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FINANCIAL SERVICES REGULATORY REFORM IN THE FACE OF AN ECONOMIC MELTDOWN[†]

Harvey L. Pitt^{*}

It is a pleasure to speak in a historic city that has engendered so much innovation over the last century-and a-half.¹ This symposium—which is devoted to examining our current economic crisis and current bailout efforts—could not be more timely, as we and the rest of the world struggle to cope with the worst recession in at least eighty years.²

[†] This article is derived from, and updates, the Keynote Address given by the Author at the University of Dayton School of Law's Symposium on the current economic crisis, its causes, effects and proposed solutions.

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¹ Dayton can claim more patents per capita than any other U.S. city. Perhaps the most famous invention associated with Dayton is the airplane, created by the Wright Brothers. Others include the yo-yo, electric car starter, portable crib and cash register. See generally CURT DALTON, DAYTON INVENTIONS: FACT AND FICTION (2003) (describing the multitude of inventions that originated in Dayton).

² A number of measurements indicate that the current economic downturn is the worst since at least the Great Depression. For example, the longest previous post-Depression decline was sixteen months. The current crisis began in December 2007, putting its duration at twenty-two months and counting. As of late March 2009, 86% of industries had cut production, topping the largest reduction in the Federal Reserve's forty-two year history of tracking that statistic. In addition, for the first time in the thirty-two years of record-keeping, as of December 2008, every state reported an increase in unemployment, and the drop in household wealth in the current downturn has been the largest in the post-World War II period. See Chris Isadore, *The Great Recession: Economists Generally Agree This Is the Worst Economic Downturn Since the Great Depression, but They Say Despite Pain, Another Depression Isn't Likely*, CNNMONEY.COM, Mar. 15, 2009, http://money.cnn.com/2009/03/25/news/economy/depression_comparisons/index.htm?postversion=2009032517. In April 2009, the International Monetary Fund characterized the then-current world economic situation, including the situation in the U.S., as "the deepest global recession since the Great Depression," affecting "all corners of the globe." INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK, APRIL 2009: CRISIS AND RECOVERY 9 (2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf>. This characterization was confirmed by recent Commerce Department data, which indicated that the U.S. economy contracted 1.9% from the fourth quarter of 2007 to the end of 2008, and Gross Domestic Product shrank 3.9%, reflecting the worst post-Great Depression slump. See Bob Willis, *U.S. Recession Worst Since Great Depression, Revised Data Show*, BLOOMBERG.COM, Aug. 1, 2009, <http://bloomberg.com/apps/news?pid=20601087&sid=aNivTjr852TI>; see also Press Release, Bureau of Econ. Analysis, U.S. Dep't of Commerce, National Income and Product Accounts: Gross Domestic Product: Second Quarter 2009 (Advance Estimate): Comprehensive Revision: 1929 through First Quarter 2009 (July 31, 2009) (available at http://www.bea.gov/newsreleases/national/gdp/2009/pdf/gdp2q09_adv.pdf); Lawrence Mishel & Heidi Shierholz, *The Worst Downturn Since the Great Depression*, ECON. POLICY INST. June 2, 2009, http://www.epi.org/publications/entry/jobspict_200906_preview. This view is widely shared among many, including President Barack Obama. See Paul Krugman, *Averting the Worst*, N.Y. TIMES, Aug. 10, 2009, at A17; Nouriel Roubini, *The Risk of Double-Dip Recession is Rising*, FIN. TIMES, Aug. 24, 2009, at 7 (the New York University professor of economics who predicted the financial crisis); Interview by Spiegel staff with Joseph Stiglitz, American Economist & Professor at Columbia Univ. (Apr. 3, 2009), available at <http://www.salon.com/news/feature/2009/04/03/stiglitz>; Fareed Zakaria GPS

Nor is there a more appropriate venue for this Symposium than the University of Dayton School of Law. Part of an important and valuable faith-based higher education facility,³ the School of Law—known in a prior incarnation as the College of Law—opened its doors during robust economic times in 1922, and included women and African-Americans among its first graduating class in 1926, testimony to the remarkable achievement of its stellar objectives.⁴ With the onset of the Great Depression, the College of Law, like much of the Nation, found itself facing insurmountable economic challenges, and closed in 1935.⁵ Four decades later, it rose again, better and stronger than ever.⁶

To consider the implications of our current economic predicament, I would like to identify some of the landmarks on the road to our current market mess, discuss some features to look for along the road to reform and recovery, and then offer some thoughts on how to cope with downward-spiraling markets.

To understand where we are, we need to know from whence we came. This reminds me of an unfortunate historical moment, when Supreme Court Justice Oliver Wendell Holmes had boarded a train, but could not find his ticket. As the conductor watched in vain, the eighty-eight-year-old Justice frantically searched his pockets. The conductor, recognizing the Justice, assured him he did not need a ticket, saying: “Don’t worry about your ticket, Mr. Holmes. We all know who you are. When you get to your destination, you can find it and just mail it to us.”

“My dear man, the problem is not my ticket,” quipped Holmes, who was renowned for his quick wit. “The problem is . . . where am I going?”⁷

The moral, I suppose, is found in the wisdom of the man many consider to be the twentieth century’s greatest sage—Yogi Berra—who

(CNN television broadcast July 21, 2009) (interview by Fareed Zakaria with Timothy Geithner, Sec’y of the Treasury, U.S. Dep’t of the Treasury), available at <http://www.cnn.com/video/#/video/us/2009/07/12/gps.geithner.exclusive.cnn?iref=videosearch>; *The Tonight Show* (NBC Television broadcast Mar. 19, 2009) (interview by Jay Leno with President Barack Obama) (transcript available at http://www.whitehouse.gov/the_press_office/Interview-of-the-President-by-Jay-Leno-on-the-Tonight-Show-3-19-09/).

³ “The School of Law is part of the University of Dayton, [a Catholic, Marianist institution,] which was founded in 1850 and is the largest private university in Ohio, with more than 10,000 undergraduate, graduate, and professional students.” University of Dayton School of Law, History of the School of Law, <http://law.udayton.edu/NR/exeres/2C528C4A-6A61-43D7-A634-A6258A052764.htm> (last visited Nov. 14, 2009).

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ See Jonathan Turley, *The 9 Incredibles: What We Can Learn from the Greatest Supreme Court Justices of All Time That Might Help Us Pick More Winners Now*, AM. HIST., Oct. 2009, at 31.

noted, “[y]ou got to be very careful if you don’t know where you’re going because you might [wind up someplace else].”⁸

I. HOW WE GOT HERE

As our financial system has eroded, it is abundantly clear that we *have* wound up “someplace else,” and it is not any place we want to be. There appears to be a consensus that our financial services regulatory system is a prime culprit for our present quagmire.⁹ With incessant calls for reform across the political and philosophical spectrum,¹⁰ it is *also* inevitable

⁸ ALLEN BARRA, YOGI BERRA: ETERNAL YANKEE 398 (2009) (quoting Yogi Berra).

⁹ The U.S. Government Accountability Office has noted that:

[t]he current U.S. financial regulatory system has relied on a fragmented and complex arrangement of federal and state regulators—put into place over the past 150 years—that has not kept pace with major developments in financial markets and products in recent decades. As the nation finds itself in the midst of one of the worst financial crises ever, the regulatory system increasingly appears to be ill-suited to meet the nation’s needs in the 21st century. Today, responsibilities for overseeing the financial services industry are shared among almost a dozen federal banking, securities, futures, and other regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies. Much of this structure has developed as the result of statutory and regulatory changes that were often implemented in response to financial crises or significant developments in the financial services sector. . . . Several key changes in financial markets and products in recent decades have highlighted significant limitations and gaps in the existing regulatory system. . . . As a result of significant market developments in recent decades that have outpaced a fragmented and outdated regulatory structure, significant reforms to the U.S. regulatory system are critically and urgently needed. The current system has important weaknesses that, if not addressed, will continue to expose the nation’s financial system to serious risks.

U.S. GOV’T ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM Introduction (2009) [hereinafter FRAMEWORK], *available at* <http://www.gao.gov/new.items/d09216.pdf>. According to the Obama Administration:

[w]hile this crisis had many causes, . . . [g]aps and weaknesses in the supervision and regulation of financial firms presented challenges to our government’s ability to monitor, prevent, or address risks as they built up in the system. No regulator saw its job as protecting the economy and financial system as a whole. Existing approaches to bank holding company regulation focused on protecting the subsidiary bank, not on comprehensive regulation of the whole firm. Investment banks were permitted to opt for a different regime under a different regulator, and in doing so, escaped adequate constraints on leverage. Other firms, such as AIG, owned insured depositories, but escaped the strictures of serious holding company regulation because the depositories that they owned were technically not “banks” under relevant law.

U.S. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION, REBUILDING FINANCIAL SUPERVISION AND REGULATION 2 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter NEW FOUNDATION].

¹⁰ Calls for regulatory reform have been sounded for decades. *See, e.g.*, U.S. DEP’T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 3, app. B (2008), *available at* <http://www.treas.gov/press/releases/reports/Blueprint.pdf>; *see also* CTR. FOR CAPITAL MKT. COMPETITIVENESS, U.S. CHAMBER OF COMMERCE, REGULATORY REFORM PRINCIPLES 1-4 (2008), *available at* http://www.uschamber.com/assets/ccmc/081114ccmc_principles.pdf (the Author is one of the signatories to the Chamber’s Regulatory Reform Principles); FRAMEWORK, *supra* note 9, at 1; Lloyd

that our regulatory system is in for a thorough overhaul very soon.¹¹ These pressures for reform will require us to dismantle the existing system—metaphorically speaking—and then methodically remodel, rebuild, and renovate it, using recent experience in determining which parts to keep, which parts to revise or rehabilitate, which parts to discard, and what parts to add.

This process must start with identifying the root causes of our current mess. These are myriad, and stretch back at least to the Great Depression. Among them, let me highlight three:

First, starting in 1987, our national leaders began encouraging the relaxed extension of credit.¹² As demand for credit increased, financial engineers created new instruments to increase banks' lending capacity. These ingenious new instruments permitted banks to move loans, along with the risk of holding them to maturity, off their balance sheets.¹³ Two decades of easy credit later—with attendant excesses—we experienced a precipitous credit contraction, leaving both the financial system and those who operated within it unprepared to cope with the changed reality.¹⁴

Second, the regulatory system governing our dynamic, rapidly evolving capital markets, is, and for quite some time has been, badly broken. Largely devised during the New Deal, after the *last* collapse of our financial services industry, the regulatory system consists of a multitude of federal statutes—each purporting to govern one segment of the industry with its

Blankfein, *Do Not Destroy the Essential Catalyst of Risk*, FIN. TIMES, Feb. 9, 2009, at 7 (Mr. Blankfein is CEO of Goldman Sachs); David C. John, *Republicans' Financial Regulatory Reform Plan a Good Start*, WEBMEMO, June 15, 2009, <http://www.heritage.org/research/regulation/wm2484.cfm>.

¹¹ The Obama Administration's proposal for financial regulatory reform, introduced on June 17, 2009, in a White Paper, set out an aggressive schedule for the adoption of its recommendations. See NEW FOUNDATION, *supra* note 9, at 2; see also Press Release, Timothy Geithner, Sec'y of the Treasury, Financial Regulatory Reform: Opening Statement Before the Senate Banking Committee (June 18, 2009) (available at <http://www.treas.gov/press/releases/tg176.htm>).

¹² The modern era of easy credit is considered by many to date back to 1987. See, e.g., MARK ZANDI, FINANCIAL SHOCK: GLOBAL PANIC AND GOVERNMENT BAILOUTS—HOW WE GOT HERE AND WHAT MUST BE DONE TO FIX IT 67-81 (Jim Boyd ed., updated ed. 2009).

¹³ See *Transparency in Accounting: Proposed Changes to Accounting for Off-Balance Sheet Entities: Hearing Before the Subcomm. on Securities, Insurance and Investment of the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. 3-5 (2008) (testimony of George P. Miller, Executive Dir., Am. Securitization Forum), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=6ff4a28e-7355-48a3-8ae4-23c9ba90403f; Gerald Caprio, Jr. et al., *The 2007 Meltdown in Structured Securitization: Searching for Lessons Not Scapegoats* 6 (World Bank Dev. Research Group Fin. & Private Sector, Working Paper No. 4756, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1424352; Alan Katz & Ian Katz, *Greenspan Slept as Off-Books Debt Escaped Scrutiny*, BLOOMBERG.COM, Oct. 30, 2008, http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aYJZOB_gZi0I.

¹⁴ In an October 2008 article, Edmund S. Phelps, the 2006 winner of the Nobel Prize in Economics, noted, "credit contraction is starting to crimp working capital and investment outlay at small businesses and is having wider effects on business activity through its impact on interest rates, exchange rates and consumer loans." Edmund S. Phelps, *We Need to Recapitalize the Banks*, WALL ST. J., Oct. 1, 2008, at A25.

own regulations and regulators.¹⁵ Added to this is a layer of frequently overlapping state and local statutes and regulations, and the result is a thicket of statutes, a tangle of regulations, and an alphabet soup of agencies, including more than fifty regulators each for insurance companies, securities broker-dealers, and commercial and investment banks, and that does not even include commodities, credit unions, and allied regulators.¹⁶

The shortcomings of this regime became unmistakable by at least the 1970s, with the advent of money market mutual funds and a responsive bank regulatory approach that allowed commercial banks to offer a host of until then *verboden* financial services.¹⁷ To the extent this patchwork regulatory system retained any vestiges of viability, these were swept away with passage of the Gramm-Leach-Bliley Act (“GLB”) in 1999.¹⁸ The GLB, among other things, repealed the Glass-Steagall Act, removing what little was left of the barriers the New Deal erected between commercial and investment banking. While there have been frequent assertions that GLB was a precipitating cause of our present economic woes,¹⁹ things would have been far worse if commercial banks—with their steady stream of depositors’ funds—had not been in a position to cushion the blow of faltering investment banks.²⁰

¹⁵ In the first 100 days of the New Deal, Congress passed the Glass-Steagall Act, which mandated the separation of commercial and investment banking and created the Federal Deposit Insurance Corporation. Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 32, 48 Stat. 162 (1933) (codified as amended at 12 U.S.C. §§ 24, 78, 377-378 (1994 & Supp. 1997)) (repealed 1999). It also passed the Securities Act. Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (2006). The following year Congress passed the Securities Exchange Act, which established the Securities and Exchange Commission and concentrated federal regulatory authority over securities trading, securities markets, and securities professionals in the SEC. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (2006). But, in establishing a federal regulatory regime for securities transactions, it explicitly preserved existing common law, state regulatory provisions and remedies. See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1, 760-62 (4th ed. 2001).

¹⁶ See U.S. GEN. SERV. ADMIN., 2009 CONSUMER ACTION HANDBOOK 147-59 (2009), available at http://www.consumeraction.gov/pdfs/2009_Handbook_Web_Version.pdf; National Association of Insurance Commissioners, 2009 Membership List (Sep. 18, 2009), http://www.naic.org/documents/members_membershiplist.pdf.

¹⁷ See JANE W. D’ARISTA, 2 THE EVOLUTION OF U.S. FINANCE: RESTRUCTURING INSTITUTIONS AND MARKETS 12-15 (1994).

¹⁸ The Gramm-Leach-Bliley Act was enacted under the name “Financial Modernization Act of 1999.” Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended at 15 U.S.C. §§ 6801-6809 (2000)).

¹⁹ See, e.g., David Leonhardt, *Reconsideration: Washington’s Invisible Hand*, N.Y. TIMES, Sept. 26, 2008 (Magazine), at MM32 (“The current financial crisis is frequently called the worst since the Great Depression. And Gramm-Leach-Bliley is often cited as a cause, even by some of its onetime supporters.”).

²⁰ See, e.g., Maria Bartiroma, *Bill Clinton on the Banking Crisis, McCain, and Hillary*, BUSINESSWEEK, Oct. 6, 2008, at 19-20, available at http://www.businessweek.com/print/magazine/content/08_40/b4102000409948.htm (“I don’t see that signing that bill [GLB] had anything to do with the current crisis. Indeed, one of the things that has helped stabilize the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn’t signed that bill.”) (quoting former President Bill Clinton); see also Mark Calabria, *Did Deregulation Cause the Financial Crisis?*, CATO POLICY REPORT (Cato Institute, Washington, D.C.), July/Aug. 2009, at 1, 6 (July/August 2009), available at http://www.cato.org/pubs/policy_report/v31n4/

No, the *real* problem with GLB was not what it *did*, but what it *did not* do—it did not modernize the anachronistic regulatory patchwork system or provide a means for regulating new and exotic instruments, such as credit default obligations.²¹ Particularly, in light of Congressional turf concerns,²² this was just too much to tackle as part of GLB’s historic financial market modernization.²³ So, for the last decade we have had a twenty-first century financial marketplace operating under a twentieth century regulatory system.²⁴

cpr31n4-1.pdf; James A. Leach, *Regulatory Reform: Did Gramm-Leach-Bliley Contribute to Crisis?*, NW. FIN. REV., Oct. 15, 2008, available at <http://www.allbusiness.com/government/government-bodies-offices/11672482-1.html> (“If it weren’t for statutory change [the enactment of GLB], JPMorgan Chase would not have been in a position to rescue Bear Stearns and [Bank] of America would not have been able to help stabilize Merrill Lynch.”); American Bankers Association, *Gramm-Leach-Bliley Helped to Resolve—Not Cause—the Credit Crisis*, http://www.aba.com/Press+Room/PR_EconomicStabilization_GLBA.htm (last visited Sep. 20, 2009); James L. Gattuso, *Meltdowns and Myths: Did Deregulation Cause the Financial Crisis?*, WEBMEMO, Oct. 22, 2008, <http://www.heritage.org/research/economy/wm2109.cfm>.

²¹ Early in the crisis, then-SEC Chairman Christopher Cox characterized the financial regulatory system as “stovepiping” and “nearly irrelevant to today’s market.” Damian Paletta & Kara Scannell, *Politics & Economics: Washington Revisits Financial Regulation*, WALL ST. J., Mar. 21, 2008, at A6. More recently, Treasury Secretary Timothy Geithner testified that, “[a] patchwork of supervisory responsibility, loopholes that allowed some institutions to shop for the weakest regulator, and the rise of new financial institutions and instruments that were almost entirely outside the government’s supervisory framework left regulators largely blind to emerging dangers and without the tools needed to address them.” *Regulatory Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals: Part Two: Hearing on Financial Regulatory Reform Before the H. Financial Serv. Comm.*, 111th Cong. 5 (July 24, 2009) (testimony of Timothy Geithner, Sec’y of the Treasury) [hereinafter *Hearings*], available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner_-_treasury.pdf.

²² For example, oversight of the SEC and the Federal Reserve are within the purview of the Senate Committee on Banking, Housing & Urban Affairs and the House Financial Services Committee. House Committee on Financial Services, *Who We Are*, <http://financialservices.house.gov/who.html> (last visited Nov. 15, 2009); see also U.S. Senate Committee on Banking, Housing, & Urban Affairs, *Committee Information*, http://banking.senate.gov/public/index.cfm?Fuseaction=CommitteeInformation.Subcommittee&Subcommittee_ID=decb3c3c-2f60-49ae-ac2a-d82e1b912c9c (last visited Nov. 15, 2009). The Commodity Futures Trading Commission is answerable to the Senate Agricultural, Nutrition and Forestry Committee and the House Committee on Agriculture. See U.S. Senate Committee on Agriculture, Nutrition and Forestry, <http://ag.senate.gov/site/subcmtes.html> (last visited Aug. 27, 2009); House Committee on Agriculture, <http://agriculture.house.gov/inside/subcomms.html> (last visited Nov. 15, 2009). A thoroughgoing overhaul of the financial regulatory system would inevitably result in a shifting of regulatory authority between, and/or an absolute loss of regulatory authority by one or both of, these agencies and, therefore, a shifting or loss of authority among their respective Congressional oversight committees. See, e.g., Sarah Lynch, *SEC-CFTC Turf Battle Revived over CDS Role in Financial Crisis*, DOW JONES ON-LINE, Oct. 9, 2008, <http://www.efinancialnews.com/usedition/content/2452123986>; Posting of Arthur Owens to Iowa Banking Law Blog, <http://www.iowabankinglawblog.com/2009/06/turf-battles-may-impede-financial-regulatory-reform.html> (July 9, 2009 12:15 EST).

²³ See, e.g., Joanna Chung, *Complexity Has Led to Cracks in System*, FIN. TIMES, June 12, 2009, at 6 (“The source of many problems currently facing the banking sector was Gramm-Leach-Bliley, which allowed for the creation of financial ‘supermarkets’ but left the old, separate regulatory structures intact.”).

²⁴ This view was espoused during last year’s presidential campaign by then-candidate Barack Obama. In a speech on regulatory reform, he stated, among other things, that since the repeal of the Glass-Steagall Act in 1999 “we’ve overseen 21st century innovation, including the aggressive introduction of new and complex financial instruments like hedge funds and non-bank financial companies, with outdated 20th century regulatory tools.” Barack Obama, 2008 Presidential Candidate,

Third, there was an appalling lack of both internal and external transparency. The lifeblood of capital markets is a steady flow of significant data.²⁵ Internal transparency would have provided financial services firms with at least an inkling of how much risk they had exposed themselves to with their positions in the sub-prime market.²⁶ Firms held AAA-rated securities, thinking these were virtually riskless, while investors and broker-dealers leveraged these instruments extensively.²⁷ However, there simply was no internal transparency in the firms creating and distributing these new synthetic securities.²⁸ Nor was anyone—senior managers, directors, regulators included—willing to sound a note of caution, much less reflection.

Requiring internal transparency lies at the heart of directors' fiduciary obligations, and not just in financial services companies.²⁹ To survive tumultuous times, directors must understand their companies' businesses as well as the risks to and posed by them, and they must ensure that senior managers do the same.³⁰ Risk management must be a top priority

Obama on 'Renewing the American Economy,' (Mar. 27, 2008), <http://www.nytimes.com/2008/03/27/us/politics/27text-obama.html?pagewanted=print>.

²⁵ See, e.g., CTR. FOR CAPITAL MKTS. COMPETITIVENESS, *supra* note 10, at 1; COMM'N ON FIN. SERVS. & INS., INT'L CHAMBER OF COMMERCE, ICC POLICY STATEMENT: "IMPROVING THE QUALITY OF FINANCIAL AND BUSINESS REPORTING" (2005), available at http://www.iccwbo.org/uploadedFiles/ICC/policy/financial_services/Statements/162final%20Financial%20and%20Business%20Reporting.pdf; Henry M. Paulson, Treasury Secretary, Address on the Competitiveness of U.S. Capital Markets to the Economic Club of New York (Nov. 20, 2006), <http://www.treas.gov/press/releases/hp174.htm>; Mary Schapiro, Chairman, SEC, Address to the Annual Conference of the Society of American Business Editors and Writers (Apr. 27, 2009), <http://www.sec.gov/news/speech/2009/spch042709mls.htm>.

²⁶ The degree to which firms were oblivious to their own exposure is reflected in the cascade of serial write-downs by major financial firms, including Bear Stearns, Citigroup, Merrill Lynch, UBS, Barclays, HSBC, Deutsche Bank and BNP Paribas. See *Timeline: Sub-prime Losses*, BBC NEWS, May 19, 2008, <http://news.bbc.co.uk/2/hi/business/7096845.stm>. The degree to which firms were oblivious to their own exposure is also reflected in the resignation of chief executive officers such as James Cayne (Bear Stearns), Charles Prince (Citigroup), and Stanley O'Neal (Merrill Lynch), all of whom resigned after their firms reported subprime losses significantly higher than each had estimated. See *Bear Stearns Boss Cayne Resigns*, BBC NEWS, Jan. 9, 2008, <http://news.bbc.co.uk/2/hi/business/7178215.stm>; Jim Zarroli, *Citigroup CEO Prince Falls to Subprime Debacle*, NPR, Nov. 5, 2007, <http://www.npr.org/templates/story/story.php?storyId=15995002>; *Morgan Stanley's Top Woman Leaves*, BBC NEWS, Nov. 30, 2007, <http://news.bbc.co.uk/2/hi/business/7120311.stm>.

²⁷ See Randall Dodd & Paul Mills, *Outbreak: U.S. Subprime Contagion, Finance and Development*, 45 FIN. & DEV. 2, June 14, 2008, at 16-17, available at <http://www.imf.org/external/pubs/ft/fandd/2008/06/pdf/dodd.pdf>.

²⁸ "Some banks were caught completely unaware by concentrations [of] subprime loans that they had in their loan portfolios. Others did not fully understand their full exposure to subprime mortgages, particularly when they purchased an exposure that contained dozens of other exposures." Nout Wellink, President of the Neth. Bank & Chairman of the Basel Comm. on Banking Supervision, Remarks at the International Conference of Banking Supervisors (Sept. 24, 2008), <http://www.bis.org/review/r080925b.pdf?noframes>.

²⁹ David A. Katz & Laura A. McIntosh, *Directors: Remember the Basics*, BUSINESSWEEK ONLINE, June 19, 2008, http://www.businessweek.com/managing/content/jun2008/ca20080619_576918.htm.

³⁰ See, e.g., Elizabeth Burnett & Elizabeth Gomperz, *The New and Emerging Fiduciary Duties of Corporate Directors*, BANK DIR. MAGAZINE, First Quarter 2009, available at http://www.bankdirector.com/issues/articles.pl?article_id=12013; see generally Stephen J. Lubben & Alana J. Darnell, *Delaware's Duty Of Care*, 31 DEL. J. CORP. L. 589 (2006) (discussing unintended consequences of Delaware's increasing reliance on the assumed validity of corporate conduct based on the duties of loyalty and deference to business judgment).

in the boardroom, in strategic decisions, and in determining resource allocation.³¹ Directors must ask enough questions, with sufficient frequency and follow-up, to maintain the requisite level of understanding. Senior managers, in turn, must stand ready, willing and able to provide requisite information, whether they are asked for it or not.³² Beyond senior management, however, boards simply must have input from independent outside experts who can provide a “reality check” against management’s occasional unduly optimistic or overly naïve assumptions.³³

There also was no external transparency, so the marketplace lacked critical information about the degree to which firms really were highly-

³¹ See, e.g., Jeff Nash, *Risk Climbs to Top of Corporate To-Do List*, FIN. WK., Apr. 18, 2009, available at <http://74.125.125.104/www.financialweek.com/apps/pbcs.dll/article?AID=2008681681585> (“The credit crunch has pushed risk management to the top of corporate directors’ list of concerns. Investors are increasingly demanding that boards better understand management’s strategy for identifying and mitigating threats to the company, and that they question that strategy to protect shareholders from excessive exposure to the unforeseen.”); Clarke Murphy & J. Frank Brown, *Boards Must Take On Risk Management*, BUSINESSWEEK ONLINE, Mar. 17, 2009, <http://russellreynolds.com/pdf/thought/BusinessWeekBoardsMustTakeonRiskManagement.pdf>; see also COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM’N, ENTERPRISE RISK MANAGEMENT: INTEGRATED FRAMEWORK 6-7 (2004), available at http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf (“The board should discuss with senior management the state of the entity’s enterprise risk management and provide oversight as needed. The board should ensure it is apprised of the most significant risks, along with actions management is taking and how it is ensuring effective enterprise risk management.”).

³² It has been recognized that:

[t]he ability of the board or relevant committee to perform its oversight role effectively is, to a large extent, dependent upon the relationship and the flow of information between the directors, senior management, and the risk management executives in the company. If directors do not believe they are receiving sufficient information – including information regarding the external and internal risk environment, the specific material risk exposures affecting the company, how these risks are assessed and prioritized, risk response strategies, implementation of risk management procedures and infrastructure, and the strength and weaknesses of the overall system - they need to be proactive in asking for more.

MARTIN LIPTON ET AL., RISK MANAGEMENT AND THE BOARD OF DIRECTORS 16 (2008), available at <http://blogs.law.harvard.edu/corpgov/files/2008/11/risk-management-and-the-board-of-directors.pdf>.

³³ Boards walk a fine line between adequately overseeing a corporation’s endeavors and interfering with management, and between rationally relying upon and blindly following management’s advice. Thoughtful, deliberate use of outside advisors can help to ensure that directors are sufficiently informed to evaluate intelligently management positions without becoming involved in day-to-day management. See, e.g., Cliff Atherton, *Boards of Directors: Independent Advisers Are Essential in Tough Times*, FAMILY BUS., <http://www.familybusinessmagazine.com/column.html> (last visited Nov. 15, 2009) (“Independent advisers provide the board with an outside view. . . . By involving independent advisers, the board gains access to an outside view, one that is free to question fundamental assumptions about the business.”); Michael Schrage, *What’s a Director to Do?*, STRATEGY+BUSINESS, Aug. 25, 2004, <http://www.strategy-business.com/article/04310?pg=all> (“[O]ne could argue that hiring outside experts is the most cost-effective way for independent directors to prove their independence and positively challenge, rather than undermine, top management.”). The Delaware Corporation Law provides a safe harbor for directors relying in good faith on information, reports, opinions or statements of an expert within his or her area of expertise if selected with reasonable care by or on behalf of the corporation. DEL. CODE ANN. tit. 8, § 141(e) (2006). Most other jurisdictions provide similar protection. See, e.g., Cal. CORP. CODE § 309(b) (Deering, LEXIS through 2009-10 Sess.); N.Y. BUS. CORP. § 717(a)(2) (Consol., LEXIS through 2009 Sess.); OR. REV. STAT. § 60.357(2) (2007); VA. CODE ANN. § 13.1-690(C) (West 2007); N.C. GEN. STAT. § 55-8-30(B) (West 2000); see also 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE §§ 4.02-.03 (1994); MODEL BUS. CORP. ACT § 8.30 (1971).

leveraged or over-extended.³⁴ As we saw with Bear Stearns and Lehman, counterparties had no grasp of the magnitude of those firms' sub-prime exposure.³⁵ Despite commitments to extend credit, counterparties did what might be expected of them—they assumed the worst—and pulled their credit lines, bringing credit markets to a screeching halt³⁶—a situation that continues to impose an enormous weight on our markets and economy.³⁷

³⁴ See, e.g., Posting of James Hamilton to Econbrowser, http://www.econbrowser.com/archives/2008/05/credit_crunch_h.html (May 13, 2008, 08:16) (stating that in the period prior to the current financial crisis, “financial institutions were allowed to take highly leveraged positions whose details are largely opaque to readers of publicly available financial statements”).

³⁵ Goldman Sachs CEO Lloyd Blankfein recently observed the following:

It seems clear now that managers of companies with large off-balance sheet exposure didn't appreciate the full magnitude of the economic risks they were exposed to; equally worrying, their counterparties were unaware of the full extent of these vehicles and, therefore, could not accurately assess the risk of doing business.

Lloyd Blankfein, CEO Goldman Sachs, Remarks to the Spring 2009 Meeting of the Council of Institutional Investors (Apr. 7, 2009), <http://www.marketwatch.com/story/text-goldman-sachs-ceo-lloyd>; see also Bastian Breitenfellner & Niklas Wagner, Government Intervention in Response to the Subprime Financial Crisis: The Good into the Pot, the Bad into the Crop 8 (Feb. 5, 2009) (unpublished draft, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1334804) (“With the increasing number of securitization transactions, the quality of the loan portfolios declined. Those who invested in the tranches of the securitization transactions often were unaware of the inherent risk.”).

³⁶ As of March 13, 2008, “[o]ther securities firms, hedge funds and other investors said they are continuing to do trades with Bear. No hedge-fund clients serviced by Bear’s prime-brokerage unit, which lends capital and facilitates trades, have been unable to redeem cash.” Kate Kelly, et al., *In Dealing With Bear Stearns, Wall Street Plays Guardedly*, WALL ST. J., Mar. 12, 2008, at C1. Within five days,

the market began turning on Bear Stearns. Phones were ringing off the hook at rival firms such as Goldman Sachs Group Inc., Morgan Stanley and Credit Suisse Group. Clients of those firms were growing worried about trades they had entered into with Bear Stearns—about whether Bear Stearns would be able to make good on its obligations. The clients asked the other investment banks whether they would be willing to take the clients’ places in the trades. But credit officers at Goldman, Morgan Stanley and others—worried themselves about Bear Stearns’s condition—began to say no.

Robin Sidel et al., *The Week That Shook Wall Street: Inside the Demise of Bear Stearns*, WALL ST. J., Mar. 18, 2008, at A1; see also Alistair Barr & Greg Morcroft, *J.P. Morgan to Buy Bear Stearns for \$2 a Share*, MARKETWATCH, Mar. 17, 2008, <http://www.marketwatch.com/story/jp-morgan-to-buy-bear-stearns-for-2-a-share> (“Bear Stearns’ business quickly crumbled last week as counterparties and clients lost confidence and stopped trading with the firm.”); Steven L. Schwarcz, *Systemic Risk Meets Subprime Mortgages*, FORBES.COM, May 1, 2008, http://www.forbes.com/2008/05/01/subprime-fed-system-oped-cx_sls_0501subprime.html (“Once investors realized that highly rated subprime-mortgage-backed securities could lose money, they began shunning all complex securitization products, including asset-backed commercial paper, which was thought to be almost as safe as cash.”).

³⁷ According to a recent Federal Reserve Board survey of bank lending practices, during the second quarter of this year domestic banks continued to tighten standards and terms on all major types of loans to businesses and consumers, and lending standards will remain tight until the second half of 2010. FED. RESERVE BD., THE JULY 2009 SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES 1 (2009), available at <http://www.federalreserve.gov/boarddocs/snloansurvey/200908/fullreport.pdf>. This condition exists notwithstanding the government’s direct infusion of billions of dollars into banks with the hope that lending and credit would loosen. See, e.g., Steve Liesman, *US Injects More Capital into Banks, Including PNC*, CNBC, Oct. 24, 2008, <http://www.cnbc.com/id/27361362> (“The injections [of capital] are designed to encourage healthy banks to boost their lending activities . . .”).

II. WHERE WE ARE

Our capital markets must operate smoothly and efficiently to operate successfully. We live in a world where financial products are fungible, services (at least until recently) have been ubiquitous, and transactions are virtually instantaneous.³⁸ At the same time, it is a world where stubbornly redundant, overlapping, discontinuous or non-existent regulation has, directly or indirectly, pretty much brought our markets to a halt.³⁹

Revamping our regulatory system must begin now, because our antediluvian system is undermining the inherent vitality of America's capital markets and threatens the freedoms we all enjoy that flow from an efficient economic system.⁴⁰ That vitality will not return until the markets function, and market participants have confidence that they are functioning, in a rational and effective regulatory framework.⁴¹

III. WHERE WE SHOULD BE HEADED

For the foreseeable future, we will be facing economic volatility and instability, in a world where U.S. influence is significantly diminished.⁴² Right now, we are faced with a myriad of challenges. Merely fixing the

³⁸ See DEBRA JOHNSON & COLIN TURNER, INTERNATIONAL BUSINESS: THEORY AND PRACTICE TO THEMES AND ISSUES IN THE MODERN WORLD ECONOMY 7 (2003); Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 4-5 nn.1-5, 11 nn. 24-28 (Fall/Winter 2005). The trend toward ubiquity of services has been slowed by contraction in the financial services market, which lost 489,000 jobs in the first six months of 2009, with nearly two-thirds in the finance and insurance sectors. Nayla Kazzi & Heather Boushey, *Uneven Job Losses: Interactive Map on State Employment Rates*, CENTER FOR AMERICAN PROGRESS, July 17, 2009, http://www.americanprogress.org/issues/2009/07/jobloss_jun.html.

³⁹ See Brown, *supra* note 38, at 11 nn. 24-28; see also sources cited *supra* notes 22-25.

⁴⁰ See, e.g., Milton Friedman, *Economic Freedom, Human Freedom, Political Freedom: Lecture at the Smith Center for Private Enterprise Studies, California State University East Bay at Hayward Campus* (Nov. 1, 1991), <http://www.sbe.csu Hayward.edu/~sbesc/frlect.html> (citing MILTON FRIEDMAN ET AL., CAPITALISM AND FREEDOM 9-10 (1962)).

⁴¹ See, e.g., G-20, THE GLOBAL PLAN FOR RECOVERY AND REFORM ¶ 13 (2009), available at <http://www.g20.org/Documents/final-communication.pdf> ("Major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis. Confidence will not be restored until we rebuild trust in our financial system."); see also CTR. FOR CAPITAL MKTS. COMPETITIVENESS, U.S. CHAMBER OF COMMERCE, RESTORING CONFIDENCE IN THE U.S. CAPITAL MARKETS: A CALL FOR FINANCIAL SERVICES REGULATORY MODERNIZATION (2009), available at http://www.uschamber.com/assets/ccmc/090311_ccmc_declaration.pdf.

⁴² See generally INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: RESPONDING TO THE FINANCIAL CRISIS AND MEASURING SYSTEMIC RISKS (2009), available at <http://www.imf.org/external/pubs/ft/gfst/2009/01/pdf/text.pdf> (addressing the stress the global financial system is under); INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK: CRISIS AND RECOVERY (2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/01/index.htm> (discussing the uncertainty of the current economic outlook); NAT'L INTELLIGENCE COUNCIL, GLOBAL TRENDS 2025: A TRANSFORMED WORLD (2008), available at http://www.dni.gov/nic/PDF_2025/2025_Global_Trends_Final_Report.pdf (analyzing the global role the U.S. will play in the future); Adriana Z. Fernandez & Alex Nikolsko-Rzhevskyy, *Globalization and the Changing Nature of the U.S. Economy's Influence in the World*, 3 ECON. LETTER 11, November 2008, at 2-4, available at <http://dallasfed.org/research/eclct/2008/el0811.html> (discussing the impact that the U.S. economy has on the rest of the world).

regulatory system is necessary, but not sufficient.⁴³

Some things must be done in the short term:

First, government must regularly receive and analyze a steady flow of significant information about every aspect of our financial and capital markets, including data that measures, or permits measurement of, risk. The precise metrics should be designated, subject to flexibility, which permits modifications over time. This can and should start now, but regulating those from whom data is collected should follow after regulators have begun assessing the implications of what the information gathered reveals. While there are frequently calls for immediate regulatory action, regulations will surely be more effective if they are preceded by a thorough understanding of the activities, transactions and products sought to be regulated.⁴⁴

Second, analyses of this new stream of information, as well as some forms of the information itself, must be disseminated to the markets. Proprietary and competitive considerations will help inform what data should be aggregated or disclosed generically, and whether some data should be released only after an appropriate time delay, but the more information that flows out and the more transparent the markets become, the more efficiently markets will operate and the sooner investor confidence will return.⁴⁵

⁴³ Just as the U.S. regulatory system was not the sole cause of the current crisis, neither will replacing it, even with an entirely effective and efficient one, resolve the current crisis or prevent the next one. Damage from the crisis has spread throughout the real U.S. economy—in terms of loss of jobs and productive capacity, the demise of businesses and damage to the viability of many that survive. *See generally* MARTIN NEIL BAIL & DOUGLAS J. ELLIOTT, *THE U.S. FINANCIAL AND ECONOMIC CRISIS: WHERE DOES IT STAND AND WHERE DO WE GO FROM HERE?* (2009), available at http://www.brookings.edu/~media/Files/rc/papers/2009/0615_economic_crisis_baily_elliott/0615_economic_crisis_baily_elliott.pdf (discussing the current state of the economy and the steps that can be taken to move forward). Ameliorating these effects is likewise critical to full economic recovery. *Id.* at 22-25. Even a full recovery of the U.S. economy is not sufficient. An increasingly interconnected global economy demands global, not merely national, solutions. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, *THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM* (2009), available at [http://www.capmktreg.org/pdfs/TGFC-CCMR_Report_\(5-26-09\).pdf](http://www.capmktreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf).

⁴⁴ Before *any* new regulations are seriously considered, and certainly before they are put in place, government needs to understand (1) who or what it seeks to regulate; (2) why regulation is thought to be necessary; (3) how a particular approach will achieve government's legitimate objectives; (4) what *other*, perhaps unintended and perhaps detrimental, effects particular regulatory proposals may have, and on whom; and (5) what alternatives are available. And, regulatory zeal be tempered by the unpleasant but unavoidable realization that there will always be people who attempt to game any system; all the regulation in the world will not protect us from miscreants who are intent on committing fraud.

⁴⁵ Former Under Secretary of the U.S. Department of Treasury, Peter Fischer, has stated:

Restoring the vitality of our nation's securities markets is dependent upon improving the quality of information that investors receive. Nothing is more important.

Third, Congress must ensure that *government* has responsibility and accountability to redress *every* crisis and authority to regulate *every* new product, service, or activity, all subject to appropriate review and oversight. The phenomenon of regulators asking themselves—and each other—who, if anyone, had authority to act in the face of a market crisis and of *no* regulator having authority over a product or activity cannot be permitted to recur.⁴⁶

Fourth, government must enhance its risk management capabilities. When I chaired the SEC, I recommended creation of a risk management unit, which ultimately was created after I left.⁴⁷ As of December 2007, it had only two people, one economist and one accountant.⁴⁸ Today, the office is larger and has more tools at its disposal,⁴⁹ but robust risk assessment is a government-wide

Our securities markets are extremely efficient at pricing and allocating capital on the basis of all available information. Unfortunately, the important information is too often not available. When critical information is absent, or where great disparities exist in the quality of information available to different players, the power of markets is misdirected and the allocation of resources becomes skewed

Peter R. Fisher, Under Sec'y, U.S. Dep't of the Treasury, Restoring Investor Confidence: The Key Is Disclosure, Remarks to the Securities Industry Association (Nov. 8, 2002), <http://ustreas.gov/press/releases/po3609.htm>; see also L. Gordon Crovitz, *Information Age: Transparency Is More Powerful than Regulation*, WALL ST. J., Mar. 30, 2009, at A21 ("Better transparency is the surest way to make markets more efficient and less volatile. Market wisdom results when more people access better information.").

⁴⁶ Our current regulatory system is predicated on the assumption that what an enterprise is called, or what it was at birth, should determine who regulates it. See Brown, *supra* note 38, 10-11 nn. 23-24. As a practical matter, this has led to gaps in the regulatory fabric, including gaps in regulation of subprime mortgages and mortgage-backed securities, as well as a complete lack of regulation of instruments such as credit default swaps, which are generally viewed as a major contributor to the recent financial crisis. See *Hearings, supra* note 21, at 5 (testimony of Timothy Geithner); *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Serv.*, 111th Cong. 1 (2009) (statement of Orice M. Williams, Director, Financial Markets & Community Investment), available at <http://www.gao.gov/new.items/d09397t.pdf>; *Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Concerning Turmoil in U.S. Credit Markets Before S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 6 (2008) (statement of Christopher Cox, Chairman, U.S. SEC), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c17161d3-a5f7-4544-9ade-7dc2197ddce0; Christopher Cox, Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008), <http://www.sec.gov/news/speech/2008/spch100808cc.htm>.

⁴⁷ The SEC's Office of Risk Assessment was created in 2004. U.S. Securities and Exchange Commission, Office of Risk Assessment, <http://www.sec.gov/about/offices/ora.htm> (last visited Nov. 16, 2009).

⁴⁸ Unpublished figures provided by the SEC Staff. In 2005, the Office of Risk Assessment had a total of seven employees. By early 2007, that number began to dwindle, and by March 2008, the office consisted of one staffer and newly appointed Director Jonathan Sokobin. The SEC's Office of Risk Assessment: Reloaded, <http://www.complianceweek.com/blog/carton/2008/10/29/the-secs-office-of-risk-assessment-reloaded/> (Oct. 29, 2008, 01:02) (online posting by Bruce Carton).

⁴⁹ In fiscal year 2008, the SEC Office of Risk Assessment had nine positions, equating to three FTE. In 2009, these numbers had grown to eight and twelve, respectively, and the SEC's 2009 budget

need, requiring coordination among all financial regulators.⁵⁰

Fifth, to significantly reduce the likelihood of another Madoff-esque fraud⁵¹ and, more importantly, to instill confidence in its effectiveness as a market watchdog, the SEC must completely restructure its compliance, examination, and inspection paradigm. Since the mid-1990s when the SEC examination function was last reorganized,⁵² the SEC examination team has effectively gone zero for the twenty-first century. The SEC missed major problems with Wall Street analysts,⁵³ mutual fund market timing⁵⁴ and late trading,⁵⁵ hedge funds,⁵⁶ Bear Stearns, the sub-prime market,⁵⁷ and now a string of Ponzi and other schemes and scams, for which Bernard Madoff is the poster child.⁵⁸ With that record, a new approach clearly is in order.

Shortly before leaving the Commission in 2003, I led the

request calls for ten FTE on the basis of twelve positions. SEC, IN BRIEF: FY 2010 CONGRESSIONAL JUSTIFICATION I (2009), <http://www.sec.gov/about/secfy10congbudgjust.pdf>.

⁵⁰ Disciplined, coordinated, government-wide risk assessment is necessary to identify and address emerging systemic risks before they can take root and create another crisis. Such risk assessment can only be effective if it is predicated on coordination, cooperation, and sharing of information among relevant regulators. In June 2009, the Obama Administration proposed creation of a new government body, the Financial Services Oversight Council, to be composed of the existing principal federal financial regulators, to identify emerging systemic risks and improve interagency cooperation. See NEW FOUNDATION, *supra* note 9, at 3-5, 19-20.

⁵¹ In December 2008, the illegal activities of Bernard Madoff, who managed billions of dollars in assets, came to light, revealing that Mr. Madoff had engaged in one of the largest investment frauds ever discovered. See Diana B. Henriques, *Plea from Madoff Accountant May Lead to Tax Cases*, N.Y. TIMES, Nov. 4, 2009, at B2. Madoff ran a so-called “Ponzi Scheme” (where funds from later investors, rather than from investment results, are used to repay earlier investors) named after the fraud artist Charles Ponzi. See MITCHELL ZUCKOFF, *PONZI’S SCHEME: THE TRUE STORY OF A FINANCIAL LEGEND* 288-89 (2005).

⁵² See Office of the Inspector Gen., SEC, Audit Report No. 254: Compliance Inspections and Examinations (1998), available at <http://www.sec-oig.gov/Reports/AuditsInspections/1998/254fin.htm>.

⁵³ See, e.g., Gretchen Morgenson, *Wall Street Firms Endorse Ethics Standards for Analysts*, N.Y. TIMES, June 13, 2001, at C1.

⁵⁴ See, e.g., Diana B. Henriques, *Spitzer Casting a Very Wide Net*, N.Y. TIMES, Oct. 12, 2003, § 3, at 1.

⁵⁵ See, e.g., Amey Stone, *A Primer on the Mutual-Fund Scandal*, BUSINESSWEEK ONLINE, Sept. 22, 2003, http://www.businessweek.com/bwdaily/dnflash/sep2003/nf20030922_7646.htm.

⁵⁶ See, e.g., Ari Weinberg, *Eliot Spitzer Finds His Canary*, FORBES.COM, Sept. 3, 2003, http://www.forbes.com/2003/09/03/cx_aw_0903spitzer.html.

⁵⁷ See, e.g., Rick Brooks & Constance Mitchell Ford, *The United States of Subprime: Data Show Bad Loans Permeate the Nation; Pain Could Last Years*, WALL ST. J., Oct. 11, 2007, at A1.

⁵⁸ See Strengthening the SEC’s Vital Enforcement Responsibilities: Hearing Before the Subcomm. on Securities, Insurance, and Investments of the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. 4 (2009) (statement of Robert Khuzami, Director, Division of Enforcement, SEC) http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e939892e-0d06-4da7-9ddf-52a2def98458 (discussing recent SEC activity); Press Release, FBI, *Highlighting Recent FBI “Ponzi” Scheme Investigations* (Apr. 1, 2009) (available at <http://www.fbi.gov/pressrel/pressrel09/ponzi040109.htm>) (listing recent Ponzi schemes investigated by the Federal Bureau of Investigation); Karey Wutkowski, *SEC Says Magnitude of Ponzi Schemes Growing*, REUTERS, Feb. 6, 2009, <http://www.reuters.com/article/harryMarkopolos/idUSTRE5154QR20090206>.

Commission's publication of my proposal that all money managers be examined either annually or biennially, depending on size, by an independent expert third-party examiner, with the SEC setting reviewer qualifications and examination requirements, and with a written report provided to the Commission and the managers' customers.⁵⁹ This is analogous to the approach followed in auditing public company financial statements.⁶⁰ "Enlisting" third-party expert examiners is not a guarantee against future Madoffs, but it will equalize the sophistication gap between young men and women recently graduated from college, who now do the SEC's examinations, and experienced money managers. It also would permit the agency to oversee regular and frequent examinations by experts, who understand and keep up with changes in industry practice on a real time basis in a way that is just not practical for government regulators.⁶¹

Over the longer term, we need to replace our regulatory framework with one that rationally addresses the universe of companies, activities, products, and services comprising the financial services industry, and has sufficient flexibility to evolve along with the industry. I believe we need a unified über regulator with authority over everything except monetary policy and systemic risk—which I would leave to an independent Federal Reserve Board. This über regulator would handle securities, commodities, futures, and banking regulation under rules that would be uniform across

⁵⁹ Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 25925, Investment Advisers Act Release No. 2107, 79 SEC Docket 1696 (Feb. 5, 2003).

⁶⁰ The U.S. Government Accountability Office has noted:

The statutory independent audit requirement, in effect, grants a franchise to the nation's public accountants, as an audit opinion on a public company's financial statements must be secured before an issuer of securities can go to market, have the securities listed on the nation's stock exchanges, or comply with the reporting requirements of the securities laws.

U.S. GOV'T ACCOUNTABILITY OFFICE, PUBL'N NO. GAO-08-163, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION 7 (2008), available at <http://www.gao.gov/new.items/d08163.pdf>.

⁶¹ Earlier this year Lori Richards, then the director of the SEC's Office of Compliance Inspections and Examinations, testified that the SEC had 425 staff dedicated to examinations of registered investment advisers and mutual funds, and approximately 315 staff dedicated to examinations of registered broker-dealers, and noted that OCIE is responsible for regulating 11,300 investment advisers, 950 fund complexes (representing over 4,600 registered funds), 5,500 broker-dealers (including 174,000 branch offices and 676,000 registered representatives) and 600 transfer agents. She indicated that, in 2008, the SEC conducted: 1,521 investment adviser examinations (approximately 14% of the registered community); 219 fund complex examinations (approximately 23%); and 135 transfer agent examinations (approximately 22%), as well as 720 cause, oversight and sweep examinations of broker dealer firms. *Examinations by the Securities and Exchange Commission and Issues Raised by the Bernard L. Madoff Investment Securities Matter: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 9-10 (2009) (testimony of Lori A. Richards, Director, Office of Compliance Inspections & Examinations, SEC), available at http://banking.senate.gov/public/_files/RichardsTestimonySEC12709.pdf. The SEC subsequently put out a call for qualified industry professionals to serve as Industry and Markets Fellows in the Office of Risk Assessment. See SEC, Opportunities for Industry Professionals with the SEC, http://www.sec.gov/jobs/jobs_industryprofessionals.shtml (last visited Nov. 27, 2009).

markets and institutions, eliminating the possibility of, and the incentives for, regulatory arbitrage.

The new regulatory order also must provide a seamless interface among regulators. If the current crisis has taught us anything, it is that regulators must work hand-in-glove to ensure they are all fully cognizant of market changes and they fully consider, *before* implementation, potential impacts, throughout the markets, of every regulatory initiative.⁶²

The current bailout efforts are certainly well-intentioned. But, we also know where the road of good intentions can lead.⁶³ In pursuing the incredibly difficult task of re-starting our economy, I think it is important to keep several premises clearly in mind:

- We must have a game plan;⁶⁴
- We need complete transparency for that game plan—in other words, we must tell everyone what we are doing;⁶⁵
- We have to resist the twin temptations inherent in every crisis—affixing blame and politicizing the development of solutions;⁶⁶

⁶² There are many reasons that make it essential to develop coordination among regulators in securing full information, and obtaining a full understanding of the ramifications of a proposed course of action. Most obviously, a failure to fully understand all possible effects of an action in all corners of the economy and financial system opens the door to the law of unintended consequences. If one or more effects have not been identified and thought through, and then occur, there is no way to know what mischief may result, either as a direct consequence of their occurrence, or by interference with intended results. In addition, an assessment of costs and benefits is required as a predicate to adoption of federal regulations. See Exec. Order No. 12866, 58 Fed. Reg. 51,735 (Sep. 30, 1993). Therefore, the failure to fully consider all costs and benefits could jeopardize the validity of newly adopted regulations.

⁶³ “The road to hell is paved with good intentions.” H.G. BOHN, *BOHN’S ANTIQUARIAN LIBRARY: A HANDBOOK OF PROVERBS* 514 (London, George Bell & Sons 1888), available at <http://www.archive.org/details/ahandbookprover01raygoog>.

⁶⁴ While many of the proposals in the Administration’s regulatory reform plan may make a great deal of sense, they are being done “in the dark” and “on the fly.” If the recent crisis has done nothing else, it has underscored the complexity and interrelatedness of our financial and economic systems and their regulatory overlay. Taking a piecemeal approach or trying to address each problem in a vacuum, without regard to the others and to the system as a whole, is a recipe for incomplete coverage and ineffective response—the very weaknesses that lie at the root of our current regulatory failure. And, leaving various regulators on their own to address their own “pieces” of a problem or crisis puts them in the position of the blind men touching an elephant. Each will act and draw conclusions based on the part which he, she, or it experienced and is exposed to, but no one will grasp, or respond to, the crisis in its entirety. See JOHN GODFREY SAXE, *THE POEMS OF JOHN GODFREY SAXE* 135-36 (Boston, James R. Osgood & Co. 1873) (using a story about how different blind men, touching only one portion of the elephant, identified it differently).

⁶⁵ As noted previously, investor confidence, market efficiency, and ultimately, economic recovery, all require the utmost transparency. See *supra* note 45. This includes honest, complete, consistent and timely disclosure about what steps have been, are being and will be taken, and a similarly forthright evaluation of their effects over time. Without such disclosure, market participants and the public will not have confidence that the government is doing what it says and saying what it does.

⁶⁶ Resolving our ongoing economic crisis requires an enormous amount of effort and focus, and resolving it effectively requires that considerations be weighed in a fair and impartial manner. In many crises, the tendency is, first, to point fingers, rather than cabin the problem and then solve it. To redress any crisis, there must be a consensus on what are the problems actually needing solutions. That is largely impossible to achieve, if the first step taken is to opine fingers. See MILKEN INST., *THE SAVINGS AND*

- We should put money in the hands of people who will spend it, not companies that will use it to cover up or ameliorate past mistakes;⁶⁷ and
- We need to be honest with the American people.

Having looked backward and forward, I would like to highlight some lessons that may prove useful in negotiating these turbulent, and still downward-spiraling, markets.

*A. Trust, but (especially) verify.*⁶⁸

Thorough due diligence must precede any transaction involving a significant amount of money, whether the money is yours or someone else's. It is fine, and even necessary, to rely on experts, and it is understandable to assume that government regulators will find misconduct before it victimizes us, but it is never acceptable to forego our own critical review. If we do not understand what we are being told, we should not invest.⁶⁹

LOAN CRISIS: LESSONS FROM A REGULATORY FAILURE xii-xiii (James R. Barth, Susanne Trimball, & Glenn Yago eds., 2004). Once a crisis has been resolved, it is useful to understand how it arose, and what may have exacerbated the crisis. Affixing blame at the outset of a crisis—a popular Washington, D.C. preoccupation—is both backward-looking and counter-productive. It does nothing to resolve the current crisis and requires time, attention and resources that can be better applied to developing and implementing solutions. Politicized solutions are guaranteed to be suboptimal and in turn open the door to additional crises in the future.

⁶⁷ The purpose of injecting money into the economy is to stimulate economic activity. Because it is human (and organizational) nature to try to ameliorate the appearance of past mistakes, putting money into the hands of those who have committed the mistakes sought to be corrected will, predictably, not have the desired effect. By way of example, according to a new Center for Public Integrity analysis of public records, of the twenty-five firms expected to participate in the Home Affordable Modification Program (HAMP), “at least 21 were heavily involved in the subprime lending industry.” Mara Der Hovanesian, *The Subprime Gift That Keeps on Giving*, BUSINESSWEEK ONLINE, Aug. 26, 2009, http://www.businessweek.com/investing/wall_street_news_blog/archives/2009/08/the_subprime_gi.html. Under the HAMP program, up to \$50 billion will be applied to help homeowners stay current in their mortgages, but much of that money will go directly to institutions that helped create the subprime crisis in the first place. *See id.* In addition, the federal government invested \$20 billion in General Motors (GM), then fired its CEO, Rick Wagoner, invested nearly an additional \$20 billion and then forced GM into bankruptcy. Online Video Recording: Intelligent Investing with Steve Forbes (Forbes.com 2009) (interview by Steve Forbes with Harvey L. Pitt, Chief Executive, Kalorama Partners) (transcript available at <http://www.forbes.com/2009/08/06/pitt-sarbanes-oxley-intelligent-investing-short.html>). None of this has had any appreciable stimulative effect. In contrast, the government dedicated \$3 billion to the Cash for Clunkers Program and, while there is some argument about exactly how effective the program will prove to have been in the long term, there is no question that it stimulated new sales and helped the economy to some degree. *See* Daniel Gross, *Cash for Clunkers Helped Car Dealers, but... Did It Also Help the Economy?*, SLATE, Aug. 24, 2009, <http://www.slate.com/id/2226156/>.

⁶⁸ *See, e.g.*, Ronald Reagan, President of the U.S., Remarks on Signing the Intermediate-Range Nuclear Forces Treaty (Dec. 8, 1987), <http://www.reagan.utexas.edu/archives/speeches/1987/120887c.htm>.

⁶⁹ It makes no more sense to invest in an instrument the risks and returns of which you do not fully understand than to purchase the proverbial pig in a poke. Recent history provides a number of object lessons in the dangers faced by investors who do not educate themselves. For example, in the wake of the Enron collapse, the General Accounting Office pointed to the lack of educated investors. *See Private Pensions, Key Issues to Consider Following the Enron Collapse: Hearing Before S. Finance Comm.*, 107th Cong. (2002) (statement of David M. Walker, U.S. Comptroller General), available at <http://www.gao.gov/new.items/d02480t.pdf>. Similarly, the recent Madoff scandal demonstrates the critical need to understand in what you are investing, and with whom. *See* The Investor's Clearinghouse,

B. Look for problems before they find you.

According to folk wisdom, you should never go looking for problems—if they are destined to find you, they will. This just is not so in our highly regulated world. You can, and you must, look for problems and potential problems *before* they come looking for you.⁷⁰

C. There is no such thing as a small problem.

Small problems have an annoying habit—left unaddressed, they coalesce and morph into big problems. This is particularly true when economic pressures or other external influences act as an irritant. Life is easier if problems are identified and addressed early.

D. The “Golden Rule” is risk management.

It is critical to invest the resources necessary to establish sound risk management now in order to weather the remainder of the current crisis and for success as recovery follows.

*E. Being smart is good; being too smart is dangerous.*⁷¹

When seeking to make money or circumvent obstacles, it is often tempting to develop novel, unique, or clever approaches. Making money is to be encouraged, and circumventing obstacles is both permissible and sometimes downright necessary, but only if the proposed plan is thoroughly vetted and its consequences understood first.

F. The third little pig had it right.

In the story, little pigs one and two built their houses out of flimsy materials and ultimately found themselves serving as dinner for the wolf.⁷² Be like the third little pig and be sure the building blocks of your plans and strategies are sound before moving forward to implement them.

Avoiding Madoff-Style Ponzi Schemes: 12 of the Best Resources for Investors (Jan. 27, 2009), <http://www.investoreducation.org/Release012709.cfm?CFID=2968435&CFTOKEN=63069582>; *see also* SEC, Questions You Should Ask About Your Investments, <http://sec.gov/investor/pubs/askquestions.htm> (last visited Nov. 18, 2009).

⁷⁰ Benjamin Franklin famously observed that “[a]n ounce of prevention is worth a pound of cure.” The Electric Ben Franklin, <http://www.ushistory.org/franklin/quotable/quote67.htm> (last visited Nov. 18, 2009). While he coined this phrase in the context of fire prevention, its application to other sorts of crises is equally clear. In virtually all cases, less effort (expended in ferreting out potential problems) is required to prevent a crisis (and less disruption results from the effort), than is required to solve a crisis once it becomes a reality. In addition, pre-crisis actions can be designed to be constructive rather than remedial and can be undertaken in a deliberate manner.

⁷¹ There clearly is such a thing as being too smart for one’s own good. *See, e.g.,* Mark Kingwell, *Too Smart for Our Own Good*, THE GLOBE AND MAIL, available at <http://theglobeandmail.com/news/opinions/too-smart-for-our-own-good/article1158051/>.

⁷² The story of the three little pigs originated as a folk tale and first appeared in print in 1849. Sean Kelly, *Still Huffing, Still Puffing*, N.Y. TIMES, May 20, 2001, § 7, at 20.

G. Do not become a victim of your own success.

One of the worst mistakes—and one that often accompanies success—is to become complacent.⁷³ If you hope for the best, but plan for the worst, you likely will never be caught off guard, be unprepared, or wind up disappointed.

*H. A friend in need is often very lonely.*⁷⁴

This is especially true if your “new best friend” is a regulator or legislator who gains “new best friend” status because *you* need immediate assistance. Get to know regulators and legislators *before*, not *when*, you need them.

I. Heed unconventional wisdom.

Constructive dissent and contrarian thought ought to be encouraged to counterbalance “group think” mentality which, left unchecked, results in the emperor parading naked, while everyone else loses their shirts, in and around the marketplace.

J. It usually gets worse before it gets better.

These are unprecedented times. There will be more bad news, and it will take a long time to recover from this crisis. On the other hand, it is not wise to bet against the resilience of Americans and our financial system.

K. Maintain a sense of humor.

Over the last several years we have probably all taken ourselves somewhat too seriously. Adlai Stevenson had it wrong when, after losing to Dwight D. Eisenhower yet again, he somberly intoned, “[i]t hurts too much to laugh, but I’m too old to cry.”⁷⁵ If you do not laugh, the pain is only that much harder to handle.

⁷³ As Bill Gates has observed, “[s]uccess is a lousy teacher.” BILL GATES ET AL., *THE ROAD AHEAD* 35 (2d ed. Penguin Group 1996) (1995). The reason is that most people have the tendency, in the face of success, to believe they had a lot to do with their own success. In truth, success is dependent upon far more important factors, not the least of which is luck.

⁷⁴ In the movie, “Wedding Crashers,” Vince Vaughn’s character, Jeremy Grey, wisely notes that “[a] friend in need is a pest.” WEDDING CRASHERS (New Line Cinema 2005) (quotation available at <http://www.imdb.com/title/tt0396269/quotes>).

⁷⁵ Adlai Stevenson, *Presidential Also-Rans*, TIME.COM, Nov. 4, 2008, http://www.time.com/time/specials/packages/article/0,28804,1856570_1856573_1856527,00.html.