Philosophy of Residual Regulation

Pitt: AB degree '65, Brooklyn College
St. John's Univ. law - JD 1968
SEC - from school - 1968-1978 -
last 3 - comm. gen'l counsel
1978 Sept. Partner - Freed, Freed, ->

Bush: app't d. 26th chair SEC
2003 - founded Kalorama Partners
Strategic Consulting

① Kalorama Legal Services - law firm entity -
didn't want to go back to law in
adversarial -
keep cos. that want to do better -
Variety of advice -
Law firms - unidimensional -
Econ, Acctg, PR, Cong. Relat. -

Some clients more comfortable -
with attorney-client privilege
2 separate forms -
Contract separately, w/ clients

① Cause of Fin. Crisis -?
Multiple - too many # of causes hurt
Chance for solutions -

"Rig. system was badly broken"
Dodd-Frank - very worried - didn't do
What we needed to do
Responsibility in our regulatory system

Our system grew up after Great Depression
System based on legal - what you were born as what you were called
By 1970s - didn't make sense (Money Market Mutual Fund invention)
Sophisticated passages into these accounts - & available for use

After that occurred - banking regulators became flexible & allowing banks to allow biz (other)

[GBI] - Congress elicits barriers of Glass Steagall
No quamble w/ removing these barriers
If you're going to allow everyone to be in everyone else's biz - no revision of the structure

Modified Rules
No adjustment to modify legal structure

{1)
Free market cannot achieve it all
Law of sort - Basic precip
Don't believe - Imp. Discipline - rate - engage for services

Major problem in my view

2) Related problem - New products
"Just ill suited to comprehend what was going on & had no mandate to do so"
Deoverrides - we said no real -
-\[\text{failed to be an obey for someone to be collecting data}\]

Problem - Transparency - Stanley O'Neal -
\[\text{Merrill Lynch}\]

Markets moving faster than you can predict
Everyone saw this. It wasn't hidden.
No one stepped up and asked a minute.

If Sarbanes Oxley violation Sect. 404 - ?
\[\text{Hard to say}\]
\[\text{Could well have been a problem}\]
\[\text{Markets were deteriorating rapidly}\]
\[\text{If Sarbanes Oxley had done - should have experienced to the crisis we experienced}\]

\[\text{Regulation Outmoded}\]
\[\text{Lack of Transparency}\]

\[\text{What this crisis proved - one word - "Nimbleness"}\]
\[\text{Was not a clear ability or good-pair to deal in rational way as issues were evolving} \]
\[\text{Sufficiency crisis - I had been returned by Paulson & Co. They started the subprime - clever} \]
\[\text{They got a phone call from major brokerage firm to hurry make move.} \text{They thought they were long & they were short}\]

2006 - 2007
\[\text{NY Fed FDIC Treasury - No authority}\]
\[\text{SEC Fed}\]
CFMD Act - prohibited SEC from regulating derivatives

Dodd-Frank - (too command & control?)

Tension - we overregulate everything & we obviously say "Unfair. I think both of these poses are wrong."

Obama admin - if it had happened, this is a different manner - it had have approached this in a way that should have gotten bip. support

Ability of anyone - impact on capital markets -
1) Repeat on what's jolly on
2) Clear press on govt to analyze that data & disseminate it to the markets

SEC - upset me back then - collects data + clear do anything w/ it

Mutual funds
- Wrs not able to get this done
- Economically focused biz
Fed does a better job of it.

"They lost part of that. What needs you're creating."

Surprised - note margin.

"I was staggered by it."

Terror - fired - not for the right reason.

Credit easy t. then pulled back.

Housing philosophy - own their own home -

"Form those aren't the causes."

Troublesome - loans for the sake of securitize loan.

Securitize was a brilliant idea -

Banks sold off loans - but not if

What it produces is more loans to worse candidates.

Not the focus -

Two classes of ppl - too many who were

to take adv of it -

Banks + securitize no excuse for maintaining

High standards for loans

"The crisis is still ongoing."

In my view - we're in the middle of this."

Impact obvious: Employment
BLS understates unemployment

* Scheme used for a lot more
  suffer - not address causes of
  the crisis

Q: Securitization - Herre loans moved into
Securitization - unregulated - Not fixed?

Tadd - Frank - 5% skin in the game -
(100% -> 105% model -) - not work

Pt. more to be - continuing reps. for many
The loans -
"People who took the loans should have known."

There's more than easy blame to go around.

Big short - I see a so - who are taking @ the details
of the subprime loans - saying this
makes no sense.

Clueless - No comprehension - unreadable.
2001 - SEC returned - disclosures had long ceased to be informing plus all acts creating defenses to liability. Still hasn't been fixed

I want to fix it.

Speech - 1936 annual report - Co. 6 pp. (w/ financials app.)

"People don't have any comprehension of it -"

5 pple who looked -
"That's the way I worked."

Paulson - "I had to explain to them how the markets worked.
How you could manipulate the markets."

Paulson - "Cop on the beat."
They gave specific info -
Calls - there was follow up of some

SEC agencies -
+ publicity - spotlight - shut down the manipulation activity -
The manipulations didn't occur -
"No one prosecuted"

"Name - language - this was a gift -
No cases were lost."
If they had clean act.
Maybe they didn't.

Bob
Lauder - a regulatory function.
Governing -
Governing was equipped to deal with securities?

"No, not really."

When I was Chairman - top to bottom review.
Bureaucracy done. It was finished at recom.

I left it to Bill Donaldson, successor.
We did not put our
never had
SEC did not have risk mgmt capability.

Eron kik - Monday staff meeting.
predicted "Next crisis is going to be in the mutual fund industry."

SEC, SEC - proposals to privatize.
Opponents argue most people are not.
Not capable of mgmt on execs.

Problem - will blow up.
This is what got me interested in fraud right.

Stated: failed to staff - Feb 2003 rule proposal -
When I got there, SEC office of inspector
OICE - 5yr. cycle to look at money risks

Proposal outsourcing - require of every investment advisor exam every yr. or every other yr. -
Regul. by SEC
OICE

SEC - can't do inspections from - they can't do inspections - "It's a joke"

No way SEC - no talent - can't pay what rec. -
And system he came up with for a compliance audit

No institutional system - "That is there throughout jur", -
"Their will always be reactive but my goal was to make them much more proactive"

Q. Tension too much - Not every Regul -
Financial conglomerates - passed in Europe
SEC - Find an equivalent regulation

"No, that was just developing (when he left)"

Q. Prior to that program existing -
"Weins approached SEC to get into the prudential regulation business - on his watch?"
"I don't know that we had gotten himself, at least when it was there."

Possible - Prudential Regulation is Salutary, not sufficient. We prove that in response to you.

Let set up a hotbed for the people who are regulated.

Goal is to tell them how they should handle it, versus after the fact enforcement.

SEC - Wavering that they would arrive.

Shield bad actors, they don't see.

Cox - did tamper the system, which was voluntary.

Congress asked -

Farrell & Fruechte - claims they

They should be subject to they registered to SEC

ASC system did have weakness, in learning it was initially voluntary."

Farmi & Friedman - claims they
Regulation was not very effective.

2001-2003 - Any deal, even if we don't have jurisdiction, is done with holding co., then broken dealer.

Example:

Merger of London Stock Exchange (used to rep. Lloyds of London)

Then we audit, but I heard no disc.

Deregulation - Greenspan was worried about regulating derivatives.

Q: SEC - AAA - relief or rating?

Broken dealer: "The SEC's bloodstream."

2:20 pm
What did the SEC see internally about whether the leverage was OK?

I did recall some discussions.

SEC had no grudges over rating agencies.

Rating agencies get courts to say opinion protected by First Amendment.

Because of 9/11, the warnings got lost.

Investment that mutual funds could make: "wanted us to lower the standards."

Rating agencies: I will not do that.
Report issued during that time from SEC -
SEC initially agencies on equities
Not derivative
"it was important"

Talked a lot of hedge funds -

FAV - not one idea of evidence -
Fair Market Value problem is that very SEC, never helped to ensure a consistent way that put value assessors

Here are impute economists to check valuation
of assets

If you had have done that, "Fair Market Value" would have been cited

People were just making it up -

Buffett: "They were making it myth"

They never do that -
"The rating agencies were completely shocked by this."

"Rating agencies - it concerned me -"

"No one was raising the issue."

"They must have been slipping there. Basically they missed the day."

"It's like the little dirty secret."

"SEC didn't focus on this issue."

"Regulator - focus on pars - not functioning."

"I think the problems are known."

"The supposed system we had did not function. The lack of audit is never really an excuse."

"Enron - the former CEO to certify their finances."
"We had a rush - we had to use it."

Let a causal tell you.

 Merrill - Lehman - bonuses -
Retention bonuses - lawyers said yes -
"Represent a corp. Not just call by backstret shrills."
Pl don't step up -

"Agencies could have done things."
Emergency -
"No doubt in my mind - could 't still have done more."

Self-report - Rule 144A - took away the
speed bumps that were in the
Securities market -

Rational basis for concern.

If company needs capital - ought to be able to
get it instantly -
Not contributions - IRA + self-regrets
SEC - Regulation - closest keep up w/ the times - if markets are challenging dramatically, you have to inculcate

doubtful that is helping.

Comparable w/-

Inertia dynamics of markets -

After 9/11 up to NYC - press conf. crisis might do all my life - we had to be our front -

Lacking an fort when fin. crisis started to hit - started to hit before 2007

Bear Stearns - where was SEC when it started to go down. Why weren't they front & center.

Lacked transparency -

(The Panic) his clients asked him what was going on.

JPMorgan - "The govt. & to Bear was the bailout"
"Lehman had good solid assets."
What hand to Lehman—was almost critical in my book—

"That blood was on the govt's hand."

Prior to Lehman (on the street) it was assumed govt had bail out

"I think they panicked—just this on their watch the US will have another Great Depression."

Fed have weaken
Treasu in charge of FSOE—
Too much auth.
Deregulation—gets distorted?
The big idea—recession that free market
Can do it all

Ex. Vigne–my friend, Levitt
He wanted the options exchanges
Have a common interface

Trade Through Rule—if you trade three
Bear res. price
Get SEC to pass; didn’t put it in effect
Terror of that rule; a club to get options

Ex—Dereg ¼ gives. Result: insensitive stuff
Get all 5 options in a room
Repealed. The trade thru rule—illegal
2003—uniform interface

"From my view it was deregulation"

Analysts report—my in Nov.
If you do it—got it done by May. Big change

"Deregulation didn’t need a gut
Regul. to get what twenty"
I'm sure there were people who underestimated the religious nature of it all.

"All too often, from chauvinists.

"But is a serious business."
Come in and tell us what's going on.
You can't regulate if you don't want to know what people think about.

A less hospitable environment to
exploring cooperation.

I think it caused friction in a way -
lack of trust resulted.

Don't like prescription rules.