COMMENTARY ON REDESIGNING THE SEC: DOES THE TREASURY HAVE A BETTER IDEA?

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THE question framed for discussion is whether, if the SEC needs redesigning, the Treasury Blueprint presents a better idea?[1] The simple answer is "no." A more detailed explanation as to why that is the answer is provided in Professors Coffee and Sale's excellent article.[2] My view[3] is that Treasury, as evidenced again by its Blueprint, and as it has shown so many times over the past couple of years (that is, 2007 and 2008), simply misunderstands the point of financial regulation and the appropriate mission of government in this area more generally (perhaps this will change with the new Obama Administration). This analysis may seem harsh, but it reflects the current realities of the financial world. The depression-era possibilities we now face emerge not from a failure of regulation per se, but from government's failure to execute its central mission properly. Because the issues noted here have been understood for a decade, and because no action has been taken to address them, I write this with a little frustration.

The issue of what is to be done now transcends questions of whether regulation should be principles-based or rules-based, or whether states or the securities self-regulatory organization ("SRO") should play a greater or lesser role in securities enforcement. The foundation on which the securities industry regulatory

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[1] See Dep't of Treasury, Blueprint for a Modernized Financial Regulatory Structure (2008).

[2] John C. Coffee, Jr. & Hillary A. Sale, Redesigning the SEC: Does the Treasury Have a Better Idea?, 95 Va. L. Rev. 707 (2009).

[3] My view is informed by time in private practice, at the Commission, and in management of a regulated broker-dealer.

structure—and the larger financial services regulatory structure—have been built has not just been shaken; it has been demolished by changes over the last quarter-century that have accelerated in the last decade. The failure to keep pace, which has significantly contributed to our current financial system problems, is attributable to a variety of factors, including:

- the Commission itself for buying into its own securities-centric and after-the-fact enforcement worldview, without understanding its own strengths and weaknesses and its ability to play a far broader but more focused role (by being the protector of ***all financial services*** *consumers*, not just *investors*, but not necessarily a markets, systemic risk, or solvency regulator);
- Administrations that have viewed the Commission as somewhat irrelevant and unimportant, providing little leadership or willingness to support initiatives for reform of the enabling statutes and failing to recognize that we have financial products and services, not separate securities, banking, insurance, and commodities/futures products and services;
- a Congress that seeks to maintain artificial jurisdictional boundaries between committees that foster distinctions and separation in otherwise naturally intertwined businesses, thereby creating regulatory chasms into which much of the economy has recently fallen;
- a self-regulatory apparatus that has become, notwithstanding some of the best regulatory management and personnel, focused on sustaining itself in part with fines for rule violations that are minor in terms of true investor protection and has subsequently resulted in the organization being less focused on addressing problems that cost more to enforce and investigate, but potentially return little in fines;[4] and, perhaps most important,

[4] This is not a condemnation of Financial Industry Regulatory Authority's ("FINRA") management or personnel. If an organization is structured such that its revenues are based in significant part on collecting fines, then its mission will morph in significant part to focus on fine collection. An organization almost always responds to incentives to do what compensates it best. For governmental agencies, compensation usually is determined by cost-effective accomplishment of missions accompanied

- an industry that has spent an inordinate amount on lobbying to keep the status quo so that it could continue to maintain high profits, opaque business offerings, and a regulatory structure that protected and served the industry as much as policed it.

Let us examine where we are. Currently, financial services fall into four rather broad areas, because that is how the statutes and regulations define them. Unfortunately, financial services *regulation* also follows these definitional *product* lines, as opposed to the *goals* that regulation otherwise has, such as protecting financial consumers, promoting efficient markets, limiting solvency risk, or stemming systemic risk.

To review, first, we have securities that are created, issued, and sold by certain entities, packaged by others, traded by still others, and rated, opined on, or audited and vouched for by others still, with still others advising as to whether to buy or sell and at what price, or buying and selling for themselves. Some entities do many of these functions, some only one. Some are regulated and some are not, depending on a variety of factors. Some entities are very, very large, others tiny. Some embody the highest level of integrity, some exhibit perpetual looseness in their commitment to basic business ethics. All are potentially touched, at least at the extreme with regard to addressing fraud, by the Commission or state regulators. In addition, many are regulated by the Financial Industry Regulatory Authority ("FINRA"), a quasi-public entity when it comes to its immunity and authority to compel entities to be regulated by it and pay into it, and a quasi-private one when it comes to

by public accolade or other higher goals. For example, NASA and its personnel clearly are dedicated to the exploration of space, not making money, and the agency measures its success in various metrics related to its space missions. The NIH measures its success by its ability to promote health and the medical sciences; the CIA by its ability to protect the country from its enemies; etc. If agencies, however, were forced to be self-sustaining, they would quickly shift their mission from lofty initiatives such as exploring the universe to launching commercial space flights; from basic health research to development of the most lucrative health measures; or from protecting the country to better-paying, commercial spying. We try not to encourage such morphing of regulatory mission in government agencies, yet that is precisely the position in which we place FINRA. So, although it has done a reasonable job in maintaining its mission, there is little doubt that too much of FINRA's effort focuses on enforcement that results in fine-generating activities that have only a modest connection to real investor protection.

its pay scale, ability to keep the monies it collects from fining its "members," and other matters.[5]

Second, we have bank-type services, including commercial and consumer lending, mortgage lending, credit card offerings, cash deposit services, transaction processing, and a whole host of other services, regulated by a collection of agencies including the Federal Reserve, Treasury Department, Office of the Comptroller of the Currency ("OCC"), Office of Thrift Supervision, the Federal Deposit Insurance Corporation ("FDIC"), Office of Federal Housing Enterprise Oversight, and numerous state agencies. There is no self-regulatory agency for bank-type services.

Third, there are commodities and futures services and instruments, generally broken down into those that are required to be traded on an exchange and those that are not. When exchange-traded, these products are subject to the rules of the powerful futures exchanges whose mission is to promote and maintain efficient futures trading. All this is regulated, to the extent not exempted by statute, by the Commodities Futures Trading Commission ("CFTC").

Fourth, there is insurance. Insurance is the outlier, only indirectly regulated by the federal government and self-regulatory organizations. For the most part, insurance is subjected exclusively to individual state regulation.

Keeping with this product-defined view of regulation, those who sell, advise, or create the various financial services in the areas noted above are generally subject to approval, registration, and regulation by those agencies with authority over the regulated instruments in that area. Those who are involved with securities—such as brokers, dealers, or advisors—are subject to regulation by the Commission (and for brokers and dealers, FINRA); those offering non-exempt futures or commodities are subject to CFTC registration and regulation; those offering banking services are subject to approval by and registration with the specific banking agencies; and those who provide insurance are subject to approval by and registration with the states. Finally, of course, this regulation is also limited jurisdictionally to the general geography of the United States.

[5] See Coffee & Sale, supra note 2, at 729, 768–69.

The regulatory landscape described above was created primarily during the formative time of the post-Depression era, although banks and exchanges were around centuries before. For long periods of time, it worked reasonably well. So what has changed?

Some changes are obvious. The boundaries are no longer clear regarding which category various instruments fall into, or which entities are selling them. For example, instruments such as single-stock futures, by definition, blur two categories. Likewise, while there are important differences between money market accounts and money market funds, they are not marketed to consumers in ways that make the differences salient or understandable. Entities previously limited to selling only one service in the group of four now sell many or all.[6] Meanwhile, various entities that we now know have enormous implications for the stability of financial services as a whole (for example, the former Long Term Capital Management[7] as well as today's large hedge funds) are not regulated at all, or only very lightly so, because they do not sell, advise, or create (they consume), any of the traditional defined services.

The current structure has also been subverted by more subtle and adverse influences. The products and activities of the established incumbents come to define the regulatory paradigm. Innovations from new entrants, even if they pose no new discernible risk to the public while offering considerable benefits, languish for years or decades in the regulatory maze while incumbents stave off their introduction with sometimes real, but sometimes fanciful, concerns. Securities examples that quickly come to mind are discount brokerage, exchange-traded funds, and even Folios.[8] Similarly, regulatory proposals with obvious benefits to investors—such as a simple monthly disclosure informing mutual fund investors of how much they are actually paying to be in a mutual fund (thereby encouraging competition as to real expenses and fees while educating investors as to what their real costs are)—are relegated by in-

[6] For other reasons, primarily the need for capital, some of the largest supermarkets, like Citigroup, are unwinding.

[7] See, e.g., Wikipedia, Long-Term Capital Management, http://en.wikipedia.org/wiki/Long-Term_Capital_Management (last visited Mar. 8, 2009).

[8] See, e.g., Wikipedia, Discount Brokerage, http://en.wikipedia.org/wiki/Discount_brokerage (last visited Mar. 24, 2009); Wikipedia, Exchange-traded Fund, http://en.wikipedia.org/wiki/Exchange-traded_fund (last visited Mar. 24, 2009); Folio Investing, https://www.folioinvesting.com (last visited Mar. 24, 2009).

dustry opposition to the pile of interesting ideas not to be acted upon, where this particular one remains.

The same infirmity in the system explains the longevity of structures profitable to incumbents that are maintained with the assistance of the regulator. As an example, for years it was known that market makers were making outsized profits because of wide spreads in the stocks they traded. The wide spreads held because of a nuanced form of price-fixing that, also for years, was blessed and protected by the Commission—namely the Exchanges' enforcement of rules maintaining minimum spreads through trading in "eighths" (12.5 cents) instead of in smaller increments, such as pennies.[9] Not only were profits high, but the business was so lucrative that market makers started to "pay for order flow" to get more, actually restoring some level of competition to a flawed marketplace. But, instead of fostering payment for order flow (or the better solution of "decimalization," noted below), the Commission sought to ban it. Only after internal divisions within the Commission surfaced, and pressure began from members of Congress for the superior idea of moving the exchanges to smaller trading increments, specifically pennies, was the more obvious solution of "decimalization" finally embraced. In sum, the right answer was known for almost a decade but resisted by the same Commission that had the authority to fix the problem.

The point of these examples is not that regulators make mistakes. Of course they do; they are human. The point is that exclusive authority coupled with regulatory capture leads to many serious or potentially serious mistakes. For example, if only one regulator has sole authority over everything related to securities, then the primary lobbyists, the primary providers of information, and the primary focus of concern is only the securities industry. To the extent that the regulatory process is supposed to take into account competing views and concerns offered by zealous adversaries, there simply is no "other side." The regulator hears only from its special industry.

[9] Initially thought of as a quaint regulation enforcing a bygone tradition, trading in fractions of dollars ("pieces of eight") evolved into simple price-fixing. With "eighths" as the minimum spread, each risk-free bid-ask trade netted 12.5 cents.

By contrast, for example, in communications regulation there is an inevitable convergence blurring industry lines. Whatever the telecommunications companies seek to do before the Federal Communications Commission, they can be certain it will be well scrutinized and strongly objected to by the cable industry, and vice versa. In addition, strong advocacy groups, some industry funded, have been established to press consumers' perspectives, even if they carry a particular industry's bias. No such competition, nor the advocacy it fosters, occurs in financial services—in part because each regulator has its own industry, with the others being outsiders.

As another point specific to securities regulation, the existence of a self-regulatory organization has been a bittersweet development. The existence of a strong self-regulator could be a material adjunct to the Commission's mission. But it also allows the industry to argue—in the name of avoiding duplication—for a governmental regulator with far fewer resources than it should have to do its job well. Moreover, if the self-regulator is viewed as the entity that has "feet on the ground," then the result is a governmental regulator that becomes increasingly removed and then isolated from the day-to-day operations of regulated entities, and therefore increasingly surprised by problems surfacing on the street. It is not just coincidental that more and more securities frauds and systemic violations are problems first identified by state regulators and others, as the Commission finds itself too distant from what happens around it because of the interposition of the SRO. And as noted previously,[10] an additional detriment to this SRO structure is that FINRA obtains significant portions of its income from the fines it levies—and keeps—and it is therefore motivated to focus on what makes money (such as violations of obscure rules whose investor benefit is attenuated at best) as opposed to what truly benefits investors.

One final observation is that the current regulatory structure has contributed to significant regulatory gaps. By focusing on the products and services being sold instead of the goals of government regulation, we have encouraged institutions to invent products and services that are outside of regulatory oversight. Various good and worthwhile derivatives products, for example, might have fallen

[10] See supra note 4 and accompanying text.

into an intricate web of conflicting rules from different regulators with presumptive authority. Because of that, two things happened: some products were designed to remain outside the regulatory system altogether and others were precluded from being regulated by Congress[11] after lobbying showed that, without an exemption, the current regulatory structure likely would have been deadly to their creation and offering. The result is a lack of oversight and regulation that has now led to significant problems. Had the regulatory structure been better and more reasonable, the gap allowing products to be designed to escape regulation would not have existed, and Congress, presumably, would not have been so easily convinced to exempt the others.

To summarize, the current financial services regulatory landscape is a balkanized one. It consists of four generally separate fiefdoms based primarily on archaic product definitions. That balkanization allows for gaps in coverage as well as barriers that keep others out. It results in agencies being internally focused on their industries, something that can lead in part to regulatory capture. Moreover, in the case of securities, because of the interposition of a fine-funded, self-regulatory organization, it can also foster ignorance of everyday, street-level happenings while the government regulator pursues less meritorious, yet lucrative, violations. This is not a pretty sight.

But all is not lost. The regulatory structure has been evolving on its own, notwithstanding the lack of any updated foundation onto which it can graft.

Take the Commission, for example. Although it regulates brokerages for solvency concerns by ensuring they have sufficient capital and take prudent risks, and has done an admirable job, it does so as an ancillary strategy to its prime mission of protecting investors. Its staff monitoring capital and risks are small, and its means for monitoring are largely paper-based, just as they have been for decades. But the Commission's crown jewel (Madoff notwithstanding) is a different division: enforcement. Promoting investor protection by understanding varying and complex frauds, assisting the U.S. Attorneys on criminal matters in connection with

[11] See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

securities issues, and tackling international conspiracies is part of what it does best. If one had to describe the Commission in just a few words, the strong consensus would be that it is an agency focused on investor protection through aggressive enforcement. Like most things that evolve, the Commission has found its niche and comparative advantage.

By contrast, banking regulators, such as the OCC and the FDIC, have focused more on entity solvency (consistent with their obligation of insuring bank deposits), and far less on disclosures to bank customers or ensuring that such customers fully understand various bank products. Technology is used to monitor risks, inspectors are in the field, resident in banks, and their clear objective is to minimize the number of bank failures. Given the number of banks and the task, generally, they have performed well, even though their protection of consumers, especially in the mortgage area (but in others as well), leaves something to be desired. In a similar vein, the bank regulators have done little to foster exchanges or marketplaces that could assist their efforts. The over-the-counter derivatives marketplace, which is basically bank-operated, is opaque and not very efficient. Working with exchanges or understanding how they best operate has simply not been central to their mission.

Working with exchanges and understanding how they best operate, however, has been integral to the mission of the CFTC. There is likely no regulator anywhere that is as fluent and capable in understanding the mechanics of markets, or as focused on their workings, as the CFTC. But its concentration on markets has left it somewhat lacking in, for example, consumer protection.

And then there is the Federal Reserve ("Fed"). With its monetary policy mission it has been the best regulator to consider, more broadly, issues of systemic risk. Although some debate the ability of any regulator to address systemic risk issues effectively, believing the issues to be too complex for our current level of knowledge, the Fed at least has the staff and the focus to be credible here and to supply what added value a regulator can supply. None of the other regulatory agencies can match the Fed's breadth or depth in this area, and with the Fed's exclusive authority over monetary policy, none of the other regulators have much in the way of comparable tools. By contrast, the Fed is simply no match for the Commission, the FDIC, or the CFTC with respect to consumer

protection, solvency regulation, or exchange regulation, respectively.

So, if the Treasury's Blueprint is not the right approach, what is?

The answer is straightforward. First, recognize that the landscape is one of financial regulation, not securities, banking, futures, or insurance. Second, recognize that governmental goals and missions are not to regulate securities or banking or futures products or insurance, but to protect financial consumers, reduce entity insolvency, foster efficient, transparent and fair marketplaces, and address systemic risk. Third, understand that there are real benefits from having industries that *can* offer substitutes and competition, and then having those industries *actually offer* them—in other words, promote financial services convergence and competition just like communications convergence and competition—instead of seeking to preclude such substitutes. Fourth, devise a regulatory structure that plays to the inherent strengths of respective governmental agencies. So, if an agency is primarily staffed with enforcement lawyers, expect its focus and strengths to be different from those of an agency staffed with economists. Fifth, recognize that although self-regulation can play a valuable role (especially voluntary self-regulation[12]), it is not as useful as a well-functioning governmental agency.

Combining these principles leads to a well-defined, but very new, regulatory structure premised on the creation of agencies focused on the *goals* of financial regulation.

The current regulatory agencies, already somewhat transformed into what is proposed, could be enlisted for this purpose. Under this proposal, the Commission would become a financial consumer protection agency with a broad mandate to protect all financial consumers, not just investors. It would use its formidable skills to protect mortgagees, depositors, insureds, and those who trade in the futures markets as well as securities investors. The CFTC would regulate and manage all exchanges, including the futures exchanges as it does now, and also the securities exchanges and any

[12] There are many examples, from Good Housekeeping seals to Better Business Bureaus, that prove the benefits of various forms of self-regulation, especially, as in these examples, where they are voluntary, and innovators or outliers can go their own way. Self-regulation, however, does not substitute for a truly well-functioning governmental agency.

other exchanges developed in the future for derivatives, swaps, or other financial instruments. The numerous bank regulators would be combined and focus primarily on entity solvency concerns across all financial services companies, regardless of whether they sell securities, bank products, futures, insurance products, or combinations of them. Finally, the Fed would formally be given the authority and responsibility it has already assumed to focus on systemic risk, regardless of whether the entity potentially posing it is a massive bank, securities firm, insurance company, futures merchant, hedge fund, other entity, or a combination thereof.

It would be useful for the financial regulatory agencies to coordinate with each other. This could be done by placing all the agencies under a single department such as Treasury, by enshrining more clearly the President's Working Group with its own support staff and mission of overall financial services regulation coordination, or by expanding the role of the National Economic Council and using it for this purpose.

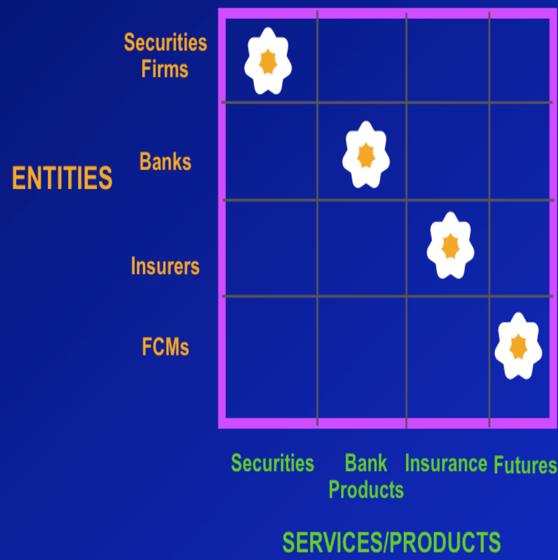
A graphical presentation of this transformation is provided in the attached designs.

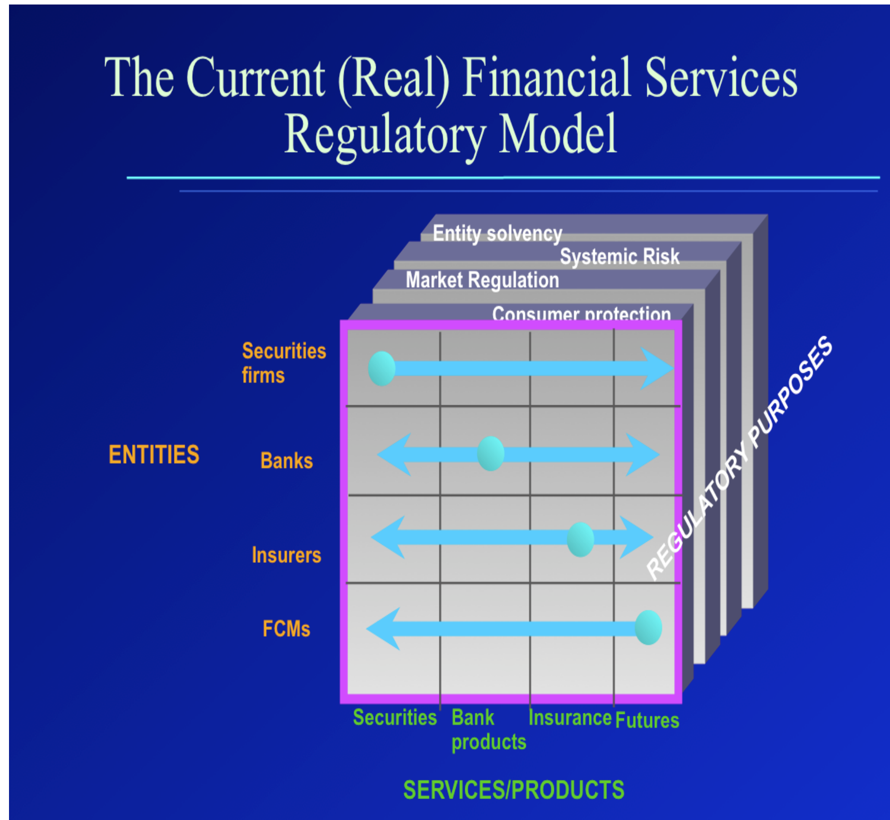
Obviously, if this broad change in the landscape of financial services regulation is accepted, additional detail will be needed to fill in the picture to make the transition a smooth one. But if accepted, we will have a financial services regulatory structure that will serve us well for the foreseeable future. There will need to be significant support from the President and the heads of the affected agencies to make this possible. By contrast, believing it is too hard to effect change in this area simply dooms us to increasing regulatory disappointments. Strangely, our current structure is not very old, but some in the financial services sector accept it as if it has always been here and is ordained by a higher authority. We can change it, and we must change it unless we want to condemn ourselves to more failures. Financial services are simply too important to surrender to inertia, or to believe we have already reached and implemented the pinnacle of our thoughts on optimal regulatory structures, especially in light of the current debacle.

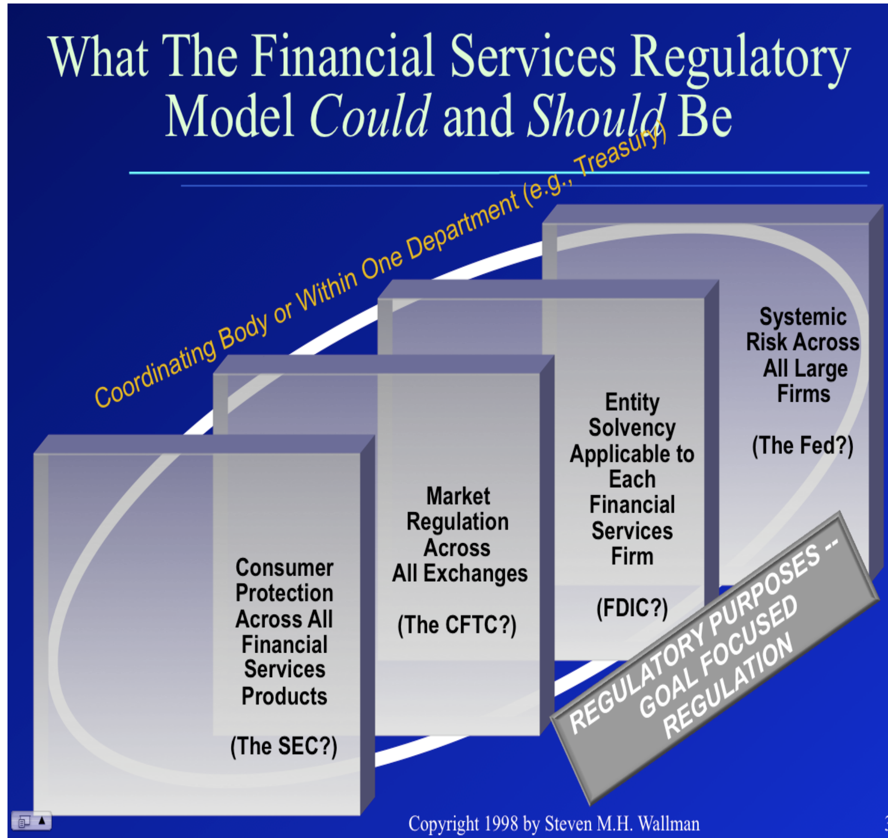
A decade ago, I proposed the above set of changes in Congressional testimony on reforming the financial services sector.[13] The observation at the time from the members of Congress who heard the presentation was that it was a compelling vision for the future, but that only a deep and broad crisis could cause Congress to consider such changes. Sadly, and unnecessarily, we now have that crisis. Perhaps then, at least something good may come from it if we recognize now is the time we can embrace and implement this vision.

[13] See Technology and Banking: Hearing Before the Subcomm. on Capital Markets, Securities, & Government Sponsored Enterprises of the H. Comm. on Banking & Financial Servs., 106th Cong. 53–60 (1999) (statement of Steven M.H Wallman).

APPENDIX




The Current (Real) Financial Services Regulatory Model
Entity solvency
Systemic Risk
Market Regulation
Consumer protection
REGULATORY PURPOSES
ENTITIES
Securities firms
Banks
Insurers
FCMs
Securities
Bank products
Insurance
Futures
SERVICES/PRODUCTS


What The Financial Services Regulatory Model *Could* and *Should* Be
Coordinating Body or Within One Department (e.g., Treasury)
Consumer Protection Across All Financial Services Products
(The SEC?)
Market Regulation Across All Exchanges
(The CFTC?)
Entity Solvency Applicable to Each Financial Services Firm
(FDIC?)
Systemic Risk Across All Large Firms
(The Fed?)
REGULATORY PURPOSES -- GOAL FOCUSED REGULATION
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