesota, the Fed can still supervise more than 4,900 bank holding companies and about 900 state-chartered Fed-member banks, though the institutions could choose to be overseen by the F.D.I.C.)

28) The Council, on a nondelegable basis and by a vote of not fewer than 2/3 of the members then serving, including an affirmative vote by the Chairperson, may determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, in accordance with this title, if the Council determines that material financial distress at the U.S. nonbank financial company would pose a threat to the financial stability of the United States. http://banking.senate.gov/public/_files/TheRestoring American FinancialStabilityActof2010AYO10732_xml0.pdf

Board of Governors of the Federal Reserve will now have a formal responsibility to identify, measure, monitor, and mitigate risks to U.S. financial stability.[29] In addition, the Board of Governors can establish standards regarding executive compensation at bank holding companies where compensation is regarded as excessive.

Just as the bill provides the Federal Reserve with more powers, the SEC has increased its authority and jurisdiction in the bill. The SEC and CFTC will regulate over-the-counter derivatives.[30] Moreover, the SEC will have a new Office of Credit Ratings with its own compliance staff and the authority to fine agencies. The SEC is required to examine Nationally Recognized Statistical Ratings Organizations at least once a year and make key findings public. Finally, the bill provides that the SEC the authority to deregister an agency for providing bad ratings over time.[31] The bill further states that the SEC has the authority to grant shareholders proxy access to nominate directors.[32]

Finally, and perhaps most importantly, regulators like the Federal Reserve and the SEC are given the power to decide important issues in the future. The bill requests that regulators conduct studies and then make decisions regarding limiting the risky activities of large financial firms and in setting capital standards for banks. While this is meant to provide regulators with

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29) http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf

30) http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf (The bill further provides that most derivatives will be cleared through centralized clearing houses and traded on exchanges, un-cleared swaps will be subject to margin requirements and swap dealers and major swap participants will be subject to capital requirements, and all trades will be reported so that regulators can monitor risks in this large, complex market.)

31) Available at http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf ; see also ://banking.senate.gov/public/_files/TheRestoringAmericanFinancialStabilityActof2010AYO10732_xml0.pdf (Bill provides also that "the Commission may issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor.")

32) http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf.

flexibility in rapidly changing markets, it poses a serious risk of giving too much discretion to regulators who have not always used their authority well in the past.[33)]

II. Regulatory Bodies, their tools, and their failures

This part will assess the SEC and the Federal Reserve, the tools at their disposal, and later why they have been subject to enormous criticism for their part in the economic crisis. For purposes of this article, the focus is mostly on the SEC and the Federal Reserve, because both bodies are closely associated with scandals and missteps leading to or coming out of the crisi s[34)] and because both, as explained above, have retained or even expanded the scope of their authority. A critical question is if this empowerment is appropriate.

Any analysis of the SEC[35)] and the Federal Reserve[36)] has to take into

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33) David Cho, Finance reform bill leaves some key decisions to regulators, Wash. Post, May 8, 2010.

34) e.g., glaring fiascos of Madoff's global Ponzi scheme, Lehman Brothers' bankruptcy, and the Federal Reserve's lack of oversight over consumer protection and the housing bubble. They are also associated with the unprecedented steps to prevent a market collapse in the aftermath of Lehman's bankruptcy. For example, the Federal Reserve, with the help of Treasury, engineered the fire sale of Bear Stearns, a beleaguered investment bank, to J.P Morgan. See also William D. Cohan, Three Days That Shook the World, Fortune, Dec. 16, 2008, available at http://money.cnn.com/galleries/2008/fortune/0812/gallery.threedays.fortune/index.html (explaining the role of the Federal Reserve and the Treasury in softening the blow of Lehman Brothers failure)

35) The Securities and Exchange Commission (SEC) is the federal agency primarily responsible for administering and enforcing federal securities laws. The SEC tries to protect investors by ensuring that the securities markets are honest and fair. When necessary, the SEC enforces securities laws through fines, referral for criminal prosecution, revocation or suspension of licenses, and injunctions. Headquartered in Washington, D.C., the commission is composed of five members appointed by the president. No more than three members may be from one political party.

36) The Federal Reserve is one of several federal banking regulators that share responsibility for supervising and examining depository institutions. The objective of their activities is to ensure

account whether or not they had the necessary tools to have prevented or at least mitigated the crisis. While there is no unanimous opinion, many such as Eliot Spitzer,[37] have pointed out that there were at least some effective regulatory measures that were available to regulators yet remained unused. For example, federal regulators were in charge of "prudential supervision," the duty to ensure the "safety and soundness" of banks.[38] Moreover, in Mark Green's interview with Eliot Spitzer, January 24, 2009, Spitzer stated "If you look at what, and I hate to point back to the office when I was Attorney General a number of years ago, what we were able to do with a very simple fraud provision in a state law. We were able to delve into the fundamental financial workings of every one of these companies, from AIG to the major banks to the hedge funds on occasion. All you needed was a simple anti-fraud provision in a statute, and the Fed, the SEC, the OCC had all the power they needed to look at these entities and to set credit ratios, capital

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the financial strength and stability of the banking system. The New York Fed conducts on-site and off-site examinations of member depository institutions. The Federal Reserve's responsibilities extend to all state-chartered banks that are members of the Federal Reserve System, all U.S. bank holding companies and many of the U.S. operations of foreign banking organizations. In addition, the Federal Reserve can provide temporary or long-term liquidity to any depository institution that meets its criteria for discount window borrowing. The Federal Reserve is also responsible for enforcing laws and establishing rules to protect bank customers.

37) In Mark Green's interview with Eliot Spitzer, January 24, 2009, Spitzer declared "the SEC doesn't need more people, it doesn't need more laws, it needs a will to act. That has been overlooked. Whenever there's a failure they say: "Well, give us more people." They have 3500 people more, by a factor of probably a hundred, than I had when we were doing cases in the AEG's office. They didn't know where to look, or how to act to be tough. They don't need more laws either, they just need to enforce the laws on the books." available at http://www.huffingtonpost.com/mark-green/7-days-spitzer-on-wall-st_b_160568.html Although Eliot Spitzer has stated we need to replace people at the regulatory agencies (The one thing I would say would be put people at the Fed, put people at the SEC, who affirmatively want to regulate), this author's opinion that it is not so much people but the culture, the lack of transparency, misaligned incentives and organization of the regulators that has made them less effective than they could have been.

38) Simon Johnson and James Kwak, Capital Requirements Are Not Enough, N.Y. Times, Apr. 1, 2010 (The Treasury Department says that bank regulators already have the power to increase capital requirements).

ratios, liquidity requirements. They just didn't do it."[39] The SEC has been the subject of three scathing investigative reports over its failure to catch irregularities in some of the biggest investment debacles in history, including those involving Lehman Brothers and Bernard L. Madoff Investment Securities.[40] Despite letters warning the SEC of a possible Ponzi scheme related to Madoff since 1998, the SEC ultimately never developed a case against Madoff.[41] The agency therefore is under tremendous pressure to prove itself.[42]

Even some regulators themselves have acknowledged that they had the ability to mitigate the damage the crisis has wrought. The Treasury Department says that bank regulators (such as SEC) already have the power to increase capital requirements[43] and Ben Bernanke has stated "that regulators arguably already had the authority to crack down on speculative trading…"[44] The Federal Reserve also had the authority to curb excesses of

39) available at http://www.huffingtonpost.com/mark-green/7-days-spitzer-on-wall-st_b_160568.html. Spitzer added "The Fed has the capacity to look at any entity on the street, and say to them, 'You have too much debt, you have too much leverage, raise your capital ratios, or you won't have access to the borrowing we authorize.'"

40) Nelson D. Schwartz and Eric Dash, With Banks Under Fire, Some Expect a Settlement, N.Y. Times, May 13, 2010.

41) Casey worked with Harry Markopolos at Rampart Investment Management from 1998 to 2001. It was Casey who first brought Bernie Madoff to the attention of Markopolos, who worked for a decade to expose the fraud. Available at http://www.pbs.org/wgbh/pages/frontline/madoff/interviews/casey.html

42) E.g., Terry Keenan, This Ponzi Scheme Is Creme de la Creme, N.Y. Post, Dec. 14, 2008, at 35; SEC: Some Watchdog!, Boston Herald, Dec. 16, 2008, at 20; Loren Steffy, SEC Short of Wisdom on Short-Selling, Houston Chron., July 18,2008, Business, at 1.

43) Julie Satow, Ex-SEC Official Blames Agency for Blow-Up of Broker-Dealers, N.Y. Sun, Sept. 18, 2008 (The Securities and Exchange Commission can blame itself for the current crisis. That is the allegation being made by a former SEC official, Lee Pickard, who says a rule change in 2004 led to the failure of Lehman Brothers, Bear Stearns, and Merrill Lynch. The SEC allowed five firms – the three that have collapsed plus Goldman Sachs and Morgan Stanley – to more than double the leverage they were allowed to keep on their balance sheets and remove discounts that had been applied to the assets they had been required to keep to protect them from defaults.)

44) Sewell Chan, Traction for Banking Regulation, N.Y. Times, Feb. 25, 2010.

the mortgage market and predatory lending practices leading up to the crisis. Moreover, the Federal Reserve had the legal authority to limit the size of banks, arguably combating the “too big to fail” problem.[45] Former Chairman Alan Greenspan (and famed advocate of deregulation), in fact, commented that the Federal Reserve had not done enough to address the risks to the financial system posed by very large banks.[46] Given the agreement of even some regulators that the problem is not that regulators did not have the authority or tools to prevent or minimize the crisis, the question turns to why regulators stood at the sidelines while the economy was headed for a tailspin?

While many have lambasted regulators as incompetent and conflicted, the situation is more nuanced. Regulatory agencies have too many priorities, or even arguably conflicting ones. For example, bank regulators are supposed to ensure both bank profitability and health (a type of regulation known as “safety and soundness”) and, at the same time, that consumers are treated fairly. Thus, advocates of the Consumer Protection Bureau have pointed out that while the Federal Reserve has the power to protect consumers from fraudulent or predatory practices, they have not demonstrated as much zeal for this as their competing mission is to promote the health of the banks (who are engaging in some of the lending activities that target consumers).

Related to the problem of competing priorities, is additional confusion on the part of regulators of the scope of their role and authority given the balkanization of regulation. In the current system, regulation regarding

45) David M.Herszenhorn and Sewell Chan, Financial Debate Renews Scrutiny on Banks’ Size, N.Y. Times, Apr. 21, 2010 (Senator Ted Kaufman, Democrat of Delaware, who is a co-sponsor of the bill, said that the Federal Reserve has had the power to limit the size of banks since 1970, but has not acted. Instead, the nation’s six largest bank holding companies − Citigroup, Goldman Sachs and Morgan Stanley are the other three − have only grown bigger over the last year and a half, mainly as a result of government-brokered mergers.)

46) Sewell Chan, Greenspan Concedes That the Fed Failed to Gauge the Bubble, N.Y. Times, Mar. 18, 2010.

financial products of services depends on the identity of the entity offering the product or service, rather than the characteristics of the product or service. For example, several different federal agencies, in addition to state agencies, share responsibility for overseeing financial products and services.[47] Former Secretary of Treasury Henry Paulson recommends that the government retool the regulatory system, which "remains a hopelessly outmoded patchwork quilt built for another day and age" and is "rife with duplication, gaping holes, and counterproductive competition among regulators."[48] The bill attempts to address this problem by establishing clear lines of authority.[49]

In contrast, the bill does not effectively address the culture and organizational structure of the regulators. Regulators have long had a complex and close relationship with the banks and financial institutions they supervise. These relationships range from a revolving door in career track of

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47) Michael A. Lee, THE CONSUMER FINANCIAL PROTECTION AGENCY: WHAT IT MAY MEAN TO YOUR PRACTICE, Houston Lawyer, January/February, 2010.

48) Available at http://www.huffingtonpost.com/2010/01/27/henry-paulson-memoir-on-t_n_438545.html

49) Available at http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf (Clear Lines of Responsibility: Replaces confusing regulation riddled with dangerous loopholes, with clear lines of responsibility.

- FDIC: will regulate state banks and thrifts of all sizes and holding companies of state banks and thrifts with assets below $50 billion.
- OCC: will regulate national banks and federal thrifts of all sizes and the holding companies of national banks and federal thrifts with assets below $50 billion. The Office of Thrift Supervision is eliminated, existing thrifts will be grandfathered in, but no new charters for federal thrifts.
- Federal Reserve: will regulate bank and thrift holding companies with assets of over $50 billion, where the Fed's capital market experience will enhance its supervision. As a consolidated supervisor, the Federal Reserve can see risks whether they lie in the bank holding company or its subsidiaries. They will be responsible for finding risk throughout the system. The Vice Chair of the Federal Reserve will be responsible for supervision and will report semi-annually to Congress.
- Dual Banking System: Preserves the dual banking system, leaving in place the state banking system that governs most of our nation's community banks.)

bankers becoming government regulators and back again to private practic e[50] to simply friendship. Moreover, while much has been discussed about the culture and risk management philosophy of banks[51] there has not been enough attention paid to the culture of the regulatory bodies. Eliot Spitzer has referred to the SEC as stagnant.[52] Current SEC Chair Mary Schapiro has acknowledged SEC's passivity[53] but explains that this was the result of following a deregulatory culture.[54]

In other words, some regulators before the economic crisis overrelied on the banks, financial companies, and ratings agencies to know what they were doing, if only because any excessive risk taking would presumably hurt themselves.[55] The surprise of former Federal Reserve Chairman Alan

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50) Eric Lichtblau, Lawmakers Regulate Banks, Then Flock to Them, N.Y. Times, Apr. 13, 2010.

51) Gillian Tett, Fool's Gold, 2009, at 147-151 shows how JP Morgan was able to protect itself from much of the fallout of the economic crisis but its judicious use of risk management controls and due to its very team-oriented rational and prudent culture.

52) Available at http://www.huffingtonpost.com/mark-green/7-days-spitzer-on-wall-st_b_160568.html "The failure to transform is what I think happened to the SEC, so it didn't understand what were the new challenges in the new marketplace that it needed to confront to restore integrity to the capital markets."

53) Mary Schapiro, who became S.E.C. chairwoman last year, has vowed to reinvigorate the agency. Edward Wyatt, S.E.C. Puts Wall St. on Notice, N.Y. Times, Apr. 18, 2010 ("I think everybody a few years ago got caught up in the idea that the markets are self-correcting and self-disciplined, and that the people in Wall Street will do a better job protecting the financial system than the regulators would," she said. "I do think the S.E.C. got diverted by that philosophy.")

54) Senator Kaufman points out "Through a series of decisions in the 1980s and 1990s, the Federal Reserve liberalized prudential limitations placed upon commercial banks, allowing them to engage in securities underwriting and trading activities, which had traditionally been the particular province of investment banks. One fateful decision in 1987 to relax Glass-Steagall restrictions passed over the objections of then Federal Reserve Chairman Paul Volcker, the man who is today leading the charge to restrict government-backed banks from engaging in proprietary trading and other speculative activities. Available at http://kaufman.senate.gov /press/statements/statement/?id=ACA5B91A-6E51-4D6B-A367-414AD9641500"

55) Former Chairman of Federal Reserve Alan Greenspan in his 2009 Congressional testimony admitted he had made a mistake in believing that the market could be trusted to self-regulate. It should be noted that even executives at JP Morgan, according to Fool's Gold, commented that it did not know the extent of what the other banks were doing with CDOs and ABS and MBS products and the neglect of risk controls that JP Morgan had followed. Gillian Tett, Fool's

Greenspan and of JP Morgan, which largely steered clear of the most risky assets and degree of leverage of its competitors, at the realization of the level of risk-taking other financial firms were doing demonstrates the assumption that banks could be trusted to self-regulate.

Compounding this deregulatory zeal was the fact that some regulators simply did not understand the issues at hand. For example, some regulators at the SEC were unaware of the debt and leverage and off balance sheet derivatives exposure of banks and other financial institutions.[56] The derivatives exposure,[57] in particular, was not well understood by most regulators.[58] This was especially problematic as the derivatives industry was exponentially growing, from just over $95 trillion at the end of 2000 to over

Gold, (2009) at 142.

56) available at http://kaufman.senate.gov/press/statements/statement/?id=ACA5B91A-6E51-4D6B-A367-414AD9641500 (With the completion of the Basel II Capital Accord, determinations on capital adequacy became dependent on the judgments of rating agencies and, increasingly, the banks' own internal models. While this was a recipe for disaster, it reflected in part the extent to which the size and complexity of this new era of quantitative finance exceeded the regulators' own comprehension. When Basel II was effectively applied to investment banks like Lehman Brothers and Goldman Sachs, which had far more precarious and potentially explosive business models that utilized overnight funding to finance illiquid inventories of assets, the results were even worse. The SEC, which had no track record to speak of with respect to ensuring the safety and soundness of financial institutions, allowed these investment banks to leverage a small base of capital over 40 times into asset holdings that, in some cases, exceeded $1 trillion.)

57) A pox on your swaps Banks face up to a tougher derivatives regime than many had expected, The Economist, Apr. 29 2010 (Derivatives-dealing has become one of the most profitable activities for Wall Street's giants. The business is thought to have generated revenue of around $22.6 billion in 2009. JPMorgan Chase has said that fully one-third of its investment-banking profits came from OTC derivatives in 2006-2008.)

58) A notable exception may be Secretary Treasury Tim Geithner, who, at the time as President of New York Federal Reserve saw reason for concern about derivatives market. From 2005 onwards he urged banks to prepare for so-called "fat tails," a term for statistically infrequent but often excessively overlooked risk of a highly negative event. He was concerned about not only the rapid growth of complex derivates but also the leverage banks bore. In September 2005 he gathered representatives of largest banks to New York Fed office and told them they would have to revamp back office operations so that the long delays of processing of paperwork of trades no longer existed. Under implicit threat of more regulatory pressure if they did not comply, the banks overhauled their back offices. Gillian Tett, Fool's Gold, 2009 at 159.

$600 trillion in 2009.[59)]

Thus, despite their authority to limit size of banks, raise capital requirements, and/or to regulate harmful consumer products and practices, regulators did little to stop the growing tide of over-leveraged, excessive risk-taking.[60)]

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59) available at http://kaufman.senate.gov/press/statements/statement/?id=ACA5B91A-6E51-4D6B-A367-414AD9641500 (About a year after repealing Glass-Steagall, Congress passed legislation – the Commodity Futures Modernization Act of 2000 (CFMA) – to allow over-the-counter (OTC) derivatives to essentially remain unregulated. Following the collapse of the hedge fund Long Term Capital Management (LTCM) in 1998, then Commodities Futures Trading Commission (CFTC) Chairwoman Brooksley Born began to warn of problems in this market. Unfortunately, her calls for stronger regulation of the derivatives market clashed with the uncompromising free-market philosophies of Federal Reserve Chairman Alan Greenspan, then Treasury Secretary Robert Rubin and later Treasury Secretary Larry Summers. To head off any attempt by the CFTC or another agency from regulating this market, they successfully convinced Congress to pass the CFMA.
The explosive growth of the OTC derivatives market following the passage of the CFMA was stunning – the size of the OTC derivatives market grew from just over $95 trillion at the end of 2000 to over $600 trillion in 2009. This growth had profound implications for the overall risk profile of the financial system. While derivatives can be used as a valuable tool to mitigate or hedge risk, they can also be used as an inexpensive way to take on leverage and risk…certain OTC derivatives called credit default swaps were crucial in allowing banks to evade their regulatory capital requirements. In other contexts, CDS contracts have been used to speculate on the credit worthiness of a particular company or asset.
But they pose other problems as well. Since derivatives represent contingent liabilities or assets, the risks associated with them are imperfectly accounted for on company balance sheets. And they have concentrated risk in the banking sector, since even before the repeal of Glass-Steagall, large commercial banks like J.P. Morgan were major derivatives dealers. Finally, the proliferation of derivatives has significantly increased the interdependence of financial actors while also overwhelming their back-office infrastructure. Hence, while the growth of derivatives greatly increased counterparty credit risks between financial institutions – the risk, that is, that the other party will default at some point during the life of the derivative contract – those entities had little ability to quantify those risks, let alone manage them.)

60) available at http://kaufman.senate.gov/press/statements/statement/?id=ACA5B91A-6E51-4D6B-A367-414AD9641500 (the regulators sat idly by as our financial institutions bulked up on short-term debt to finance large inventories of collateralized debt obligations backed by subprime loans and leveraged loans that financed speculative buyouts in the corporate sector. They could have sounded the alarm bells and restricted this behavior, but they did not. They could have raised capital requirements, but instead farmed out this function to credit rating agencies and the banks themselves. They could have imposed consumer-related protections

III. A Modest Proposal Regarding Regulators.

While it is always possible that Congress can get bogged down in an amendment vote, there is near-certainty at this point that financial regulation, in the aftermath of a crisis that necessitated a $2.5 trillion dollar bailout[61] is coming. This article recognizes the value in many aspects of the bill in its current form, but sets forth some suggestions as to what should be changed, added or considered.

An easy solution to the most obvious example of regulatory conflict of interest has not been provided. Regulators should not have to rely on banks they supervise to provide any part of their budget, as is the case of the Office of Thrift Supervision (OTC). In fact, fees from Washington Mutual (one of the biggest bank failures in American history) to OTC made up about 15 percent of the agency's budget – more than any other single bank.[62] Perhaps it is no surprise then that it was under the watch of the OTC that Washington Mutual imploded. Regulatory financial reliance leads to, at best, a conflict of interest and, at worst, a complete relinquishing of regulatory authority. Any bill should promptly end this conflict of interest.

Relatedly, each regulator should have a sufficient budget to keep up-to-date as financial innovation churns away, producing more sophisticated and complex products on a daily basis. According to the Fed reviews, the New York Fed conducted inadequate examination of Citigroup for years. A 2005 review found that the New York Fed did not have the time or manpower to properly regulate Citigroup.[63] Each regulator therefore should

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sooner and to a greater degree, but they did not. The sad reality is that regulators had substantial powers, but chose to abdicate their responsibilities.)

61) Available at http://kaufman.senate.gov/press/statements/statement/?id=ACA5B91A-6E51-4D6B-A367-414AD9641500

62) See Regulator Defends WaMu Oversight, N.Y. Times, THE ASSOCIATED PRESS, Apr. 16, 2010.

63) Sewell Chan and Eric Dash, Fed Reviews Find Errors in Oversight of Citigroup, N.Y. Times, Apr. 7, 2010.

have a budget free from dependence on banks and large enough to accommodate adequate staffing.

The bill should also carve out a truly independent Consumer Protection Bureau. Elizabeth Warren, Harvard Law professor and chair of the Congressional Oversight Panel for TARP, is a strong advocate of a separate consumer protection agency[64] with its own budget and the ability to make its own rules and enforce such rules. Nevertheless, the bill in its current form houses the Bureau in the Federal Reserve and the rules promulgated by the Bureau still needs other regulators' approval before they are implemented. This half-hearted independence is dangerous. The Federal Reserve, a regulator which had the authority to crack down on mortgage market abuses before the crisis, failed to exercise it. Its approval should not be required when the Bureau writes its rules, nor is it the appropriate place for this agency. Pressed by Charlie Rose why a new bureaucracy should be created even though the Federal Reserve has the tools to start regulating consumer products, Warren responded that the "bureaucracies in Washington right no w…each own a piece of consumer financial protection. Bloated, inefficient and either ignored and ineffective or captured by the large financial institutions… what I want is to take this agency out…shrink it down, and make it effective. You've got to have an agency that's ultimately independent."[65]

In order to be effective, regulators need to be aware of the rapid changes and developments with which financial products are engineered and marketed in modern financial markets. The legislation tries to address the need for information gathering and analysis by regulators. In the area of derivatives, the bill requires data collection and publication so that regulators can monitor and respond to risks. It also requires hedge funds that manage over 100

64) Sewell Chan, Traction for Banking Regulation, N.Y. Times, Feb. 25, 2010. "Elizabeth Warren, the Harvard Law professor who first proposed the agency, said in an interview on Wednesday that the agency should stand alone. 'I keep looking for the word independence,' she said."

65) Elizabeth Warren: Outrage and Financial Reform, Charlie Rose At the Table, Mar. 4, 2010.

million to register with the SEC as investment advisers and provide information about their trades and portfolios so that the SEC can assess systemic risk posed by a fund.[66] Further, the bill provides that the Council may request that large bank holding companies submit reports about their financial condition and risk management system.[67]

Studies and analysis, while necessary, are never sufficient. By way of example, in the summer of 1998, Long-Term Capital Management, a behemoth hedge fund, collapsed. At the time it had $1.25 trillion in notional value of over-the-counter derivatives, and it only had $4 billion in capital to support that investment, and it was going to default, devastating the counterparties in the derivatives contracts. Even though a systemic meltdown was averted due to the counterparties (OTC derivatives dealers) stepping in to take the hit, there were some who recognized the collapse as a red flag of the danger posed by unregulated derivatives market. As head of the Commodity Futures Trading Commission (CFTC) at the time, Brooksley Born pushed for regulation of this shadow market. Less than a month later, however, Congress passed a statute saying that the CFTC could take no regulatory action in the over-the-counter derivatives market for the next six

66) Available at http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf
67) available at http://banking.senate.gov/public/_files/TheRestoringAmericanFinancialStabilityActof2010AYO10732_xml0.pdf
(SEC. 116. REPORTS.
(a) IN GENERAL.—Subject to subsection (b), the Council, acting through the Office of Financial Research, may require a bank holding company with total consolidated assets of $50,000,000,000 or greater or a nonbank financial company supervised by the Board of Governors, and any subsidiary thereof, to submit certified reports to keep the Council informed as to—
(1) the financial condition of the company;
(2) systems for monitoring and controlling financial, operating, and other risks;
(3) transactions with any subsidiary that is a depository institution; and
(4) the extent to which the activities and operations of the company and any subsidiary thereof, could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall financial stability of the United States.)

months. Congress also said, however, that it would like the President's Working Group to do a study of hedge funds like LTCM and of the over-the-counter derivatives market and report back to Congress about whether or not there were problems in the areas. When information had been gathered and the study came out, the over-the counter derivatives report by the President's Working Group strongly recommended that there was no need for regulation. Born believes that as a direct result of that report, in 2000 the Commodity Futures Modernization Act (CFMA) that took away all jurisdiction over over-the-counter derivatives from the CFTC was enacted. The Act also took away any potential jurisdiction on the part of the SEC, and prohibits state regulators from interfering with the over-the-counter derivatives markets. In other words, derivatives became immune from all government oversight.[68] Thus, in at least one recent example, a information gathering and a study did little to ensure that proper regulation was administered.

Similarly, an investor advisory committee to SEC, provided by the bill,[69] does not make certain stronger or more active regulation. The SEC does not have to accept in part or whole the recommendations of this committee. The presumption that such a toothless committee would have an impact on the

68) According to 8/28/2009 interview with PBS, Born's attempts to regulate derivatives was derailed by then-Federal Reserve Chairman Alan Greenspan, then-Treasury Secretary Robert Rubin and then-Deputy Treasury Secretary Larry Summers, who instead urged Congress to limit future regulation. Available at http://www.pbs.org/wgbh/pages/frontline/warning/interviews/born.html#shutdown

69) 'SEC. 39. INVESTOR ADVISORY COMMITTEE.
PURPOSE.—The Committee shall—''(A) advise and consult with the Commission on—''(i) regulatory priorities of the Commission; (ii) issues relating to the regulation of securities products, trading strategies, and fee structures, and the effectiveness of disclosure; (iii) initiatives to protect investor interest; and''(iv) initiatives to promote investor confidence and the integrity of the securities marketplace; and (B) submit to the Commission such findings and recommendations as the Committee determines are appropriate, including recommendations for proposed legislative changes.'' Available at http://banking.senate.gov/public/_files/TheRestoringAmericanFinancialStabilityActof2010AYO10732_xml0.pdf

SEC is tenuous, particularly as the markets calm and people forget the pains of the crisis in a few years.[70)]

Beyond ensuring they have the means and motivation to utilize their regulatory powers, the bill needs to address the potentially overly close relationship regulators have with the financial institutions they supervise. How do we prevent them from being overly cozy with financial institutions the way former head of OTC appears to have been?[71)] One answer is by making sure their budget is independent of bank fees. Another is by recognizing and addressing the fact that the influence may not be direct or nefarious but the subtle effect of having shared experiences in financial markets. There is undoubtedly a revolving door pattern in regulators and private actors in financial markets.[72)]

The current legislation attempts to slightly separate the ties interlocking government regulators and financial companies, by having the President of

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70) Alan Blinder, vice chairman of the Federal Reserve Board from 1994 to 1996, commented in PBS interview that "to think that we're going to make financial markets free of excesses is an illusion. You'd like to think that something like this will not happen again for 35 years. People forget faster than that." Available at http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/interviews/blinder.html#glasssteagall

71) Former director of Office Thrift Supervision took fire in Congress for emails suggesting that the regulator's failure to prevent collapse of Washington Mutual stemmed from an overly deferential close relationship to the bank executives. In addition, fees from Washington Mutual to OTC made up about 15 percent of the agency's budget. See Regulator Defends WaMu Oversight, N.Y. Times, By THE ASSOCIATED PRESS, Apr. 16, 2010.

72) Joseph Stiglitz was a member and then chairman of the Council of Economic Advisers (1993-1997) and senior vice president and chief economist of the World Bank (1997-2000). In a PBS interview conducted on July 28, 2009, he commented "Government inevitably is going to reflect the pressure of special interests, particularly as elections get near. And remember, many of these people came from or were closely allied with financial markets. We have a problem of revolving doors: people coming from the financial markets, going to government and going back to financial markets. Their mind-set is affected by financial markets; they see things through the lens of the financial markets. And so they don't have to be influenced; they are the financial markets, in a sense. ... If we had had more people that, for instance, had suffered from the problems of predatory lending, there might have been less confidence that financial markets always work so well. ..." available at http://www.pbs.org/wgbh/pages/frontline/warning/interviews/stiglitz.html#shutdown

the New York Federal Reserve chosen by the President rather than by directors, some of whom are banks. However, this does not address the fact that probably the worst problem for regulators is not that of purposeful bias but more a subconscious bias due to close working relationships and backgrounds. For example, many bank supervisors work on a daily basis inside the headquarters of the largest financial firms and have established close relationships with executives of the companies they oversee.

Thus, perhaps the best solution for recognizing and responding to the subtle biases in favor of the banks and financial companies under supervision is more transparency and accountability. There has been much talk about the need to shine a light on the banks, particularly the shadow banking system, but there needs to be more transparency for regulatory agencies and institutions as well.

The Federal Reserve in recent years has taken steps toward greater disclosure but is still viewed in much the same light as portrayed in William Greider's 1987 book, "Secrets of the Temple: How the Federal Reserve Runs the Country."[73] Some have pointed out that since the crisis began, the central bank has pumped nearly $4.3 trillion into the nation's banks, but the taxpayers who are paying for these bailouts know almost nothing about them. The public does not know exactly who the Federal Reserve extended loans to, the terms of the loans, or what Federal Reserve officials signed off on them.

In 2008, Bloomberg L.P. sued the Federal Reserve under the Freedom of Information Act, seeking to compel the central bank to disclose the names of the companies that benefit from the emergency lending programs. (Several news organizations have filed briefs in support of Bloomberg. The New York Times has filed a similar suit.) A federal judge in Manhattan ruled in Bloomberg's favor last November, and a three-member panel of appellate

73) Sewell Chan, Consensus for Limits to Secrecy at the Fed, N.Y. Times, May 9, 2010.

judges upheld that ruling in March. But recently the Federal Reserve asked the full United States Court of Appeals for the Second Circuit to take up the case. Robert E. Mannion, a former deputy general counsel for the Federal Reserve, said it had "essentially stonewalled" and said that greater disclosure about the lending programs was warranted.[74] The bill should compel the Federal Reserve to disclose such information.

The same need for more transparency applies to the Treasury. Some citizens have complained that despite the money that has been sunk into the American mortgage companies, Fannie and Freddie, taxpayers who now own the mortgage giants, do not know much about their actions.[75]

One amendment to the legislation that authorizes an audit of the Federal Reserve's emergency actions during and after the 2008 financial crisis is being considered. Even if this amendment should pass, the value would diminish as this is only a one-time audit. What would be more powerful is if the legislation required more regular and frequent audits and if there are more investigations similar to what is currently being done by special inspector general office of the Troubled Asset Relief Program, Neil Barofsky. Barofsky has authority to monitor and root out fraud and waste in the management of TARP, the $700 billion program passed in October 2008 to remove toxic debt from the banks. The special inspector general, in a series of reports, interviews and congressional hearings, has heaped criticism on the Treasury Department's operation of the program.[76] In addition to more

74) Sewell Chan, Consensus for Limits to Secrecy at the Fed, N.Y. Times, May 9, 2010.

75) Gretchen Morgenson, Ignoring the Elephant in the Bailout, N.Y. Times, May 7, 2010 ("The truth about Fannie and Freddie has always been hard to come by in Washington, and huge piles of money seem to circulate silently around both firms. REMEMBER last Christmas Eve? That's when the Treasury quietly decided to remove the $400 billion limit on federal borrowings available to Fannie and Freddie through 2012. That stealth move didn't engender much confidence in either the companies or their government guardian. But because taxpayers own Freddie and Fannie, we should know more about their buying habits, as Mr. Baker points out. Unfortunately, if the government's past actions are any indication of what we can expect, then don't hold your breath waiting for the facts.")

regular audits and investigations, regulators themselves should be pushed to become more transparent. If nothing else, a culture of secrecy gives the appearance of a conflict of interest, causing distrust in the public's mind.

Administration officials say one of the most scrutinized debates will be over new capital standards that regulators would need to set for the banking industry.[77] The more money that banks set aside, the less they have available to generate profits. Before the financial crisis, regulators did not require big financial firms to put aside enough money, administration officials have said. As a result, when the credit markets tightened, major banks came close to failing -- and nearly brought down the entire financial system.

Thus, strict limits on capital standards is crucial. However, the bill simply establishes the Financial Stability Oversight Council to monitor systemic risk and make recommendations to the Federal Reserve for increasingly strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity, with significant requirements on companies that pose risks to the financial system.[78] The bill's solution to the "too big to fail" problem leaves too much discretion to regulators. Ironically, given that many in Congress have castigated regulators for sitting by the sidelines as the causes of the crisis grew, the bill simply provides that regulators will compel the largest banks to hold more capital (determined by

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76) Barofsky Says Criminal Charges Possible in Alleged AIG Coverup, April 28, 2010 (Bloomberg) (Barofsky says he's battling an entrenched culture of secrecy in the Treasury and elsewhere. "One of the important lessons that I hope will be learned from this entire financial crisis is that the reflexive reaction against transparency, that disclosure will bring terrible things, has not been proven true," he says.)

77) Mark Thoma, an economics professor at the University of Oregon, in an op-ed piece in New York Times, wrote "Senator Dodd's proposal does allow regulators to set limits on leverage, but that is not enough. This crisis demonstrates that trusting the judgment of regulators who are subject to ideological and regulatory capture can lead to insufficient oversight. We need strict upper bounds on leverage – 15 to 1 for example – limits that are independent of the regulators put in charge under any particular administration."

78) Available at http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf

regulator) as a cushion against losses. In response to the bill's capital provision, liberal Democrats Senators Sherrod Brown (D-Ohio) and Ted Kaufman (D-Del.), proposed an amendment that would have cut down the size and scope of megabanks so that their individual failure would not bring down the entire system. Specifically, under the Brown-Kaufman amendment, no bank could hold more than 10 percent of the total amount of insured deposits, and a limit would have been imposed on liabilities of a single bank to two percent of GDP.[79] The amendment failed recently, allowing regulators the flexibility to impose as strict or as loose capital requirements as they decide. Such discretion does not make sense, particularly as the banks that were too big to fail in 2008 have become larger. As the American financial system was falling apart in the aftermath of the bankruptcy filing by Lehman Brothers, the Treasury and the Federal Reserve joined efforts to encourage and shape the mergers between commercial banks and investment banks. While there may have been necessity at the time for such maneuvers, the result was that the remaining banks with any strength have become even bigger,[80] suggesting a need for even stricter capital standards.[81] Such

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79) Senate Votes for Wall Street; Megabanks to Remain Behemoths, posted 5/6/2010, available at http://www.huffingtonpost.com/2010/05/06/senate-votes-for-wall-str_n_567063.html (After the vote, Kaufman defended the provision. "I believe this idea was sound policy -- and I further believe that a mainstream consensus will continue to grow that these megabanks are too large, too complex and too internally conflicted to regulate successfully," he said, echoing a position voiced by regional Fed presidents, former top Fed officials, and former top bankers on Wall Street.)

80) Deal book, New York Times Financial Debate Renews Scrutiny on Banks' Size, Apr. 21, 2010. (During the crisis, Bank of America swallowed Merrill Lynch, JPMorgan Chase bought Bear Stearns and Wells Fargo acquired Wachovia. Goldman and Morgan converted to bank holding companies to gain access to lending from the Fed's discount window.)

81) Following the crisis, the U.S. mega banks left standing have even more dominant positions. Take the multi-trillion-dollar market for OTC derivatives. The five largest banks control 95 percent of that market. With such strong pricing power, these firms could afford to expand dramatically their margins. The Federal Reserve estimated that those five banks made $35 billion from trading in the first half of 2009 alone. Of course, they used these outsized profits from trading activities in derivatives and other securities not only to replenish their capital, but

concentration of power in hands of few players is at an unprecedented level.[82] The increase in concentrated power among the remaining banks comes with increased risk. Setting capital requirements should not be left to regulators' discretion when they have in the past offered exceptions and loopholes to such requirements and when they have been demonstrated to be subject to euphoria of markets.[83] Rather, the set limits as seen in Senator Kaufman's proposed amendment, should be incorporated directly into the legislation.

Finally, the bill should incorporate sunset-like provisions that require rigorous performance measurements to better assess the effects of the regulation once the markets have calmed. Such an inclusion could address the concerns of some Republicans that a sweeping regulatory bill would overregulate and have unintended adverse consequences.[84] It could require Congress to assess the results of the reforms and how closely the aims of the legislation have been met.

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also to pay billions of dollars in bonuses. Available at http://kaufman.senate.gov/press/statements/statement/?id=ACA5B91A-6E51-4D6B-A367-414AD9641500

82) MIT professor Simon Johnson and James Kwak, a researcher at Yale Law School, estimate that the six largest U.S. banks now have total assets in excess of 63 percent of our overall GDP. Only 15 years ago, the six largest U.S. banks had assets equal to 17 percent of GDP.

83) Simon Johnson and James Kwak, Capital Requirements Are Not Enough, N.Y. Times, Apr. 1, 2010 (But because capital requirements are enforced by regulatory agencies, which have the power to overlook shortfalls case by case (called "regulatory forbearance"), they can be an unreliable instrument during an economic boom, when regulators are infected by enthusiasm wafting in from the financial markets, if not by the more sinister problem of regulatory capture.)

84) David M. Herszenhorn and Edward Wyatt, G.O.P. Blocks Debate on Financial Oversight Bill, N.Y. Times, Apr. 26, 2010 (Senator Judd Gregg, Republican of New Hampshire, said that Republicans wanted to prevent a collapse like the one in 2008 but that Democrats were in danger of over-regulating the financial system and risked strangling the economy.)

IV. Conclusion

Reform in the aftermath of a near catastrophic crisis is almost inevitable. Thus, the bill currently being fiercely debated in the Senate, will almost surely pass in one form or another. In addition, reform by way of settlements of government investigations appears possible as well. In 2002, the New York Attorney General opened cases against the major banks and investment houses accusing them of breaching the so-called "Chinese wall" and alleging that there were conflicts of interests in the way analysts and investment bankers in the same company interacted. This investigation ended in a global settlement in which 10 banks paid $1.4 billion total and pledged to change the way their analysts and investment bankers interacted to prevent conflicts of interest. Recently, the current New York Attorney General, Andrew Cuomo, is investigating whether firms may have devised and sold securities to investors without telling them they were simultaneously betting against them in the years preceding the 2008 crisis.[85] Some experts are predicting a global settlement by banks akin to the 2002 settlement, only this time the price of any settlement may be higher and come with more structural reforms.[86]

Thus, while there will undoubtedly be sea of changes enveloping financial regulation in the near future, real reform cannot be complete without some cooperation and action on a global level. The 2008 economic crisis, though this paper deals clearly with American considered regulatory reforms, had roots that went beyond America's borders.[87] Just as the collapse of Lehman

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85) Wall Street firms typically play both sides of trades, whether to help buyers and sellers of everything from simple stocks to complicated derivatives complete their transactions, or to make proprietary bets on whether they would rise or fall.

86) Nelson D. Schwartz and Eric Dash, With Banks Under Fire, Some Expect a Settlement, N.Y. Times, May 13, 2010.

87) Dam, Kenneth W., The Subprime Crisis and Financial Regulation: International and Comparative Perspectives (March 26, 2010). Chicago Journal of International Law, Vol. 10, No. 2, 2010; U of Chicago Law & Economics, Olin Working Paper No. 517. Available at SSRN:

in 2008 sent shockwaves, first across America, and then criss-crossing the globe, so too the recent dip of the European markets in the first two weeks of May 2010 (initially related to Greece's woes) rapidly infected markets outside of Europe. These two events starkly demonstrate the interconnected nature of the modern world's banking system and markets. International markets in fact only calmed once European leaders agreed to provide a huge rescue package of nearly $1 trillion[88] in a sweeping effort to combat the debt crisis.[89]

Reform of the financial markets then, to be most effective, must include, in addition to any bill that passes that addresses both the changes financial firms and regulators must undergo, international cooperation. The Senate bill does not set forth explicitly any new capital requirements, leaving too much power in the hands of the regulators. However, whatever the regulators decide in the future, attention must also be paid to the ongoing international

http://ssrn.com/abstract=1579048 (Most economic and legal discussion of the subprime mortgage loan crisis (and the follow-on financial crisis) focuses on the United States. However, many other countries participated in the subprime securitization aspect of the crisis, not just by buying U.S.-originated consumer mortgage-backed securities but also by using off-balance sheet entities in connection with such securities.)

88) James Kanter and Landon Thomas Jr., E.U. Details $957 Billion Rescue Package, N.Y. Times, May 9, 2010 (In an extraordinary session that lasted into the early morning hours, finance ministers from the European Union agreed on a deal that would provide $560 billion in new loans and $76 billion under an existing lending program. Elena Salgado, the Spanish finance minister, who announced the deal, also said the International Monetary Fund was prepared to give up to $321 billion separately.)

89) Id. Also see Nelson D. Schwartz and Eric Dash, Greek Debt Woes Ripple Outward, From Asia to U.S., N.Y. Times, May 8, 2010 (What was once a local worry about the debt burden of one of Europe's smallest economies has quickly gone global. Already, jittery investors have forced Brazil to scale back bond sales as interest rates soared and caused currencies in Asia like the Korean won to weaken. Ten companies around the world that had planned to issue stock delayed their offerings, the most in a single week since October 2008. The increased global anxiety threatens to slow the recovery in the United States, where job growth has finally picked up after the deepest recession since the Great Depression. It could also inhibit consumer spending as stock portfolios shrink and loans are harder to come by. "It's not just a European problem, it's the U.S., Japan and the U.K. right now," said Ian Kelson, a bond fund manager in London with T. Rowe Price. "It's across the board.")

effort led by a group based in Switzerland called the Basel Committee on Banking Supervision.[90] Lawmakers and administration officials say that capital standards need to be coordinated across borders, otherwise banks will move to countries with the weakest rules. Agreement on capital standards, however, will take time, which may give banks and other financial companies the opportunity to influence the outcome or create loopholes. Moreover, the Basel Committee does not have the power to force nations to adopt its standards.[91] Thus, while any agreement presented by the Basel Committee would be welcome, the bill currently being considered in Congress needs to pass in as strong a form as possible. In addition to the concrete reforms in the bill, the legislation provides that American regulators will "consult and coordinate with foreign regulatory authorities" to establish international standards.[92]

Consideration therefore of the interconnected nature of the markets magnifies the need for reform on many levels-both domestic and international. Although the legislation has its weaknesses, the bill, as it stands currently, provides valuable regulatory tools. Moreover, although many now believe that the bill will pass in some form, that was not so clear

90) Simon Johnson and James Kwak, Capital Requirements Are Not Enough, N.Y. Times, Apr. 1, 2010 (The Treasury Department says that bank regulators already have the power to increase capital requirements, and they will do so as part of an international agreement that they hope to reach by the end of this year.)

91) David Cho, Finance reform bill leaves some key decisions to regulators, Wash. Post, May 8, 2010.

92) SEC. 761. INTERNATIONAL HARMONIZATION. In order to promote effective and consistent global regulation of swaps and security-based swaps, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Financial Stability Oversight Council, and the Treasury Department－(1) shall, both individually and collectively, consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of such swaps; and (2) may, both individually and collectively, agree to such information-sharing arrangements as may be deemed to be necessary or appropriate in the public interest or for the protection of investors and swap counterparties. Available at http://banking.senate.gov/public/_files/TheRestoringAmericanFinancialStabilityActof2010AYO10732_xml0.pdf

even a few months ago.[93] In other words, the bill's passage, the most ambitious overhaul of the financial system since the 1930s, will be a feat. A new agency, the consumer financial protection regulator, will be born.[94] This article points out the bill's insufficient attention to making regulators more transparent, controlling their discretion, and preventing their conflicts of interest. At the same time, the legislation, expected to pass in the next few weeks, is certainly better than no reform. In fact, the current legislation represents a substantial step forward in financial reform.

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Key words the financial system, Derivatives, "Too big to fail" banks or financial institutions, the Basel Committee on Banking Supervision.

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93) Elizabeth Warren commented "Since bringing our economy to the brink of collapse, Wall Street has spent more than a year and hundreds of millions of dollars in an all-out effort to block financial reform." Katie Benner, Broke! Fixing America's fiscal crisis Elizabeth Warren's war, Fortune, Mar. 17, 2010.

94) David Cho, Finance reform bill leaves some key decisions to regulators, Wash. Post, May 8, 2010.

국문초록

규제기관의 투명성 제고

리디아 강
(서강대학교 법학전문대학원 조교수)

2008년 미국을 비롯하여 아이슬란드, 그리스, 두바이로 확산된 경제위기가 2년 가량 지난 지금 미국 의회는 규제개혁법안의 통과를 앞두고 있다. 그것은 대공황기의 개혁 이래 최대의 금융체제개혁이 될 것이다. 몇 주 이내로 통과될 것으로 예상되는 이 법안은 여러 약속을 담고 있다. 그것은 「소비자보호국」의 신설하고, 체제를 위협하는 기업을 해산시킬 권한을 갖는 기구를 설치하며, 은행이나 금융회사의 최소자본기준을 설정할 권한을 국제당국에 부여하고, 증권거래소가 최대의 헤지펀드를 규제하도록 규정하고 있다. 이 법안은 주로 은행과 금융기관의 문화와 경영행태를 변화시키는 것, 위험을 감수하면서 단기적 이익을 쫓지 않도록 유인구조를 변화시키는 것 그리고 투명성과 위험관리능력을 제고하는 것에 초점을 두고 있다. 본고는 이러한 조치들이 바람직한 방향이라고 본다. 그러나 법안에는 약점도 있는 데 특히 한 가지 점이 현저하다. 즉, 법안은 위에 거론된 것 못지 않게 긴박한 요청들, 다시 말해 규제기구들과 이들의 문화를 개혁하고 이를 통해 규제기구가 더 효율적으로 작동하도록 하는 문제를 빠뜨리고 있는 것이다.

본고는 4개의 부분으로 구성되어 있다. 우선 제1부는 법안의 내용을 분석하고 규제기관의 개혁에 대한 거론이 없다는 점을 지적한다. 제2부는 규제기관이 적어도 위기를 완화시키는 데 필요한 도구를 가지고 있는지 여부를 검토한다. 이어 제3부는 규제기관의 비효율, 이익충돌 그리고 투명성에 관한 논의를 검토한다. 본고는 규제기관의 투명성과 책임성을 제고하는 것뿐만 아니라 규제기관의 재량권 제한을 권고한다. 사실 음습한 금융체제에 빛을 비추어야 한다는 논의는 많이 있었다. 금융체제에 투명성을 증가시키자는 논의는 규제자에 대해서

도 마찬가지로 적용된다. 마지막으로 제5부는 금융규제개혁이 효과적이기 위해서는 국제적인 협력이 필요하다는 점을 지적함으로써 결론을 맺고 있다.

주제어 금융체제, 파생상품, “파산시키기에는 너무 큰” 은행 및 금융회사, 은행감독에 관한 바젤 위원회.