

# **What Are the Regulators Doing?**

## **Address to the St. Louis Traders Association Convention**

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### **Introduction**

Some of you know that I was born and raised in California. That makes me a Dodger fan. But, as your last speaker, I don't intend to run this into extra innings. I am looking forward to what should be a great ballgame.

It is fitting to start a discussion about regulation by talking about professional baseball, as there is hardly a more regulated activity anywhere, except perhaps for the trading desk. Everything in baseball is regulated. The number of feet between home plate and the pitcher's mound, the size of the base paths, the size of the bases, the composition of bats and baseballs, size of mitts, and most especially, the conduct of the players. And, there are the regulators, by which I mean referees, of course, but also the Commissioners, who make all of these rules with plenty of political interference from the owners.

When I first started listening to baseball, Don Drysdale was pitching for the Dodgers. (Stan the Man Musial was still playing for the Cardinals, by the way, which shows you how long ago that was.) As Don later admitted after he became a radio announcer for the Angels, when the other side seemed to be hitting his pitches too aggressively, Don would start throwing the ball at their heads. Lots of players complained. I think even Ken Boyer had a word or two to say about this. But Don always denied that he would intentionally throw the ball at anyone, until he retired. Then, he became more honest.

This sort of thing was a fairly common practice in the 50s; ballplayers that complained were considered wimps. But you don't see bean balls quite so much anymore. First of all, the owners don't like to see pitchers throwing balls at the heads of their batters, who are valuable pieces of property. Of course, players also didn't earn quite so much when Drysdale was pitching. But it's also because we no longer believe the bean ball is a fair strategy. So, pitchers who toss them, and managers who call for them, are ejected from the game. Naturally, someone has to decide when a pitcher has really tried to bounce a fast ball off someone's head, as compared to being just a bit wild. Some ump's may be a bit more tolerant than others, but the trend is against it.

So the question is, when do we decide that the existing regulations just aren't working and need to be changed? Ball players getting hurt unnecessarily usually leads to a change of the rules, or a tightening in their enforcement, in baseball. It's not really different in the world of financial services regulation.

We're in the midst of a financial crisis, and there have been some startling scandals. I knew Bernie Madoff. For me, that one hit close to home. This sort of thing indicates that things aren't working, leading to calls for change. The worse it is, the more things can be expected to change.

Back in February, when Chris asked me to speak, I was originally planning on discussing what the regulators were doing right and what they were doing wrong. We thought that by now, there would be a bunch of new rules. And recently, the SEC has been engaged in a flurry of rule-making activity.

First, there is the short-sale rule proposal, which is an attempt to return the markets, so far as short sales are concerned, to the pre-2007 environment. In reaction to the Madoff episode, the SEC also proposed a revision of the investment adviser custody rules, which would also return those rules for the most part to their pre-2007 condition. The SEC has also made it easier for the enforcement division to do its job, and they have responded with a whole bunch of enforcement actions. This also returns to the policies that existed before 2007.

Does anyone see a pattern emerging here? The regulatory plan seems to be to return everything to the pre-crisis period. The same strategy is ongoing with other regulators. The Treasury Department's TALF program is an attempt to get the securitization market going again.

Sadly, restoring past glory never works for reasons all of us know too well.

Some of you may remember Buzzy Geduld, my old boss. He once told me that the markets were going to change so much that in 5 years we wouldn't recognize them. Then he said, "I bet you think I just said something profound." I said, "yes." He was, after all, the boss, and I honestly did think I was hearing a prophecy. Buzzy just laughed and said, "it wasn't profound. It was stupid. I could have said the same thing on every day of my life in this business and been correct every time."

This is the problem. Things change in the markets. As a result, it's impossible to recreate the past. Right now, the markets have reacted to unprecedented levels of government intervention. I think these measures were absolutely necessary. I think taking over AIG and GM was essential to avoid economic collapse. But, the markets will not easily forget that this happened.

Right now, it seems to me that the markets are reacting more to what the government will do than market fundamentals. Bad news everywhere, but the Dow goes up. Why? Because that means more intervention is likely. The Obama administration tells us that they will stop intervening as rapidly as possible. But, what happens when the Fed stops buying commercial paper? If the market collapses again, there will be some expectations built into prices that the government will save the day.

Nonetheless, I predict there will come a time when regulators stop trying to resurrect the past and start to make new rules for the future. We are going to attempt to predict what the regulatory landscape might look like in the brave, new world. If it doesn't turn out as predicted, just remember the wise words of Yogi Berra:

## **Our Predictions**

**“Prediction is very hard,  
especially about the future.”**

**-- Yogi Berra**

The first step is understanding why things need to change. Another quotation makes that point.

## Why Change Anything?

**“In today's regulatory environment, it's virtually impossible to violate rules.”**

**-- Bernard Madoff**

There will always be bad guys as long as there are humans. It has been against the law in just about every civilized nation for many millennia to steal. “Thou shalt not steal” is one of the Biblical Ten Commandments. Despite this, there are still thieves. But, when theft becomes commonplace or spectacular, we look to our elected representatives to do something about it. The good people of Dodge City hired Wyatt Earp to clean things up. In this day and age, we expect Congress and the Obama administration to get to the bottom of things and make sure it doesn't happen again.

### **What the Madoff Case Tells Us.**

My predictions about the future of regulation are based on four propositions, two of which are illustrated by the Madoff case. So, what does the Madoff case tell us?

# What the Madoff Case Tells Us

## Proposition One:

### New Rules Aren't Always the Answer.

The Madoff fraud was a Ponzi scheme, which was illegal long before Madoff used it, named after a career criminal named Charles Ponzi.

Ponzi was born in Italy. His first known crime was check forgery, for which he spent three years in prison in Canada. After his release, he became a "mule," smuggling illegal immigrants into the United States. For this, he enjoyed the hospitality of the Federal penitentiary in Atlanta for two years. Then he got married in 1919 and settled down by launching the infamous "Ponzi scheme."

Ponzi claimed to buy stamps in Spain for four cents and resell them in the United States for five cents. He actually didn't buy any stamps, but used money from one investor to pay 50% returns to other investors. This scam became quite spectacular before the bubble burst in the fall of 1919.

After paying his debt to society for the Ponzi scheme, Ponzi was released and promptly engineered a fraudulent land scam in Florida. This time, he was deported to Italy.

Somehow, he managed to get a job working for the Italian treasury. At the time, Italy was run by Mussolini. Ponzi managed to steal funds from the treasury, and fearing Mussolini's wrath, fled to Brazil, where he eventually died of old age.

The point is that the Ponzi scheme is part of the tool box of the career criminal. Another rule prohibiting the practice won't fix anything. The Madoff case is a problem of enforcement, which brings me to Proposition Two.

## **What the Madoff Case Tells Us**

### **Proposition Two:**

### **Better Enforcement of Existing Rules May Not Be Enough.**

Ponzi schemes are a regular part of the SEC's enforcement agenda, managed out of its Denver office. Year in, year out, the SEC investigates about 400 Ponzi schemes annually. While Madoff and other well-publicized schemes have drawn the public's attention, the fact is that the number of Ponzi schemes is relatively constant over time. In recent times, the amount of money has increased, but the actual number of schemes remains about the same every year.

There are some who say that Ponzi schemes are like other miscreant human behaviors. Since we can't eliminate them, there's nothing more that can be done.

I don't think the public, the ultimate beneficiary and supporter of regulatory enforcement, will accept that as an answer. While the number of Ponzi schemes may have remained constant, the amount of theft has grown too large to ignore. There is a difference between the occasional adolescent shoplifting of a candy bar from the grocery store and the guy who robs the place at the point of gun in broad daylight. I believe the public will demand that something be done to prevent another Madoff. The amount of the theft was simply too large to accept as the usual business of law enforcement.

So, what can be done?

In 1992, the SEC's Division of Enforcement responded to a complaint that an accountant in New York was acting as an unregistered broker-dealer. It turns out that the accountant was accepting client funds and investing them with Madoff. The SEC's lawyers knew that Madoff was a registered broker-dealer and that ended their inquiry with respect to the destination of client funds. They continued to investigate the accountant.

What the SEC's lawyers did not know is that a registered broker-dealer is not permitted to manage client funds on a discretionary basis, unless that is a part of its business plan approved by FINRA. My guess is that very few "SEC" lawyers, whether they work for the agency or in private practice, know that broker-dealers are only permitted to operate in approved lines of business. The SEC's lawyers also were not aware that Madoff was not approved to operate a discretionary account business, which is what managing other people's money is called when the business is conducted by a registered broker-dealer.

On the other hand, FINRA's examination staff was well aware that Madoff was not approved to operate a discretionary account business. In my experience, the first question in every FINRA examination requires a broker-dealer to describe its lines of business. FINRA conducted about 15 examinations of the Madoff firm between 1992 and 2008. My guess is that the question came up 15 times and that Madoff only disclosed his trading business to the FINRA examiners.

So, why didn't the SEC's lawyers communicate their findings to FINRA? Even if the SEC was not aware of its importance, the information about Madoff's business would have been of great interest to FINRA.

The answer is that there is no procedure for the SEC to communicate this sort of information to FINRA. If anything, there are strict internal rules to prevent leaks of information gained in examinations from being shared with other regulators. In part, these rules are necessary to protect the integrity of investigations and the rights of defendants. It is also true that regulators have turf to protect, something that has become glaringly evident now that Congress is considering reallocating regulatory responsibilities.

What is desperately needed, if we are to avoid repeat episodes like Madoff and other notorious financial frauds, is a process where one regulator shares its findings with another. The technology to do this is ridiculously cheap. Just about every one of the firms regulated by the SEC uses some sort of interactive database software to share information between departments. Something as inexpensive as

Salesforce.com would probably work. For a bit more money, trivial next to what investors lost with Madoff, the SEC and FINRA could share an Oracle database.

If the SEC had dropped the results of its 1992 investigation into a “Madoff file” that was reviewed by FINRA investigators at the time, it would have been much more difficult for Madoff to dodge FINRA’s examiners, dramatically increasing the odds that the fraud would have been discovered at a stage when it was still relatively small.

So, why do these regulatory gaps exist?

Our system of financial services regulation is designed around certain entity types, as these existed in the 1930s. So, the Fed regulates banks, the SEC regulates broker-dealers, exchanges, investment advisers and investment companies, and the CFTC regulates commodities dealers and commodities exchanges. FINRA was set up in the first instance to regulate broker-dealers operating in the over-the-counter markets.

Over time, regulated entities have attempted to design their businesses to obtain the least possible regulation because regulations impose costs on doing business. Best of all is no regulation at all, especially if all of your competitors are regulated. As a result, there are gaps, where there is no regulation of important financial services businesses.

Worse yet, if something falls outside of an agency’s regulatory specialty, its significance may not be understood, which means that valuable information is ignored.

Chairman Schapiro calls this regulatory phenomenon “stovepipe regulation.” The *Economist*, being less kind, calls it “Mr. Magoo” regulation, after the famous blind cartoon character.

So, what will be done to remove the regulatory blinders?

The Obama administration says that we need to regulate functions, rather than entities. Anyone performing a certain function gets regulated, no matter what sort of entity they are. Mary Schapiro agreed with this approach in a recent speech to the mutual fund industry. On the other hand, Rick Ketchum, the CEO of FINRA, disagrees. He thinks the problem can be solved by expanding FINRA so that it also regulates investment advisers.

Personally, I think Ketchum’s proposal moves the goal posts, but doesn’t change the game. People will still exploit regulatory gaps – there will just be different gaps.

Obama's proposal would mean a radical change in the way financial services are regulated. The SEC would be more like the FTC, which regulates advertising, no matter who does it. In a sense, this takes us full circle because Congress originally thought the FTC should regulate securities offerings.

### **What Does the Current Crisis Tell Us?**

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### **Proposition Three:**

**We know that a new system of regulation is required when everyone is doing what they are paid to do, and things still go wrong.**

The failure of one bank does not mean there is a crisis. Banks, like all other business, sometimes fail.

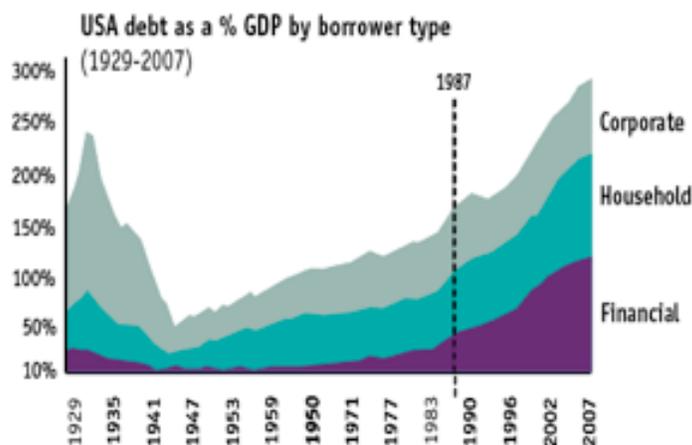
When Bear Stearns collapsed, federal banking regulators for good or bad, decided to intervene. This was unusual because the Fed was not Bear Stearns' regulator. For many months, the public debated whether the Fed's intervention with Bear Stearns was necessary. Then came Lehman.

As we all know, when Treasury refused to intervene to prevent the collapse of Lehman, or to cause it to be swallowed by another institution, Lehman was forced to declare bankruptcy.

The credit markets responded to the Lehman bankruptcy by freezing in their tracks. For a brief moment, the global economy came to a standstill. Think of it as a heart attack. As a result, the Fed was forced to intervene in ways most of us would have thought inconceivable. The Fed became the lender of first resort in the commercial paper markets, purchasing it directly from issuers. Goldman, Merrill Lynch, Bank of America, Morgan Stanley, Wells Fargo and JP Morgan all got transfusions of taxpayer money.

Something went terribly wrong. The best analysis of the causes of this financial meltdown that I have seen was put together by the Financial Services Authority (FSA), which is more or less the SEC's counterpart in London. Lord Turner is the head of the FSA, and the analysis is therefore called "The Turner Review."

## Financial System Leverage



Source: Oliver Wyman

Everyone has heard about the increase in indebtedness in the United States over the last several years. This chart depicts that indebtedness and, sure enough, there has been a substantial increase in indebtedness over the last two decades. Household indebtedness – credit cards, residential mortgages and other consumer debt – as you can see -- has increased considerably over this period. But the amount of indebtedness incurred by financial services firms had exploded. What is going on?

It turns out that most of this leverage consisted of bank loans that had been transformed into securities through the magic of securitization, which involves a bank selling its loans to a pooled investment vehicle that then issues securities collateralized by the loans. It seems odd that these securities increased the leverage of financial institutions, since the purpose of securitization is to remove loans from the balance sheets of lenders and transfer these assets to investors.

The reason for this odd result is that banks purchased the securities issued by pools created by securitization. They did this because the capital treatment was better for the security than for the loan that was the collateral for the security, on the theory that there was a ready market for the security. So, instead of reducing risks for banks, securitization did the opposite. The impact of securitization was to ramp up the leverage of the financial services industry.

Think of it as a giant Ponzi scheme. Financial institutions are supposed to supply the credit that commercial enterprises use to make things. But over the last two decades, the financial services industry has been both the supplier and the consumer of credit. When the build up of credit within the financial services industry exceeded safe limits, the system blew its top.

The build up of credit within the financial services industry also meant that an abnormal proportion of national income flowed to financial services firms.

# Financial Services Economic Impact

Exhibit 1.28: Gross value added as a percentage of GDP



Source: ONS, FSA calculations

It is important to understand that, unlike Madoff, the people who drove leverage to unreasonable heights were not trying to defraud anyone. They were just trying to package and sell securities issued by collateralized pools. This was their job, and nothing they were doing was illegal. The problem was that there were too many people doing the same thing at one time, and most importantly, the regulators were unaware of the extent of systemic risk that was being created by this collective action.

How did things get out of hand?

One cause is something called “shadow banking.” The legal definition of a bank is that it accepts deposits and makes loans. But there is a more general economic definition. A bank makes money by borrowing short-term and lending long-term. Long-term interest rates generally are higher than short-term rates, which allows banks to profit from the spread.

There is always a risk that a bank will be caught in a squeeze if most of its short-term lenders ask for their money back at once. But banks are protected by the Fed’s willingness to accept long-term loans as collateral for short-term loans to enable banks to pay depositors quickly if the need arises.

But lots of things that weren't banks, as it happens, operated under the same principle. Hedge funds, money market funds, and even securitized pools, couldn't pay back current obligations because their assets had longer-dated maturities. However, these "shadow banks" are not regulated as banks. They don't have access to the Fed's support when there is a run. In most cases, the Fed doesn't even know they are there.

In general, the Fed limits bank lending to protect the banking system through capital requirements. But it wasn't thought there was a need to protect non-bank institutions. As a result, when shadow banks experienced a run, they simply failed, or refused to pay their short-term obligations. This, in turn, placed other financial institutions in jeopardy because the short-term obligations they thought they had turned out to have longer maturities.

So, what are the cures? So far, three solutions have been advanced. The actual remedy will likely be a mix of all three.

First, it is proposed to bring more things into banking regulation. The Fed recently announced that it should regulate large investment banks. Morgan Stanley and Goldman Sachs would fit that description. There are proposals to bring money market funds under the supervision of banking regulators. Hedge funds are an open question.

Second, there are proposals to create a systemic regulator. This regulator would be responsible to prevent the sort of collective action that increased leverage throughout the system, even though each firm was operating on a safe and sound basis.

Third, there are proposals to remove the gaps from our system of financial services regulation. In general, there is a call for regulation by function. Banking regulators, under this system, would be responsible for supervising any banking activity, whether or not a bank did it. To avoid overlap, some agencies might be merged with others. There have been proposals to merge the SEC and the CFTC.

Will any of this actually happen? That is the subject of my fourth proposition, which is actually another quotation:

**Play Ball!**

**“You can always count on the  
Americans to do the right thing  
– After they have tried  
everything else.”**

**-- Winston Churchill**

Thank you very much.