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Regulation That Achieves What We Need Today

By Harvey L. Pitt, *Compliance Week Columnist* — June 24, 2008

Editor's note: Harvey Pitt recently provided a keynote address at Compliance Week's annual conference at the Mayflower Hotel in Washington, D.C., June 4-5. Below is an abridged version of the text of the speech.

I was asked to discuss the regulatory pendulums and what its recent trajectory means for public company executives. I must start by noting a small conceptual problem with this topic. Talking about a "trajectory" implies there's mathematical precision in what's been roiling our markets for the last year and a half and in what's likely to transpire from here on out. While life would be easier, albeit less interesting, if it were mathematically determinable, the reality is it isn't. So, the best I can do is describe financial market regulation's recent past and offer you some predictions about where we may be headed.

Many espouse the concept that some firms are too big to fail. I don't subscribe to that, and I don't believe the Fed embraced it in connection with Bear Stearns' meltdown. Make no mistake about it, Bear Stearns failed. When you're forced to sell substantial assets once valued in the tens of billions of dollars for an original price of $260 million, you've failed, and failed big time. But, the Fed was, in my view, right to worry not about Bear's "bigness" but about its interrelationship with major counterparties that could have brought our entire financial markets to a screeching halt had Bear gone belly-up. Those events, and the Fed's decision to open its discount window to investment banking firms for at least six months, form the backdrop for our discussion.

Where We've Been

Our regulatory regime failed because it's predicated on the assumption that what an enterprise is called, or what it was born as, determines who regulates it. It's also limited by the fact that Congress and regulatory agencies have one very significant characteristic in common—neither likes to give up jurisdiction once obtained. If you think it's hard to extract regulatory jurisdiction from the SEC and give it to the CFTC, or vice-versa, just try telling the Senate Agriculture Committee it should cede its jurisdiction over the CFTC to the Senate Banking Committee!

Unlike anything else, financial services regulation got a boost from the Great Depression, which saw passage of the Glass-Steagall Act, the Securities Act of 1933, and the

Securities Exchange Act of 1934, as well as creation of the FDIC and SEC. Three decades later came the CFTC. The result of the patchwork quilt of alphabet soup agencies leaves us with an embarrassment of regulators: today, the U.S. boasts having at least 51 insurance regulators, 57 for commercial banks, and 53 for investment banks, not counting commodities, credit unions, and allied regulators.

We're blessed—or cursed—with federal regulatory bodies, self-regulatory bodies, multiple-state regulatory bodies, local regulatory bodies, and global regulatory bodies, each struggling to define its role and justify its existence, often creating duplicative or conflicting regulations. This compartmentalized regulatory system mirrored the contours of the financial services landscape. Each new regulatory initiative with its related agency and volumes of regulations is aimed at particular market players that once had exclusive rights to market-specific products. Market participants were regulated based on birth, not substance!

This balkanized regulatory regime was ill suited to control waves of new financial products and services beginning in the 1970s, with the advent of money market mutual funds, and cresting with the exotic and complex synthetic financial instruments implicated in the rise and recent meltdown of the sub-prime market. Passage of Gramm-Leach-Bliley swept away any vestiges of viability in legacy regulatory systems. While GLB repealed Glass-Steagall and removed artificial barriers between commercial and investment banking, it deliberately left in place the existing patchwork of federal and state regulatory agencies and regimes. The political fallout from trying to modernize the regulatory structure was viewed as too much to tackle in the immediate wake of the historic deconstruction of barriers to commerce.

Where We Are?

And yet, today's financial world is, well, worlds apart from the one in which the U.S. regulatory system developed. It's a world where financial products are fungible, financial services are ubiquitous, transactions are electronic, and the effects of financial activities are global. It's a world in which our regulatory system remains redundant, overlapping, and discontinuous such that, in the final analysis, it stifles innovation, discourages informed and prudent risk taking, promotes inefficiency, encourages regulatory arbitrage, and ultimately, incentivizes domestic firms and capital to go offshore, and foreign firms and capital to avoid U.S. markets.

As the recent meltdown of the sub-prime market and Bear Stearns' collapse indicate, it leaves us a regulatory and legal system in which, at best, each regulator understands and addresses the discrete area it regulates, without fully understanding the surrounding landscape or the relationship of one area to the other. At worst, regulators don't fully understand what they regulate, causing some areas to receive attention from multiple regulators while others escape any regulatory consideration.

How Do We Get Someplace Else?

What we need is "smart" and, of course, effective, regulation. To make regulation both smart and effective, we have to start from some fundamental principles: first, capital is the lifeblood of innovation. It's also finite. Thus, an effective financial market regulatory system permits unimpeded movement of capital to its most effective uses. This means minimizing both the number of regulators and the amount of regulation. Second, financial markets are increasingly global, and the U.S. is no longer their focal point. U.S. and foreign investors can invest in either U.S. or foreign companies, so there's international competition for every investment dollar of every investor.

Third, competitors for investment dollars must compete under similar ground rules. If not, some will gain unfair advantages. And, if there are significant disparities in regulation across markets, competitors subject to higher standards may try to evade them, either by not complying or by moving to less-regulated markets. Fourth, on a related note, global markets, governed by global regulators, require global accommodations. Put another way, within the constraints of disparate cultures, local regulatory regimes should be comparable to—and compatible with—those in place internationally.

Where Should We Be Headed?

In any reevaluation and restructuring of our regulatory scheme, we must limit the burdens of regulation while providing necessary tools to avoid undermining its effectiveness. Treasury's "Blueprint for a Modernized Financial Regulatory Structure" is a useful framework for considering regulatory overhaul, but it is only the beginning of analysis, not its conclusion.

Most fundamentally, on a macro level, the right move is one toward a principles-based and prudential regulatory system and away from prescriptive approaches. Not only must regulation become more principles-based and less prescriptive, it also must be rationalized to address, consistently, the entire universe of companies, activities, products, and services that constitute the modern global financial services industry. This includes areas traditionally regulated by the SEC and its international counterparts, as well as commercial banking, commodities, and insurance. Such an overarching federal regulatory system would decrease, if not eliminate, the burdens of duplicative, overlapping regulation.

Financial market regulatory agencies should be constructed and operated as regulators with enforcement powers, not enforcement agencies that happen to regulate. The fundamental goal of regulation should be defining appropriate standards and facilitating compliance with them. Enforcement is a critical element of any regulatory system. When people fail to observe fiduciary duties, for example, they should be clobbered! But if regulation is achieved largely and primarily through enforcement actions, the system has failed. Usually, by the time enforcement actions are brought, wrongful conduct has occurred, investors have been fleeced, and ill-gotten gains have been dissipated. As a

practical matter, regulation is most effective if it induces compliance in the first instance, before violations occur.

A way to achieve better compliance is if all competitors are subject to comparable regulatory standards when they engage in comparable conduct, and there's a single regulator to whom the regulated can talk before taking action that will ultimately be detrimental to investors as well as our capital markets. Those subject to regulation should be encouraged to ask questions and vet proposed products, services, and activities in advance of implementation, rather than being left to guess at the legality of their plans and being prosecuted if they guess incorrectly.

New regulations should be approached differently as well. Any proposed new rule should, as a matter of course, be subject to disciplined consideration of the costs its new mandates impose. When regulators put pen to paper, they should bear in mind that it's always cheaper for government to propound new rules than it is for the subjects of new rules to comply; market participants are partners in the regulatory process, and neither its enemies nor its intended victims.

A steady flow of relevant information about markets and market participants is the lubricant that permits markets to function efficiently. If useful data are available, market participants can, and assuming economic rationality will, make appropriate decisions without needing regulatory intervention. The sub-prime crisis illustrates the consequences of insufficient market data. Prior to the summer of 2007, market participants relied on the ratings agencies to classify securities. The failure of the ratings agencies to perform this classification properly has created the largest private placement market in financial history. As a consequence, formerly liquid balance sheets have now become illiquid. Even today, market participants lack a central clearing house for information on underlying collateral performance and access to models that can process information into cash flows. Creating a system for production of this type of information on an ongoing basis will elevate market efficiency.

Finally, rules and regulations presumptively should be provisional. Some reasonable period after promulgation, agencies should be required to undertake reconsideration of the rule to assess what compliance actually costs, how effective it's been, and whether it's violated the "law of unintended consequences." Even after such reconsideration and a finding that a rule is not "more trouble than it is worth," it should be subject to a sunset provision to force regulators to revisit the rule's continued efficacy.

What's a Compliance Officer to Do?

Significant change is coming to the regulatory landscape, sooner or later. No matter when it happens, or what form it takes, managements and boards must take responsibility for the fates of their companies. A number of lessons from the recent failings of our regulatory system will, I expect, continue to stand companies in good stead, no matter what the contours of the regulatory landscape.

1. **Transparency is Critical.** Decisions aren't any better than the information on which they're based. Lack of information and analysis poses other dire consequences: investor decision making is impaired if critical facts are lacking; companies can't disclose what they don't know, and disseminating incomplete information begets financial exposure. Companies should secure the best possible information and analytical tools, both for risk-management purposes and for ensuring appropriate disclosure.

2. **Risk Management Can't Be Left to Chance.** A management paradigm in which risk managers veto plans that unbalance risks and rewards serves to keep a company on the straight and narrow. Some investment banks escaped the sub-prime debacle because they integrated risk management into their business processes and gave risk managers a decision-making voice. In contrast, others relentlessly pursued short-term profits, excluding risk managers and their cautionary messages.

3. **Avoid the Sara Pitt Syndrome.** My mother was a self-medicating health fanatic. It took years to have her see a doctor about stomach pain. After she went, I called to get her take on the visit. She said, "You know, Harvey, I was never sick a day in my life until I went to see that doctor!" Many boards are like my mother was—if no one tells them they have cancer, they think they don't have it! But, life doesn't work that way. Bad things happen to good companies, and rarely come from nowhere. Lists of potential horribles should be kept, checked, analyzed, and updated, with contingency planning for each.

4. **Haste Makes Waste.** Firms with significant sub-prime exposure made quick decisions in the aftermath of a market meltdown. Some initially supported affiliated hedge funds, but later reversed course and let them fail. In the legal profession, that's called piercing your own corporate veil. The consequences of these hasty decisions will be thrashed out in courts for years.

5. **Unstable Foundations Make for Short-Lived Institutions.** Players in mortgage-related industries remade themselves and built strategic plans expecting returns from sub-prime profits to continue indefinitely. Their futures were built on unsupportable mathematics and models, leaving them with personnel and infrastructure not suited to new economic reality and sub-prime assets for which there's no market. This, in turn, has led to layoffs and business unit closures.

6. **The Buck Stops Here.** In the sub-prime crisis, some firms fired CEOs and other high-ranking executives. Ultimate responsibility, though, lies with boards, which hire CEOs, and boards must accept that responsibility. This is true both in choosing senior managers and in ensuring an appropriate infrastructure of checks and balances to curtail irrational exuberance.

7. **You Only Get One Bite at the Apple.** Some firms irrevocably harmed

themselves by multiple write-downs. If you've made a mistake, you've only got one chance to say you're sorry and correct it. It's not a time for a succession of "oh-by-the-ways." It's the board's responsibility to prevent that from happening.

I realize that operating effectively in a new and changing business environment has become extremely complicated, and even daunting. But, no matter how difficult your situation or dangerous the environment, with thoughtfulness, creativity, fortitude, patience, and exacting care, you can solve any problem and surmount any obstacle. In a challenging environment, tough standards, exacting procedures, and rigorous policies will be rewarded. You can count on it.

ABOUT THE AUTHOR

Compliance Week columnist Harvey Pitt is a former chairman of the Securities Exchange Commission and founder of Kalorama Partners.

As the 26th chairman of the SEC, Pitt led Commission adoption of dozens of rules responding to corporate and accounting crises, created an SEC "real time enforcement" program, and responded to market disruptions from the Sept. 11 terrorist attack.

Before becoming SEC chairman, Pitt was senior corporate partner at Fried, Frank, Harris, Shriver & Jacobson, an international law firm, for nearly 25 years.

He served previously with the SEC from 1968-1978, including three years as Commission General Counsel.

In 2003, Pitt founded Kalorama Partners with former SEC Chief Accountant Robert K. Herdman.

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