



Toward Better Financial Market Regulation: The Issues in Depth

On June 4, 2009, a group of twenty people comprised of senior business and law faculty and business practitioners (and including among their numbers a small contingent of former senior government officials) was jointly convened by The Aspen Institute and New York University with support from Ernst & Young to discuss responses to the current economic crisis and to explore the role of financial market regulations in fostering economic recovery and growth. (A list of attendees is appended to this paper.)

A shorter account of the roundtable was released to the public in June, 2009, summarizing the ten major topics of conversation that recurred throughout the day. This paper covers similar territory, but is intended to give a more in-depth account of the topics discussed and more of the flavor of the conversation. It also delves somewhat into the discussion of the role that business and law academics can play responding to the crisis and in shaping the attitudes of the people who will ultimately become market actors. Because the event was convened under Chatham House Rules, participants have given their permission for all direct attributions.

Perhaps due both to the complex nature of the questions at stake, and to the broad scope of the discussion—which touched on practical issues relevant to a number of different sectors as well as on core philosophical questions underlying different notions of the role of markets in society—the gathering did not yield any single consensus. However, throughout the lively discussion, the participants agreed that the proper resolution of the major issues discussed is key to optimal refashioning of the U.S. regulatory system, and to the future of the markets.

These major themes are loosely grouped into two categories—specific responses to events, and broader principles that will help to set the tone as industry and regulators alike move forward toward healthier and more productive market functioning. Below are some of the major points that were raised around each topic.

Responses to Events

Regulatory attention to systemic risk

Participants largely agreed on the need for some form of systemic risk regulator with the power to maintain overall market stability in a way that none of the existing regulatory agencies are currently able to do. Said Amar Bhidé, “You can’t effectively insure banks if you can’t control the risk they take.”

Participants’ opinions varied about which institutions would be best equipped for this role. One participant suggested the Federal Reserve, because it is perceived as having the greatest amount of clout of the existing agencies. Another participant disagreed, saying that involvement in

anything but setting monetary policy would dilute the Fed's mission and diminish its independence. Yet another participant suggested that a dedicated risk department with a proactive mandate be created at the SEC. Others suggested the creation of a new financial stability council, with a Presidentially-appointed chairman.

Several participants argued for a complete overhaul of the existing regulatory system, with Charles Elson summing up this argument, "Do you really trust the people who got us into this mess to get us out of it?"

Incentivizing responsible behavior by pricing systemic risk

Roundtable participants were also relatively united in the belief that the financial system would benefit from a mechanism for pricing systemic risk. One person particularly stressed the need to ensure that market actors that create systemic risk be required to bear a financial burden for the risk they create so as to avoid creating moral hazard. Although they agreed that any system devised would necessarily be imperfect and was unlikely to eliminate systemic risk completely, participants nonetheless agreed that it is important to make some attempt at this goal.

Suggestions included requiring companies to pay a fee for access to a lender of last resort, raising capital requirements, and requiring companies to buy government-overseen insurance on risky transactions, with the stipulation that if a company were unable to afford the insurance it would be forbidden to complete the deal. The same participant who was particularly concerned about moral hazard also stressed the importance of making a distinction between a market liquidity provider and a lender of last resort.

Aligning regulation of institutions with their true market roles

Participants discussed whether and how to regulate companies and activities that are currently either unregulated or regulated in ways that are out of step with their true role in the broader economy.

Several participants pointed out that the insurance industry is currently largely unregulated, and most agreed on the need for regulation of all non-bank financial institutions (NBFIs) in a way that more closely reflects the scope of their activities and their effect on the larger economy. Some pointed out that many NBFIs "act like" banks and should therefore be regulated more like deposit-taking institutions.

Better attention to potentially destructive financial products

Participants were varied in their thoughts on how to address the destructive potential of derivatives, which played such a central role in bringing about the current crisis.

All agreed that derivatives have had a widespread effect on attitudes about financial markets as well as on the markets themselves. Some participants asserted that derivatives should be regulated, or at minimum that a clearinghouse should be established to keep track of over-the-counter derivatives. However, others argued that regulating derivatives would create the illusion

of safety around products that are inherently unsafe, and that the cost necessary to regulate them would simply be a waste of taxpayer dollars—Lawrence White asserted that “the value of regulation depends on the value of what is being regulated.” Other participants expressed skepticism that derivatives create any real value for the markets or society. In answer to the common assertion that derivatives promote market efficiency, they suggested that energy would be better spent making the market more efficient through regulatory means.

Others suggested that derivatives should be left unregulated, but that the institutions that use them should not have access to depository institutions or to taxpayer money so as to minimize effects on the broader financial system. Participants also discussed the idea of a dedicated financial products safety commission to test and evaluate new financial products for their safety to the buyer and to the market at large.

Possibility of international cooperation

Participants debated the need for and potential efficacy of international cooperation around regulatory and governance issues. This aspect of the discussion was one of the livelier parts of the day, with participants holding strong opinions on both sides of the issue.

In favor of international cooperation, some participants pointed out that most major companies are in reality global institutions, and that they can’t be regulated effectively without creating oversight capacity that is also global. Those in favor of international oversight measures called for international corporate governance standards coupled with real enforcement capacity.

Those opposed to international cooperation countered that this approach would be impractical, arguing that international cooperation is slow and leads to consensus measures which are not truly appropriate to any of the jurisdictions they cover. Some pointed to Basel II as an example of failed international standards.

Principles for Moving Forward

Strengthening regulatory capacity

Most participants agreed that regulation plays a valuable role in helping to ensure market function, but felt that the current regulatory system is both imperfectly structured, and under-resourced.

Some expressed the belief that the SEC in particular is stymied by a smokestack-style hierarchical structure which inhibits communication within the agency, as well as by a reactive mandate that keeps it behind the curve.

Participants agreed on the need for regulators to be able to recruit talented staff with expertise in different areas of the financial services industry. They acknowledged as problematic the disparity between public and private sector salary levels. They also agreed on the need for professionals from regulatory bodies and industry to understand one another’s work, without being so entwined as to reduce the effectiveness of regulation.

As a solution to all of these problems, one participant suggested the creation of a requirement with the provision that anyone who reached a senior level in a major financial institution would first work as a regulator for some predetermined number of years. Other participants cautioned that if such a requirement were in place, it would be important to ensure that it did not produce a “revolving door” effect.

Mechanisms to foster and enforce accountability

Participants differed on means, but agreed on the need to foster and enforce accountability. While some felt that the search for people to blame for the current crisis detracts from a reasoned search for solutions, others felt that it is critical to send a public message that certain kinds of destructive behaviors are unacceptable—either by banning culpable individuals from certain professions, or by exacting fines. Some suggested that the professions whose members were involved in bringing the crisis about should censure those who stepped out of line and, in the future, take a more active role in promoting and enforcing professional standards.

A number of participants also felt that some mechanisms currently in place detract from a general culture of accountability. Participants noted the moral hazard to which rating agencies were subject, and contrasted the limited liability corporation with a partnership model of the firm, which some believe fosters a culture of ownership, stewardship and care among employees. One participant also pointed out that in certain situations regulation itself can undermine accountability, when regulation is used as a shield for bad behavior, and regulators are blamed for having failed to apprehend market actors’ shenanigans.

Participants suggested a number of ways to promote a culture of greater responsibility. A return to the partnership model was a favorite. Other suggestions included ascribing fiduciary duty to a greater array of institutions, and a formalized “gatekeeper” system by which certain individuals at a firm would be considered to have personal responsibility for particular functions.

Participants also were largely unanimous in their belief that business itself must play a pivotal role in fostering greater accountability. Leonardo Burlamaqui remarked that in crisis situations such as this one, “The role of public institutions should be to encourage business leaders to take responsibility for the public interest.” Citing Sarbanes-Oxley as an example, another participant expressed the opinion that business has a poor recent track record of engagement on public policy issues, and that it must take a much more active role in helping to respond to the current crisis.

Rethinking the nature, role and value of innovation

The purpose and value of financial innovation was another lively and recurring theme in the discussion.

Some participants asserted that financial innovation is categorically and always good. Others stated that “innovation” as a concept is overrated, and that its effects in the financial markets can

be highly destructive. Krishen Mehta noted, “In some cases, what we call innovation may just be arbitrage.”

Another participant who was skeptical of the value of innovation in a financial context suggested a framework for assessing it: both buyer and seller must be willing, and must internalize all the costs of the exchange.

Promoting a long-term focus

Most participants agreed on the need to foster a long-term focus among corporations.

The practice of quarterly earnings guidance was noted as fostering problematic short-term focus. The creation of firm-wide ownership culture was raised again as a way of promoting a long-term orientation.

Several participants stated their belief that aligning compensation—of analysts and managers, as well as executives—with long-term metrics is the most effective way to, as Charles Elson put it, “incentivize people to do the right thing.”

Staying mindful of investor interests

Participants expressed concern that investors—who are critical to the ongoing functioning of the U.S. financial markets—be treated respectfully, lest they “take their money elsewhere,” as one participant phrased it. Long-term investors were noted as being particularly important.

One participant spoke of breaking down the false dichotomy in the public discourse between taxpayers and investors, given that in reality the two groups overlap. It was suggested that the current moment might be opportune for a renewed focus on questions such as proxy access and say on pay for investors. Given the role that investors play in economic growth, it was pointed out that their interests should play a central role in plans for economic recovery.

The role of academics

Roundtable participants agreed that academics at business schools and law schools alike have an important role to play in responding to the current crisis, both in publicly discussing the crisis itself, and, more generally, in the knowledge and attitudes they impart to students.

One participant noted that academics have a uniquely valuable role to play in public debate because they have historical, theoretical and empirical perspectives to offer, as well as some degree of objectivity. As William Allen put it, “Almost everyone else in the debate apart from academics has a big stake in the outcome.” Several faculty agreed that academics should make an effort to engage with journalists around these issues so that their ideas can reach a popular audience.

Participants also discussed the ways in which faculty influence their students. Thomas Cooley asserted that there is “no greater teachable moment” than the current crisis. John Coffee

pointed out that faculty's influence over their students is a "long fuse" that lasts for years to come. Participants agreed that faculty must make a concerted effort to create an environment in which students can develop a sense of integrity and professional standards.

Although not discounting the important role that academics have to play in making sense of the crisis and helping to guard against future crises, Amar Bhidé raised some concerns about the ways in which academics may contribute to some of the dysfunction that caused the crisis. He called out a tendency among academics, particularly those in fields that are perceived as being numbers-based and concerned with hard, unwavering facts, to view phenomena that don't fit into mathematical models as representing meaninglessness, rather than complexity. As an example, he made a distinction between the slippery enterprise of truly assessing the value of a company in all its many tangible and intangible complexities, and the conventions that are used to "value" a company financially. Dr. Bhidé called for business academics to take a broader view of their subject matter, and to impart to their students a similar respect for the complexities of business, the market, and the economy.

This summary of the June 4 joint roundtable was prepared by The Aspen Institute Center for Business Education (Aspen CBE). To learn more about this project or about Aspen CBE, please visit www.aspenbe.org, or contact Rachel Shattuck at rachel.shattuck@aspeninst.org.

Discussion Participants

- William Allen**, Jack H. Nusbaum Professor of Law and Business; Director, Pollack Center for Law and Business, Leonard N. Stern School of Business, New York University
- Amar Bhidé**, Lawrence D. Glaubinger Professor of Business, Columbia Business School
- John Biggs**, Executive-in-Residence, Leonard N. Stern School of Business
- Bruce Buchanan**, C.W. Nichols Professor of Business Ethics; Director, Markets, Ethics and Law Program, Leonard N. Stern School of Business, New York University
- Leonardo Burlamaqui**, Program Officer, The Ford Foundation
- John Coffee**, Adolf A. Berle Professor of Law, Columbia Law School
- Thomas Cooley**, Richard R. West Dean; Paganelli-Bull Professor of Economics, Leonard N. Stern School of Business, New York University
- William H. Donaldson**, Chairman & CEO, Donaldson Enterprises Inc.; former Chairman of the Securities and Exchange Commission
- Charles Elson**, Edgar S. Woolard Chair in Corporate Governance; Director, John L. Weinberg Center for Corporate Governance, Lerner College of Business and Economics, University of Delaware
- J. Michael Farren**, Retired Corporate Secretary and General Counsel, Xerox Corporation; former White House Deputy Counsel
- Daniel Feldman**, Special Counsel for Law and Policy, Office of the New York State Comptroller
- Felice Friedman**, Director, Global Public Policy, Ernst & Young LLP
- Rich Leimsider**, Director, The Aspen Institute Center for Business Education
- Sylvia Maxfield**, Associate Professor of Management, Simmons College School of Management
- Krishen Mehta**, Advisor, The Aspen Institute Business and Society Program
- George Muñoz**, Principle, Muñoz Investment Banking
- Steven Schwarcz**, Stanley A. Star Professor of Law and Business, Duke University School of Law
- Don Vangel**, Partner; Director, Bank Regulatory Services, Ernst & Young LLP
- David Walker**, President and CEO, Peter G. Peterson Foundation
- Lawrence White**, Arthur E. Imperatore Professor of Economics; Deputy Department Chair, Economics, Leonard N. Stern School of Business, New York University