HOW THE OBAMA ADMINISTRATION SHOULD REGULATE THE
FINANCIAL SECTOR

By Michael S. Solender¹

The Obama Administration will be looking to the financial regulatory apparatus to prevent future economic crises like the one the country is experiencing right now. This is a very ambitious objective to impose on any regulator. Much ink has been spilled in addressing how the financial regulatory apparatus should be constructed going forward. The focus has been on consolidating the multiple agencies with overlapping jurisdictions that oversee the financial services industry.² Whatever their final form, we can identify certain key attributes these ultimate financial regulators should have to give them at least some hope of doing the proactive, forward-looking thinking the Administration will need them to perform: the right people at the agencies, enough access to the institutions they regulate, enough information from those institutions to know what is happening, an internal brain trust to analyze and assess that information, and a rapid reaction team to respond to financial emergencies.

The right people

The regulatory agencies must have the right personnel, including not only experienced regulators, but also financial professionals with inside knowledge of business and the markets. Regulators themselves have recognized the value of having employees with real industry experience. For example, the Executive Director of the Securities and Exchange Commission (SEC) testified in 2003 that, with respect to regulatory examiners, “[o]ften, the best candidates . . . are those with industry experience . . . . There is no substitute for having been on the other side of the fence when it comes to performing effective compliance examinations.” Testimony of James M. McConnell,

¹ Michael S. Solender is a Senior Research Scholar and Visiting Lecturer at the Yale Law School and has served as a senior executive in the financial services industry.

Executive Director, U.S. Securities and Exchange Commission, Hearing Before House Financial Services Committee on H.R. 658, Mar. 6, 2003 (“McConnell Testimony”).3 A more poignant recognition of the value of such experience came in the now famous email from Harry Markopolos, the investment professional who doggedly pursued confessed Ponzi-schemer Bernard Madoff, in which Markopolos observed that the SEC New York Branch Chief to whom he was trying to explain his analysis of Madoff’s professed trading strategy did not have “the derivatives or mathematical background to understand the violations.” E-mail from Harry Markopolos to Jonathan Sokobin re $30 Billion Equity Derivatives Hedge fund Fraud in New York (Apr. 2, 2008).4

More regulators with industry experience could help the government overcome weaknesses that have contributed to the financial crisis. Recent U.S. Government Accountability Office (GAO) testimony points to several failings that it asserts hindered the regulatory system, including:

- Regulators have struggled, and often failed, to mitigate systemic risks posed by [the large, complex, globally active, interconnected financial] conglomerates, and to ensure they adequately manage their risks. . . . Regulators sometimes lack . . . capabilities to oversee and mitigate [these] risks.

- [T]he increasing prevalence of new and more complex investment products has challenged regulators . . . Complex structured finance products have made it difficult for . . . regulators to manage associated risks.

- Regulators failed to adequately oversee the sale of mortgage products that posed risks to consumers and the stability of the financial system.

Testimony of U.S. Government Accountability Office, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, Hearing Before Congressional Oversight Panel, Jan. 8, 2009 (“GAO Testimony”).5 One ingredient that could help address each of these weaknesses is additional industry expertise within the regulatory agencies. As a recent report by the Group of Thirty Working Group on Financial Reform6 found:

“Regardless of how regulatory agencies are reorganized, prudential supervisors have a common need to better ensure that financial institutions adequately prepare for and respond to periods of financial stress. That role requires a renewed emphasis on the complex nature of judgments

3 Available at http://financialservices.house.gov/media/pdf/030603jm.pdf
4 Available at http://online.wsj.com/documents/Madoff_AprilSECdoc_20081217.pdf
5 Available at http://www.gao.gov/new.items/d09310t.pdf
6 The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. The Working Group on Financial Reform was led by Paul Volcker, Chairman, and Tommaso Padoa-Schioppa and Arminio Fraga Neto, Vice Chairmen.
about the stability of large banking institutions. The caliber, quality, and integrity of people required to meet these challenges points to the need for more substantial efforts to attract, develop, and retain individuals fully capable of engaging senior private sector counterparts.”


The benefit of having regulators who understand the companies they regulate cannot be overstated. They are likely to know who to talk to, the questions to ask, and what databases and documents to examine. Who better to examine and oversee the large, complex, globally active, interconnected financial institutions than people who worked in them, saw their operations from the inside, and perhaps even had some role in constructing them? The complexity and interconnectedness will become less opaque to regulators when they can see the institution through the eyes of insiders. Similarly, the complex structured products and corporate finance transactions can be explained and examined by people who worked on them, marketed and sold them, and perhaps even had a role in creating them. Again, industry players will give regulators a window into these products they may not have had to date.

One silver lining of the financial crisis for the government is that it has left the market flush with skilled risk managers, lawyers, internal auditors, and other professionals from the business world newly willing to work for government wages. The consolidations and general slowdown in the financial industry has led to a significant industry contraction. The result has been massive layoffs and greatly diminished compensation. Thus, the regulatory agencies have a golden opportunity to fill their ranks with the kind of seasoned professionals they ordinarily have difficulty hiring. See McConnell Testimony (“The nature of the Commission’s work requires that we seek highly skilled individuals who are often at a point in their careers where they have a number of employment options available to them . . . We have, time and time again, seen the best applicants for accountant, economist and securities compliance examiner position snapped up by competitors before the Commission has reached the point in the rigid competitive service hiring process where it can make them an offer.”) The regulators should seize this opportunity to fill their ranks with seasoned professionals with experience in the industries they regulate.

Concern about allowing the “fox in the chicken coop” is probably overblown with most professionals as likely to be appropriately self-critical once in the public sector and properly trained, supervised, and subject to conflict of interest rules. One can find plenty of examples of the industry complaining about a former colleague “going native” upon

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8 See William Holstein, Helping 240,000 Find a Future After Wall Street, N.Y.TIMES, Jan. 17, 2009 (“[A]t the end of 2008, the number was that 240,000 had been laid off on Wall Street in an 18-month period.”); Louise Story & Eric Dash, What Goes Around, N.Y.TIMES, Dec. 19, 2008 (“The normal buzz of money -- big money -- is all but silenced. While many bankers will still collect six- or even seven-figure bonuses, the average payout for rank-and-file employees will be cut substantially.”)
joining a regulatory agency. The drive to serve the public good is strong once one is
serving in government. Nevertheless, a healthy skepticism is warranted here, especially
given the public’s view of the “revolving door” between government service and the
financial sector.9 Training and supervision of new employees is essential. Conflict of
interest rules governing post employment exist. See e.g. 5 C.F.R. 2637 (government
wide post-employment restrictions); 17 C.F.R. 200.735-8(1) (SEC); 12 C.F.R. 264a
(Federal Reserve Bank); 12 C.F.R. 336.12 (Federal Deposit Insurance Corporation); 12
C.F.R. 507 (Office of Thrift Supervision). If they are inadequate to ensure the public’s
confidence, they should be enhanced.10

Although many blame Wall Street for the crisis, excluding everyone who could
conceivably share some of the blame would leave very few knowledgeable enough to
serve effectively. If one is looking to assess blame, one could ask not only did Wall
Street take on too much risk and leverage and create products that were too complex and
opaque, but did home buyers purchase houses they could not afford, did real estate
brokers sell houses they should not have, did lenders provide financing that borrowers
could afford only if housing prices continued to climb and interest rates stayed low, did
providers of mortgages do insufficient underwriting, did investment bankers create
incentives to “feed the beast” in order to continue to generate mortgage backed securities,
did rating agencies do an inadequate job rating the tranches of the securities created by
the investment banks, and did the regulators themselves adequately oversee this process,
foresee the risks, and understand the products? If everybody in this chain of blame is
deemed ineligible to participate in the solution, there will be few indeed left in a position
to serve.

Enough access

The regulators must have sustained access to the companies they are regulating.
No matter how capable or experienced the personnel employed by the regulatory agency,
a regulator is unlikely to be able to obtain information and avert problems and crises
without sustained and meaningful access to the regulated companies and their personnel.
This is not simply a question of resources, although adequate resources are necessary
condition for regulators to obtain sufficient access. It is also a question of philosophy

Different financial regulators employ different examination approaches. The SEC
conducts four kinds of examinations of companies it regulates: “sweeps” which look at a
sample of firms to assess a particular risk, “cause” exams where the staff has reason to
believe a violation has occurred, oversight exams to evaluate the examinations conducted
of the company by a self-regulatory organization, and exams of each firm on a “cycle.”

9 See Michael Lewis & David Einhorn, The End of the Financial World as We Know It, N.Y.TIMES, Jan.
3, 2009 (“Lewis & Einhorn”) (“The new [SEC] director of risk assessment was no more likely to grasp the
risk of Bernard Madoff than the old director of risk assessment because the new guy’s thoughts and beliefs
were guided by the same incentives: the need to curry favor with the politically influential and the desire to
keep sweet the Wall Street elite.”)
10 See Lewis & Einhorn (proposing to “forbid regulators, for some meaningful amount of time after they
have left the S.E.C., from accepting high-paying jobs with Wall Street firms.”)
Examinations by the Securities and Exchange Commission Office of Compliance Inspections and Examinations, Materials from February 2008 SEC Speaks in 2008 Conference (posted March 20, 2008).\textsuperscript{11} The SEC’s Office of Compliance Inspections and Examinations reports that the cycle for “high risk” investment companies and advisors is at least two to three years, but is not specific as to the cycle for other types of financial entities. Id. at 2. Typically, a team assigned to examine one financial institution on one occasion is unlikely to have much overlap with the next team to examine the institution. Even large institutions can go for fairly long stretches of time without seeing examiners, or if they do see a team, the examiners will essentially be starting from scratch.

Bank regulators have a different approach. Section 10(d) of the Federal Deposit Insurance Act requires that the federal banking regulators (Office of the Comptroller of the Currency, Federal Reserve Bank, Office of Thrift Supervision, and Federal Deposit Insurance Corporation) for a large insured depository institution conduct a full-scope, on-site examination of the institution at least once during each 12-month period. 12 U.S.C. 1820(d). In practice, bank examiners often have a continuous, or near continuous, presence at the large financial institutions under their jurisdiction. Typically, teams of examiners are assigned to institutions and often examine those institutions multiple times. At its best, this form of regulation involves embedding a team of knowledgeable and competent regulators with an identified leader inside a company for a sustained period of time, on a repeat basis. The team learns enough about the company it is examining to make informed judgments about the risks the company is running, the key business decisions it is making, the quality of management, and the strength of internal controls.

There are various factors that can undermine effective examinations even conducted under the best model. Some degree of rotation of regulatory personnel is desirable to avoid “captive regulators” but too frequent rotation prevents the regulators from becoming sufficiently knowledgeable about the institution to really know where to look and what to ask. A proper balance needs to be struck. Employee attrition can also undermine examinations. The regulatory agencies generally need sufficiently attractive working conditions to retain their examiners. The current economic conditions will surely help with that. Finally, as discussed more fully below, the risk of “captive regulators” must be balanced against overly adversarial examiners who can disincline a company to cooperate. If a company concludes that examiners are “out to get” the company, its personnel may look for ways to minimize cooperation and provide as little information as they can get away with. In the end, this serves neither the company nor the regulator.

One could suggest that recent events have rendered no clear judgment as to which regulatory model actually achieves better results in practice. For every Bear Stearns, Lehman Brothers, and Merrill Lynch that fell principally under the SEC’s examination jurisdiction, there was a Citigroup, Wachovia or Washington Mutual that was the responsibility of bank regulators. If, in the end, the bank regulation model was no more successful in helping the large financial institutions under its jurisdiction skirt the effects of the financial crisis and the bursting of the real estate bubble, what difference does it

\textsuperscript{11} Available at \url{http://www.sec.gov/about/offices/ocie/ocieoverview.pdf}
make which examination model is adopted going forward? The answer is that the access provided by the banking examination model is a necessary but not sufficient condition to effective regulation. Without the right personnel, enough information and properly organized and forward thinking regulatory agencies, all the access in the world will not matter. On the other hand, the right people in a well-organized, forward thinking agency are unlikely to succeed if they do not have adequate and sustained access to the companies they regulate.

A principal rationale for the bank regulatory model has been to protect the federal treasury – i.e. insured bank deposits. By proposing to extend this model to at least large financial institutions that may not hold insured bank deposits, another rationale becomes relevant as well – the importance of the institution to the stability of the financial system. To the extent that failure of a large financial institution that does not hold bank deposits can threaten the stability of the financial system, that institution is certainly as deserving of the kind of examination attention given to banks and use of bank regulatory resources for this effort is clearly justified. See G30 Report at 17 (“The inherent volatility of free and open financial markets and the danger that volatility may occasionally reach crisis proportions threatening economic stability, needs to be recognized in the design of the financial system [and] . . . [r]equir[es] [that] non-bank financial institutions that are also judged potentially to be of systemic importance . . . be subject to some form of formal prudential regulation and supervision . . .”). To the extent that so many of the remaining large financial institutions are in the process of converting themselves into bank holding companies or have received substantial infusions of government funds, this issue may be largely moot in any event.

**Enough information**

The regulators must maximize the information they obtain from industry. This will require achieving the proper balance between robust enforcement of the law and creating the proper incentives for those they regulate.

Enforcement is essential for deterring and punishing serious and un-remedied wrongdoing. See Statement of Securities and Exchange Commission Chairman-Designate Mary Schapiro, Before U.S. Senate Committee on Banking, Housing and Urban Affairs, Jan. 13, 200912 (“It is precisely during times like these that we need an SEC that is the investor’s advocate – that has the staff, the will and the resources necessary . . . to vigorously prosecute those who have broken the law and cheated investors . . . First and foremost, if confirmed as Chairman, I will move aggressively to reinvigorate enforcement at the SEC. With investor confidence shaken, it is imperative that the SEC be given the resources and the support it needs to investigate and go after those who cut corners, cheat investors, and break the law.”); Testimony of Arthur Levitt, Jr., Before Senate Banking Committee, Oct. 15, 200813 at 7 (“Enforcement is so important not because the SEC can

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12 Available at http://banking.senate.gov/public/_files/SchapiroFINALtestimony11509.pdf
13 Available at http://banking.senate.gov/public/_files/LEVITTBankingCommitteeTestimonyFINAL101608.pdf
catch every cheat and prevent every abuse. It’s important because it holds people accountable and serves as a powerful deterrent to bad behavior – and is the most powerful tool a regulator has to keep a market functioning. Indeed, the signals the SEC can send to investors are critical. By bringing a tough enforcement action, making a well-timed public statement, or taking action on a critical need, the SEC builds the investors’ confidence that someone is looking out for them which, in turn, builds market trust.”

At the same time, when regulators are perceived as overly adversarial, companies have a disincentive to turn over information voluntarily where doing so will inevitably result in disciplinary action against them. Most, if not all, regulators acknowledge the wisdom of crediting cooperation and self-reporting of wrongdoing, citing a variety of rationales. See e.g. SEC Exch. Act Release No. 44969 (Oct. 23 2001) (“Seaboard Report”) 14 (“When businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly.”)

However, the different distribution of resources and organization among financial regulators has resulted in very different approaches to enforcement in practice. The SEC has a proportionally large staff (particularly of lawyers) devoted to enforcement and a tradition as a law enforcement agency. In contrast, the bank regulators, while they have enforcement staffs that do bring actions, have more resources proportionally devoted to regulation and examination and less to enforcement. As a result, no matter what is articulated as the philosophy of the agency, communication and cooperation with bank regulators appears to come at substantially less risk of future enforcement action than does communication and cooperation with the SEC.

Achieving a *modus vivendi* whereby a company that finds problems shares information with a regulator which, in turn, considers forgoing enforcement action against the company if the company itself takes appropriate disciplinary and remedial action can be an effective way to incentivize a company to be forthcoming with information. Even with a regulatory regime weighed heavily towards enforcement, a regulated company will want to try to stay on the right side of its regulator. At the same time, where there is no legal obligation to report and where the likelihood of regulatory detection is low, but where the information would be of value to regulators, it is in everyone’s interest for a company to communicate with its regulator. The regulatory system should create the proper incentives for this communication to take place. The regulators will rightly be expected to vigorously enforce the law, and by doing so judiciously, they can also keep themselves firmly in the flow of information.

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14 Available at [http://www.sec.gov/litigation/investreport/34-44969.htm](http://www.sec.gov/litigation/investreport/34-44969.htm)

15 See generally Memorandum from Paul J. McNulty to Heads of Department Components and United States Attorneys re Principles of Federal Prosecution of Business Organizations (“In conducting an investigation, determining whether to bring charges, and negotiating plea agreements, prosecutors must consider the following factors in reaching a decision as to the proper treatment of a corporate target: . . . 4. the corporation’s timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents.”)  (Available at [http://searchjustice.usdoj.gov/search?q=cache:gf9gA_1Gr7YJ:www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf+mcnulty+memorandum&access=p&output=xml_no_dtd&ie=iso-8859-1&client=default_frontend&site=default_collection&proxystylesheet=default_frontend&oe=UTF-8] )
**Internal brain trust**

The regulators should create an internal brain trust to accumulate information acquired from individual companies and industries and make comparisons between companies and across industries, looking for trends and warning signs. Even with the right people, sufficient access to companies and a free flow of the right kind of information, regulatory agencies need a central nerve center to process, synthesize, and analyze the information. The people in this nerve center need to be able to engage in the unrestrained out-of-the box thinking that can overcome conventional wisdom and test implicit assumptions.

Some parts of existing financial regulatory agencies have within their responsibilities certain aspects of this mission. See SEC Office of Economic Analysis (“engages in research in support of longer-term SEC policy initiatives and plans[,] include[ing] research into the causes and consequences of significant developments in the securities markets, in prevailing financial practices among issuer firms, and in SEC policy”); SEC Office of Risk Assessment (“formed in 2004 to help the SEC anticipate, identify, and manage risks, focusing on early identification of new or resurgent forms of fraud and illegal or questionable activities. ORA focuses on risk issues across the corporate and financial sector, including issues relevant to corporate disclosure, market operation, sales practices, new product innovation, and many other activities of financial market participants.”); OCC Office of Economic and Policy Analysis (“responsible for managing the agency's economic research and analysis program, providing policy advice on issues relating to the condition of the banking industry and trends in the provision of financial services”); CFTC Office of the Chief Economist (“conducts research on major economic issues related to the futures and options markets”).

This function needs to become centralized, and have its status enhanced, its mission clarified and publicized, and its authority clearly established. The GAO has observed that:

“[N]one of the financial regulators is tasked with assessing the risks posed across the entire financial system by a few institutions or by the collective activities of the industry . . . [N]o one regulator had the necessary scope of oversight to identify the risks to the broader financial system . . . . Having a single entity responsible for assessing threats to the overall financial system could prevent some of the crises that we have seen in the past.”

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16 Available at [http://www.sec.gov/about/economic.shtml](http://www.sec.gov/about/economic.shtml)
17 Available at [http://www.sec.gov/about/offices/ora.htm](http://www.sec.gov/about/offices/ora.htm)
18 Available at [http://www.occ.treas.gov/jobs/info.htm](http://www.occ.treas.gov/jobs/info.htm)
19 Available at [http://cftc.gov/EconomicAnalysis/index.htm](http://cftc.gov/EconomicAnalysis/index.htm)
Once established, this brain trust should become the fulcrum of information
gathered from regulated companies and it should be directed to engage in the kind of
forward-looking strategic thinking that has too often been considered a luxury within
government. This kind of thinking should expressly be directed at the kinds of questions
that, in hindsight, one wishes regulators and the industry had asked to more effect over
the last few years: if we are in a bubble driven by asset-appreciation, what might be the
effects when that bubble bursts? How can companies protect themselves now against
such effects? What are the greatest risks companies are running? Which companies are
outliers or otherwise more vulnerable? Where is there systemic risk?

**Rapid reaction team**

The regulators should have the regulatory equivalent of a “rapid reaction force” –
a team of skilled people prepared and empowered to act quickly in a financial emergency.
In addition to their regularly assigned responsibilities in ordinary circumstances, the team
could be pre-identified to assemble as a group in an emergency and have given thought
and developed systems in advance to address these kinds of crises. The team should
draw upon different skill sets – attorneys, economists, examiners, and policy-makers –
and from personnel from the different financial regulatory agencies. People with
experience with recent financial emergencies should play a central role. The U.S.
Department of Treasury itself might be the logical coordinator for this standing team,
absent a consolidation of the financial regulatory agencies.

An effort somewhat akin to a regulatory “disaster recovery” or “emergency
preparedness” plan is needed. After 9/11, much thought went into “disaster recovery.”
The corporate world formulated disaster recovery plans under the direction of regulators.
Backup data centers and redundant systems were constructed. Emergency contact
information was gathered. People were designated to be in certain locations and a
command and control structure was designed. Regulators set the priorities and examined
companies to make sure plans were in place. The emphasis was on planning and thinking
ahead. See e.g. Speech by Mary Ann Gadziala, SEC Associate Director, *Disaster
Compliance Seminar (May 1, 2003) (“[U]ntil recently, planning [for disaster recovery] .
. was theoretical and generally lacked a sense of urgency. That all changed on September
11, 2001. Potential became reality in a previously unimaginable way.”)

The financial crisis should serve as a comparable wake up call for regulators to
the need for an emergency preparedness plan for financial emergencies. As the GAO has
observed, “once firms began to fail [in 2008] and the full extent of the financial crisis
began to become clear, no formal mechanism existed to . . . potentially stop or help
mitigate the fallout from these events.” GAO Testimony at 13. See also G30 Report at
18 (“Basic crisis resolution procedures and resources should be available to official agencies to deal with instances of institutional failure so severe as to potentially impair system functioning.”) Unfortunately, these emergencies are occurring more frequently than terrorist attacks and the preparedness plan will probably need to be employed on a more frequent basis at least for the near future. If the past year has taught anything, it is to expect the unexpected. When a future Lehman or Citigroup-type crisis arises, this pre-identified rapid reaction team should be prepared to engage with the company, communicate with the other arms of government, and act as the information gathering arm and advisors for the key government decision-makers. The team would strive to make the ultimate resolutions of these crises consistent and less improvised.

**Conclusion**

Can the Obama Administration effectively regulate the financial sector? Yes, it can. But an ungainly “financial Department of Homeland Security” that lacks the regulatory attributes outlined above will not play an effective role in preventing or mitigating future financial crises. The Obama Campaign ran on a platform of financial regulatory reform as a remedy against future upheavals. To succeed, the new Administration must design an architecture for its new regulatory apparatus that ensures that the right people will have the access, information, structure and guidance to tackle their daunting job.