Commentary: Awaiting the Next Pecora Commission

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On May 20, 2009, President Obama signed into law the "Fraud Enforcement and Recovery Act of 2009 (FERA)," legislation enacted in response to the financial crisis by an overwhelming vote of both houses of Congress.

As one might expect, the Act raises penalties for financial fraud, expands the reach of government agencies, including the SEC, to investigate fraud, and expands the type of instruments that would be covered by existing prohibitions on fraudulent activities. It is a typical legislative response to ramp up enforcement resources in response to notorious criminal behavior. Old movie buffs will recall that the good citizens of Dodge City hired Wyatt Earp when things had gotten out of hand.

FERA also creates, within the legislative branch, the Financial Crisis Inquiry Commission to determine what caused the current financial crisis. The establishment of the Commission is intended to recreate the success of the famous Pecora Investigation, which examined the causes of the First Great Depression.

There actually was no "Pecora Commission." On March 4, 1932, the Senate Committee on Banking and Currency launched an investigation into the causes of the 1929 Market Crash. The Senate at the time was Republican controlled, and Democrats charged that the whole thing was a white wash. In 1933, the now Democratic controlled Senate hired Ferdinand Pecora, a New York assistant district attorney, to write the final committee's report. He found the investigation was incomplete, and asked for an additional month of hearings.

Pecora conducted the hearings loaded for bear. His expose of National City Bank (now Citibank) caused the resignation of its president. Under Pecora's grilling, JP Morgan admitted that he, and many of his partners, had paid no income taxes in 1931 and 1932, resulting in a huge public outcry.

But the greatest success of the Pecora investigation was its public exposure of a wide range of abusive practices by banks and their affiliates. Among other things, Pecora was able to place on the public record evidence of banks underwriting unsound securities to pay off bad bank loans and pools created to support market prices of bank stocks.

The hearings resulted in massive public support for new regulations. Congress responded by passing in rapid fire order the Glass-Steagall Banking Act of 1933 to separate commercial and investment banking, the Securities Act of 1933 to set penalties for filing false information about stock offerings, and the Securities Exchange Act of 1934, which formed the SEC to regulate the stock exchanges.

The FERA Commission has been charged to examine a list of twenty-two potential causes of the financial crisis. Among other things, these include the failures of federal and state regulators, monetary policies, global imbalances in savings, trade flows and fiscal imbalances of various governments, accounting practices, tax treatment of financial products, lending practices and securitization, derivatives and short selling. Compensation is on the list twice, as compensation structures generally and compensation for employees of financial services firms in particular. Finally, the Commission is required to examine the causes of each major financial institution that failed, or would have failed without exceptional governmental assistance.

To accomplish all of this, the Commission is empowered to hold hearings, subpoena witnesses, and retain staff, including consultants. I expect the Commission will seek outside legal help, and if so, we will submit our application to assist the Commission in its work.

Will the FERA Commission match the success of the Pecora Investigation? If so, we should see a substantial change in financial services regulation in the wake of its final report.

One thing that makes this seem unlikely is that the Commission's report is due on December 15, 2010. The Obama administration, as well as the relevant Committees in the House and Senate, seemed determine to introduce legislation later this year, a full year before the Commission's work is complete. If this effort succeeds, the FERA Commission's report will be anticlimactic.

Rumors emanating from the House and Senate, as well as the White House, suggest that the zeal for regulatory reform has diminished, as the economic outlook appears to be brightening. The legislation developed this year will reflect economic conditions. If the favorable economic trend continues, the vaunted reforms that result from the crisis are likely to be fairly modest.

On the other hand, if the current improvement in financial conditions is temporary, we may be knee-deep in financial tragedy next year. The FERA Commission's report in 2010 would then be very timely and result in a regulatory upheaval. As is so often the case, events on the ground will determine the outcome.

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