University of Washington School of Law

Harry Cross Visiting Professor Lecture - Professor Roberta Karmel
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Lisa Kelly: Thank you everyone for coming this afternoon. My name is Lisa Kelly, and I am one of the Associate Deans here at the Law School, together with Associate Dean Peter Nicholas. And we want to welcome you here today for our first Harry M. Cross Visiting Public Lecture this academic year.

The Cross Professorship holds a particularly warm place in my heart because actually it was the thing that first brought me here to Seattle about eight years ago. So, I feel really excited about being able to be on the other side of this podium today. So, I'm very happy today to say a few words about the Harry M. Cross Professorship as well as about our distinguished lecturer today, Roberta Karmel.

The Cross Professorship was established in 1984 by Jack MacDonald, and this was the first named professorship that was established here at the Law School. Jack MacDonald was a classmate of Harry Cross, who graduated here at the Law School in 1940. In 1943, he joined the Law School, Harry Cross did. And he became a national expert in the area of property law, particularly community property.

I also learned in doing this research that Harry Cross was an avid athletic supporter of the Huskies. He was our faculty rep for the NCAA, and also was president of the NCAA at one point in time. He also was the caretaker for our mascots, and was apparently to be found at the games with his huskies in tow.

Professor Cross also not only did all of that, but also served as Associate Dean and acting Dean here at the Law School. And so it was Professor Cross' vision and leadership that inspired Jack MacDonald, his classmate, to get together with a number of other law firms here in the Seattle community and raise the money that endows this visiting professorship. And through this visiting professorship, we are able to have here in the Law School national experts in various fields. And of course, today, we have no exception to that rule. It is in fact Professor Roberta Karmel who will be speaking to us today.

Professor Karmel is a faculty member at the Brooklyn Law School and she is the co-director of the Dennis J Block Center for Study of International Business Law. And she has been a member of the faculty for 23 years. She is a Fulbright scholar, a former SEC commissioner, a practitioner, a scholar in her own right, a teacher whose area of expertise could not be any more relevant to our times, the times that we currently find ourselves in.

She is the author of "Regulation by Prosecution," "The Securities and Exchange Commission versus Corporate America." In this era of debate over regulation of national and global markets,

we are very fortunate to have Professor Karmel here today to address the topic of the future of the Securities and Exchange Commission (SEC). Please join me in welcoming Professor Karmel.

[applause]

Professor Roberta Karmel: Thank you very much. I appreciate those kind words, and I appreciate seeing all of you out here today. I am particularly gratified that some of my students are here. After listening to me for two hours this morning, I would think they would have had enough for one day.

I am going to talk to you about the future of the Securities and Exchange Commission, the regulator for the securities markets. It used to be said, at least in New York, this was when Ed Koch was Mayor, it used to be said, "A neoconservative is a liberal who got mugged."

[laughter]

Professor Karmel: Today, I think, it would be fair to say that a neoliberal is a conservative who lost a large percentage of her retirement account in the recent stock market collapse. Actually, I would not describe myself as a former conservative, but I've always had a fair amount of respect for the securities industry as a positive contributor to the US economy. And I generally believe that securities regulation should not unduly hamper the securities markets, particularly in the context of global competition.

But, like almost all Americans, I am personally outraged by Wall Street's debacle and the government response during 2008. And, I believe that the Obama administration and the current Congress needs to engage in serious financial regulation reform. Unfortunately, I'm somewhat pessimistic that such reform will be sufficiently thoughtful, far reaching and effective in preventing future stock market volatility and banking failures.

Why? My pessimism stems from years of observing how special interests have corrupted Congressional oversight of financial regulators so that supposedly independent federal agencies are disabled from functioning appropriately. Moreover, since at least 1980, both the Legislative and Executive branches, regardless of party affiliation have been gripped by a deregulatory fever, which permitted and even encouraged Wall Street to run amuck.

The Securities and Exchange Commission has been criticized by both the left and the right for regulatory failures leading to the financial meltdown. John McCain said, "If I become President, I'm going to fire Chris Cox."

A number of the SEC's critics and the SEC's own Inspector General blame the agency for missing red flags at Bear Sterns and failing to reign in risk taking by investment bankers. The SEC's failure to uncover Bernie Madoff's Ponzi scheme, the biggest such scheme ever to have occurred, has also been highlighted. Some of this criticism is fair, but in my view the SEC was considerably less culpable than other government actors for the financial meltdown.

Congress, the Federal Reserve Board and the Executive branch all fostered an economic climate of easy money, insufficient personal and governmental savings, excessive leverage, reckless

credit practices by mortgagors, and lax regulation of financial institutions and the financial markets.

Moreover, the failure of the private and public sectors deal with the compensation structures of financial executives, which encouraged excessive risk taking, created an accident waiting to happen. Fannie Mae and Freddie Mac, despite questionable financial practices and a lack of adequate internal controls, were allowed to remain loosely regulated under a quasi governmental guarantee and grew until they were too big to fail.

The Federal Reserve Board presided over a technology bubble in the 1990's and an asset bubble thereafter without raising margin requirements or interest rates, and was firmly committed to both the continuation and growth of the derivatives market and a deregulatory agenda.

There were plenty of warning signs of an overly leveraged financial system based on the use of derivatives. For example, the stock market crash of 1987. I was the public director of the New York Stock Exchange when that event occurred. It was very frightening. Then there was the long term capital management implosion. There was the stock market bubble of the 1990s. Yet, after each of these events the President's working group and financial markets decided no action to curb derivatives trading should be taken.

If some of you may not know what is the President's working group on financial markets - This is a committee composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the SEC, and the Chairman of the Commodities Future Trading Commission, the CFTC.

David Router, who was then the Chairman of the SEC, dissented from this conclusion that nothing should be done. But, he was the only negative voice. Moreover, in 2002, the Commodities Future Trading Act was amended so that credit derivatives, probably the most toxic of the assets currently at the heart of the financial crisis, could be traded over-the-counter as completely unregulated instruments.

Even before this sub-prime mortgage crisis began to royal the financial markets, three high-powered special commissions issued reports on the need for Financial Regulatory Reform. There was a report by the Committee on Capital Market's Commission; this was composed of CEOs and other high ranking officers of a number of financial institutions and professors from Harvard, Columbia and Chicago. They issued their final report in December 2007.

An independent bipartisan commission established by the U.S. Chamber of Commerce issued its report in March of 2007. At the request of New York Senator Charles Schumer and New York City Mayor Michael Bloomberg, the McKenzie Organization issued a report in January, 2007. So, you had these three big fat reports all coming out more or less at the same time.

These reports addressed the migration of the capital markets from the United States to overseas financial markets. But, each report had a somewhat different emphasis. However, all of these reports expressed a concern about prudential supervision and the lack of a coordinated federal focus and systemic risk in the capital markets. These concerns proved present when many segments of the financial markets collapsed because of excessive leveraging.

In the meantime, the Department of the Treasury began a study of the regulatory structure in March, 2007, and then issued its blueprint for a modernized financial regulatory structure in March, 2008. I will refer to this simply the Blueprint. Although the Blueprint was issued after the near collapse of Bear Sterns and in the midst of a serious stock market and general economic turmoil, it was as much a response to the three reports I just mentioned which all dealt with the loss of U.S. capital market competitiveness as it was a response to the sub-prime mortgage and rating agency problems in the markets.

However, the Blueprint is still a viable document. It is still being talked about. It laid out a history of the vulcanized financial regulatory structure, which exists at the federal and state levels for the financial markets and financial institutions, except for its short-term, intermediate-term and long-term recommendations for reform.

The Blueprint argument for the review and reform of financial regulations was not based on a loss of competitiveness of the U.S. capital markets as these prior reports were. But rather, on developments in the capital markets, particularly globalization, improvements in information technology which led to new financial products and trading strategies, and the growing institutionalization of the markets.

According to this Blueprint, the current system of functional regulation is incompatible with these market developments because jurisdiction of disputes between regulators, slow innovation can lead to migration to foreign markets.

In addition, there is too much regulatory duplication. The Blueprint, therefore, made short-term and intermediate-term recommendations for reform and then set forth an optimum regulatory structure for the future.

Although much of the Blueprint was devoted to ideas for regulatory consolidation and streamlining of regulatory approvals, two new federal agencies were suggested; a Mortgage Origination Commission and an Office of National Insurance within the Treasury Department. So these were ideas that came a little more directly out of the financial meltdown.

Among the short-term recommendations were better coordination of the financial regulatory policy by the President's working group on financial markets, which I just described to you, gets convened whenever there is a crisis in the markets. The inclusion of additional Federal Bank regulators in that bout, also onsite examinations by the Federal Reserve Board of non-depository institutions with the focus on liquidity and funding issues.

Those are kind of the short-term recommendations. Many of the intermediate-term recommendations involve a rearrangement of federal regulation of banks. Of importance to today's lecture, however, is a recommendation that the SEC and the CFTC, the Commodities Future Trading Commission, be merged. Further, the staff members of both agencies were urged to begin working on convergence of their regulatory philosophies and methods.

As I'll explain to you that is not so easy. Before President Obama took office, the Chairman of the SEC and at least one former SEC Chairman endorsed a merger of the SEC and the CFTC. The acting chairman of the CFTC, however, endorsed consolidation of federal financial regulators generally. But dismissed a merger of the SEC and the CFTC as quote "A code for a

large for a larger SEC along with its rule-based model and culture." As I explained, the CFTC has a principle based model and culture.

But, the United States is the only country in the world to separately regulate securities and financial futures. Some of the key causes of the market melt-down are due to over-the-counter derivatives; trading regulated by neither agency, by neither the SEC nor the CFTC.

Yet, the merger of the SEC and the CFTC in the past has been difficult to implement and will probably be difficult to implement in the future just for political reasons. The SEC and the CFTC have different oversight committees and the Congress and the members of these committees receive large campaign contributions from members of the industry. Industry concerns regulation of securities of derivatives, ironically, some of these are the same organizations.

Each of these agencies also have active and concerned alumni and staff who will resist change in the regulation, their regulation, of financial markets. Further, as I said before, these agencies have different approaches to new product approvals and regulation of exchanges in other market places.

The blueprint favorably contrasts in the CFTC approach to new product approvals and regulation of financial institutions to the SEC approach. In fact the blueprint was very critical of the SEC, not for the reasons people are criticizing the SEC today, for being too lax but for being too tough and not allowing enough financial innovation.

In view of the disruption in the credit markets in 2007 and 2008 and the role of derivatives in causing these disruptions, I don't know if the CFTC's principle placed approach to regulation is as appealing to as many people as it was when the treasury blueprint was published.

For the longer term the blueprint recommended an optimum regulatory structure that recognizes the convergence of the financial services industry but also recognizes distinctions between wholesale institutional markets and retail financial transactions.

Five basic federal regulators are suggested. One, a market stability regulator for overall conditions of financial market stability. Two a prudential financial regulator for institutions with an explicit government guarantee of their business operations. Three, a business conduct regulator.

The SEC would continue as an agency separate from these three agencies and would responsible for corporate finance regulation, kind of the one part of the SEC's work that Secretary Paulson liked. Separate Federal Insurance Guarantee Corporation would be an insurer for institutions regulated by the prudential financial regulator.

Former SEC commissioner, Annette Nazareth endorsed the idea of a regulatory body charged with business conduct and investor protection but asked, "Well, why wouldn't this body be the SEC?"

In my view, it is more important to reform financial regulation than to assess how much blame each regulator had for the current financial crisis, but some of the examinations of the causes of the meltdown are necessary to propose reforms.

To what extent was the SEC responsible for the meltdown? I'm going to discuss three areas very briefly where the SEC had some responsibility. Although for the most part the SEC's powers were limited. These were the SEC's role as a consolidated regulator of holding companies of brokered dealers. I should say as a regulator for holding companies of brokered dealers. The SEC's role as overseer of disclosures by Freddie Mae and Fannie Mac and the SEC's role with regard to short sale rules.

In 1975, the SEC became responsible for administering the net capital or capital adequacy rule for all broker dealers. Prior to that, this rule had actually been administered by the New York Stock Exchange and the NASD. The New York Stock Exchange failed to prevent wholesale bankruptcies of brokered dealers in the late 1960's and early 1970's.

Congress said, the exchange into this anymore, the SEC should do it. I mean we're in a kind of similar position today where congress and others are saying, "Oh the SEC failed in this area, the Federal Reserve board should do it." That gives me a little pause for reasons I'll mention.

Generally, this rule, this net capital rule, required broker dealers to retain a debt to net capital ratio of 15 to one. In other words that was the leverage that was allowed. In April 2004, this ratio was relaxed pursuant to a SEC rule passed by William Donaldson when he was chairman of the SEC and the commissioners then serving. This really predated Chairman Cox and his commission.

The background for this rule change was that when the Graham Leach Bliley Act, which eliminated the separation of investment and commercial banking was passed, no provision was made for the regulation of broker dealer holding companies similar to the supervision of bank holding companies by the Federal Reserve Board.

The European Union threatened to become the consolidated regulator of U.S. broker dealer holding companies because in Europe there was long a model of universal banks. You didn't have any investment bank holding companies. You didn't have companies like Goldman Sachs, and Lehman Brothers, and Merrill Lynch. You just had universal banks.

In response to this threat from the European Union, the SEC said, "Well we'll do this". Since nobody could decide who ought to do it in the United States and they didn't want the European Union doing it, the SEC did this, but it did so on a voluntary basis. This was a voluntary program. It was never provided for in any statute.

The five largest such companies, which were - they're all gone now or they've become banks. You had Lehman Brothers, Bear Sterns, Goldman Sachs, Morgan Stanley, Merrill Lynch. They agreed to have the SEC become their supervisor even though there was no statutory authority for this. The quid pro quo for this voluntary relaxation regulation was a relaxation of the net capital rules.

This change permitted these firms to transfer billions of dollars of reserves against capital to their parent holding companies, foreign investment in mortgage backed securities, credit derivatives and other exotic instruments. As a result by the time of the Bear Sterns collapse, the ratios of four of the five firms subjected to this consolidated regulation regime, was in the neighborhood of 30 to one.

Chairman Cox conceded that the SEC's oversight of consolidated broker dealers, including Bear Sterns and Lehman Brothers, contributed to the financial crisis. He noted however, that the SEC's program of oversight was a voluntary program and, therefore, it was - and I'm quoting - "fundamentally flawed from the beginning."

Another voluntary program administered by the SEC, which contributed to the current crisis was the financial statement disclosures and filings by Fannie Mae and Freddie Mac. Unlike other public companies, these institutions were exempt from the registration provisions of the Securities Act of 1933 when they sold securities.

Actually, I gave a talk like this a couple of months ago at Brooklyn Law School and somebody who teaches in this area said, "Really, I didn't realize that. That Freddie Mac and Fannie Mae were exempt from SEC disclosure regulations."

In 2002, these organizations agreed to voluntarily file annual and periodic reports with the SEC but they misstated their financial statements from at least 1998 through 2004. The SEC brought an enforcement action against them. In my view, exempting categories of issuers from the registrations provisions easily leads to fraudulent financial statements.

There are other such loopholes that used to exist that have been closed over the years after scandals and insolvencies. Unfortunately, congress did not see fit to require Fannie Mae and Freddie Mac to prepare and file honest and fair financial statements.

Another politicized topic is the short sale rule. A short sale, for those of you who don't know this, is a sale of any security the seller does not own or any sale consummated by the delivery of a borrowed security. A former SEC rule prohibited any person from affecting a short sale of any exchange listed security below the price at which the last sale of that security was reported. This was known as the "uptick rule."

This rule was rescinded in the summer of 2007 because it was believed that with decimal pricing - in other words, a penny pricing instead of an eighth or quarter which used to be the case - and derivatives, the uptick rule had become really obsolete and unnecessary.

Nevertheless, after the current financial crisis was triggered by the collapse of Bear Stearns and the Lehman Brothers bankruptcy, there was a hue and cry that this was all the fault of the short sellers. And the SEC responded by prohibiting short sales in financial stocks.

There were a number of occasions on which the SEC did this, and it included in the financial stocks some stocks that might resonate with this audience - CVS CareMark, IBM, General Motors, General Electric. The short sale rules were criticized as making a volatile market worse, a clumsy effort to buoy shares of battered financial stocks and despite the ban stocks, including National City, Sovereign Bancorp, Washington Mutual and Wachovia essentially failed.

Chairman Cox later stated he thought that SEC's emergency short sale rules were a mistake. However, Mary Shapiro, the new Obama appointed SEC commissioner who, I think, took office today or yesterday, did say in her Senate confirmation hearings that she would examine whether the uptick rule should be restored.

One of the most important messages of the financial meltdown is that over-the-counter derivatives are dangerous securities and should never have been allowed to be wholly unregulated. Battles between the SEC and CFTC began almost as soon as the CFT was formed in 1975 because almost immediately thereafter the Chicago Board introduced the first futures on a security.

Distinguishing between a commodity's futures contract and a security was always difficult, and protecting jurisdictional turf frequently seemed more important to the SEC and CFTC and their respective oversight committees than did protecting investors.

The competition between the SEC and CFTC was resolved to some extent by the commodity futures modernization after 2000, which permitted commodities exchanges to trade single stock futures. Unfortunately, this statute also accepted the conclusion of the president's working group that the trading of OTC financial derivatives between sophisticated counter parties should be excluded from regulation by the CFTC and the statute also excluded these from regulation by the SEC or anybody else. This was justified on the ground that OTC financial derivatives were not susceptible to manipulation.

Modernization of the financial regulatory systems was sufficiently urgent that it became a campaign issue. I am not going to go through what Obama said during his campaign because now he's president, and I don't know what is going to happen.

Of interest also is the day after President Obama's inauguration, the Government Accounting Office, which is the audit arm of Congress, released a framework for assessing financial regulatory reform proposals. Their proposals, like the Obama campaign proposals, were very vague except that and to me one of the most important points made in this document, and is that and I am quoting: Regulators should have independence from inappropriate influence as well as prominence and authority to carry out and enforce statutory missions.

To me, this coming from the GAO, is really astonishing because we, what, who curtails their influence? Congress. The GAO report sidesteps the question of whether the SEC and the CFTC should be merged. To what extent is it likely that the Obama administration or Congress will adopt either legislation merging the SEC and the CFTC or any of the more detailed reform proposals advocated by the Treasury Blueprint or any of these other fact reports that I have mentioned.

Currently, the Federal Reserve Board by default has become the consolidated regulator of all the major investment banking holding companies who remain in business, and the SEC has closed down its consolidated regulatory program.

Here is a big question of whether it is salutary for a central banker to also be a regulator. This is a serious issue. It is beyond the scope of my talk, but it is something for Congress and the administration and the public to think about because that situation really undermines the ability of the Federal Reserve Board to operate in a certain way as the central banker.

Similarly, consolidation of the banking regulators, how they should be consolidated and the proper regulation of insurance companies, which now is entirely by the states, are subjects beyond the future of the SEC. As I've indicated, relevance to the future of the SEC is whether or

not the SEC and CFTC will be merged, and if so, whether the merge regulator will be dominated by former SEC or former CFTC commission and staffers?

President Obama nominated chairs for both agencies. It is noteworthy that his appointee to the SEC chairmanship is Mary Shapiro who not only is a former SEC commissioner but a former chair of the CFTC as well as the immediate past at Fenra. So, you might think, "All right. This is a message. These agencies are going to be merged."

On the other hand, the gentleman who has been nominated to be head of the CFTC is also a strong individual with a good background, and I don't think either of these people would have taken the job if they thought their agencies were going to disappear in the near future. In my view, however, not only should these agencies be merged, but much more importantly, the statutory framework for both agencies with regard to regulation of the securities and derivative markets needs to be changed.

The provisions of the Securities Exchange Act of 1934 dealing with the regulation of the securities market was passed in 1975 in another financial crisis, but the purpose of that act was to unfix commission rates, to integrate exchanges and over-the-counter markets and inject greater competition into the trading markets.

In addition, that statute gave the SEC authority to regulate clearing agencies, transfer agencies and other non-brokered dealer intermediaries. The SEC administered the statute in a somewhat heavy handed, rule-based manner, and that may well have been one of the factors leading to the explosion of unregulated trading markets. In other words, there were too many rules. They were too detailed. And it was very difficult for exchanges to launch new products and move forward.

On the other hand, the CFTC, in 2002, was instructed by Congress to regulate according to principles rather than rules to have a great deal of self regulation, and to leave the over the counter derivatives market alone. Financial innovation was allowed to trump financial stability.

Both agencies the SEC and CFTC directly and through there congressional oversight committees have suffered from regulatory capture by the securities industry. The mandates and regulatory methodologies for these two agencies really needs to be reconciled, and both should be made more workable and freer from industry and congressional interference.

These agencies are considered independent federal agencies. That means they are independent of the executive branch. They are not independent of congress. And neither are sufficiently large, well funded or protected by powerful political forces, particularly, after the financial crisis for which they are being blamed to operate as the expert regulatory they were intended to be.

Further, the SEC needs new authority and greater funding in order to regulate important unregulated sectors of the securities markets such as credit derivatives and hedge funds. Regulation of other sectors such as investment advisers and credit rating agencies needs to be seriously strengthened. Exemptions for so called sophisticated investors have proved chimerical and need to be re-examined.

In healthy economic times, there has always been a tension between Main Street and Wall Street - that is between industry and finance - which is good check and balance in a capitalist

system. But, since the 1980's, regulators have permitted and even encouraged financial interest to overwhelm industries needs. Market or trading interests rather than capital formation and investor protection became the focus of financial regulators.

While the genie unleashed by the derivatives trading cannot be put back in a magic lamp, the leverage injected into the financial markets by derivates needs to be seriously reduced.

A significant goal of the Securities Exchange Act of 1934 and reaction to the depression was that securities credit had to be seriously limited - that is, securities credit as compared to other kinds of credit in the economy. But, the importance of limiting such credit was forgotten or ignored by financial regulators.

Further, the SEC of the future, whatever its amended statutory authority and mandates, needs to refocus on capital formation in the stock and bond markets and the protection of investors retirement savings.

Thank you very much. I will be happy to take questions.

[applause]

Audience Member: Do you see any role for states to play in regulation? I know there is a tension between... you see it in New York all the time? Can you comment on that?

Professor Karmel: Yes, well, that is a very controversial area. I think that many securities lawyers, like myself, and the securities industry have always argued for extensive preemption of state regulation. But that's not politically feasible or politically popular.

Nevertheless, in certain areas, I would criticize state regulation. New York is special case. The present New York Attorney General and the last New York Attorney General decided to reform the securities markets in their own way. The problem is they did this by threatening firms with criminal prosecution. New York is one of only five or six states where the Attorney General can bring criminal cases. I mean, to me, there is just a basic problem with that.

Other states who's got Commissioners to operate in a different fashion, they don't get the headlines that the New York Attorney General does, and they also aren't in the middle of the securities industry.

Some people have said "Well, the New York Attorney General attacked problems that the SEC wasn't attacking." That's a little unfair. The problem of the research analyst for example was starting to be dealt with by the SEC and the predecessor of FINRA the SRO for the securities industry. But, this was being done by passing new rules.

New rules are much harder to pass than prosecutions. Prosecutions, you just sue. But, this is a whole other topic. The other area where there are questions about the role of the states are in bank regulation and insurance regulation, because almost everybody agrees that banking regulation has to be consolidated. But, some people argue that, well, community banks, smaller banks, don't need to be regulated by the federal government. They should still be regulated by the states. They are not part of the systemic problem that we are experiencing. Only the bigger

banks need to be regulated by the federal regulators. And those federal regulators should be consolidated.

Another area is insurance regulation. From my personal experiences, including having been on the board of an insurance company, which went into runoff, I don't think state insurance regulation is very good. And I think they are should be federal insurance regulation, again, of at least the big insurance companies. I mean, so much of this stock money was spent on AIG, which wasn't regulated by any federal regulator. There is something wrong with that system.

It's [inaudible] of speech. Your question, yes.

Audience Member: [off-mic question]

Professor Karmel: Excuse me. I can't hear you.

Audience Member: [off-mic question]

Professor Karmel: I think the rescission of the Glass-Steagall Act is not working out. I mean, the Glass-Steagall Act in the end was rescinded by Graham-Leach-Bliley because of Citicorp. And now that Citicorp is dismantling the... But, on the other hand, in every other country, there is universal banking, which means you don't have anything like a separation of investment banking and commercial banking.

I think this an area where... It would be nice if we could go back to a simpler financial model. But, I don't think that's possible at this point. I mean, I just don't think it's feasible when we are in a global market and all of the competitors to the U.S. banks are all universal banks - which means no Glass-Steagall.

It's a difficult issue. The other related difficult issue is whether banking and commerce should continue to be separated. And what's happened - it's going to tee this up because Goldman Sachs, for example, was a merchant bank that was involved in commerce. And now, it's a bank holding company. So, what's going to happen there? I don't know.

Yes?

Audience Member: The decision to relax the net capital funds in terms of long.... How far up in Congress did that decision...? To what extent did Congress become involved in that decision making?

Professor Karmel: The Congress was not involved in that decision at all. I am not sure of the extent to which the SEC even understood what it was doing, because I had a conversation with one of the commissioners who was a commissioner when this happened more recently, he was no longer a Commissioner. He said to me, "We did that?" I said, "Yes." This commissioner's recollection, "I don't even remember a discussion about this."

What was remembered is that the European Union said, "We are going to regulate the holding companies of broker/dealers." The Financial Regulators said politically said, "We don't want Europe regulating our financial firms. Who's going to do this?" Congress did nothing. It was kind of a sense, "Well, the Federal Reserve Board shouldn't do this, because they regulate banks." So,

the SEC said, "OK, we'll do it," but I don't think it was a very thought-through idea, it was a voluntary program.

In terms of the leverage - let me say this. In the past the Securities Regulatory System, unlike the Bank Regulatory System, was that if a securities firm becomes over leveraged, makes bad business decisions, there is a system similar to FDIC Insurance called "SIPC Insurance" to protect the funds and securities of customers being held by broker/dealers, and the broker/dealers should go bankrupt. When Drexel Burnham got into trouble that's what happened, they went bankrupt.

This time around bankruptcy just didn't seem to be an option anymore, because there was too much interactivity between all of the financial firms. The Financial Regulators did allow Lehman Brothers to go bankrupt, and many people say "This is what really caused the meltdown." So then, the Federal Reserve Board and the Secretary of the Treasury were afraid to let anybody else go bankrupt. Even with Bear Stearns, the Fed opened the discount window in order for Bear Stearns to be taken over.

I mean, the rules of the game got changed. So, if you're not going to allow certain firms to go bankrupt, then you have to change their regulation; then you can't have this kind of leverage. Some people say, "OK, broker/dealers now are going to become more like utilities. They're not going to be able to be as leveraged and make as much money, or be allowed to go bankrupt. Should that be true for every broker dealer? Probably not; probably only really the big ones.

Yes?

Audience Member: Professor, you mentioned somewhat tangentially that the executive compensation [inaudible] people running corporations did in a way that ultimately wasn't good for the system. I wonder what kind of reform or regulatory scheme you might impose to bring that into check.

Professor Karmel: I don't know. The last few years, I asked students in an exam the question - why is it that the law is so ineffectual in regulating executive compensation? I can say that I don't ever get answers that are satisfactory. But, State law, the Delaware courts haven't done any kind of a job here. Personally I think a lot of the problem is the Tax Code, that the better way to attack this is through the Tax Code.

On the other hand, when Congress rather ineffectually did this by passing IRS Code Section 161M, which limits corporations from paying executives more than $1 million a year except under circumstances where there's some kind of a formula, and a third party could figure it out, and this led to everybody getting a lot of options and a lot of stock, and these obscene, really, compensation packages.

So, that wasn't a very good check, but it seems to me if you simply say, "Compensation over a certain amount, however you figure it out, is not going to be deductible by the corporation," that's one way to go.

Higher taxes on the rich, that's another way to go. A lot of people now say, "Well, that's redistribution, we don't believe in that." We've had redistribution now for the past eight years; money has gone from the middle class to the rich, because we've changed the Tax Code.

[laughter]

Professor Karmel: So, I mean there are things that can be done. The question is whether Congress will have the backbone to do it, but they are not jobs for the Financial Regulators. On the other hand, should these financial firms be taking all of this bailout money, TARP money, whatever you want to call it, and paying high salaries with it? I mean that really I think is a ...

I guess, some paper I read in the last day or two said, "These leaders of the banks have a tin ear when it comes to what the public is thinking about them right now." I don't know how they've been so insensitive, really.

But, all of the compensation packages did encourage risk taking, and it's not just the top people, it's all of the middle managers and the whole Wall Street bonus system.

Yes?

Audience Member: [off-mic question]

Professor Karmel: A lot. I mean I've thought that in many contexts that one of the problems in the markets today, and the way those markets are regulated, is that short term investors have been given an awful lot of power and there is much less emphasis on long term investors. This I think is one of the problems, but it's easier to say that's a problem then figure out how to solve it.

Yes?

Audience Member: [off-mic question]

Professor Karmel: Oh, mark-to-market accounting. Well, I view the problem of mark-to-market accounting the same way that I view all of these criticisms of elimination of the uptick rule and short sales. I mean, this is shooting the messenger. Mark-to-marketing accounting has demonstrated the dire financial condition that financial firms are in because they have various derivatives that have no market, that are worthless.

The problem with mark-to-marketing accounting is that once financial firms are forced to value these securities they're holding at their fair market value, these firms are probably insolvent. So I say, I think is shooting the messenger really.

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