PREFACE

In The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance (3d ed. Aspen 2003), I wrote a history of the SEC from 1929-1933 stock market crash until the enactment of the Sarbanes-Oxley Act in 2002.

Misalignment: The New Financial Order and the Failure of Regulation is the successor to Transformation which carries the story of financial regulation forward in the broader account of banking insurance and securities regulation before and after the 2007-2009 financial crisis.

Misalignment necessarily involves a Tolstoyian narrative to capture the full sweep of why our financial and economic systems melted down during 2007-2009 and not only involves a detailed examination of what happened during those years, but more importantly, why our $30 trillion financial system proved so unexpectedly fragile. This is a story that reaches back to the formation of our banking, securities, insurance and housing regulatory systems, a story of well intended regulation, typically designed to address specific industry crises, being utterly overwhelmed by a global crisis.

Why did the meltdown of 2007-2009 occur?

By 2007-2009, our systems of financial regulation faced challenges caused by growth and complexity that were unimaginable when the systems were designed. The growth alone was breathtaking. On September 1, 1929, the aggregate value of all securities listed on the New York Stock Exchange was approximately $90 billion. At year end 2006, the total assets of the United States securities sector equaled $12.4 trillion, the banking sector had assets of $12.6 trillion, and the United States insurance industry held assets totaling $6 trillion.

The 2007-2009 meltdown was the consequence of a regulatory system structured to fail. It was difficult to rationalize a federal system of regulation that included five separate federal depository institutions, specifically including the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration, as well as state banking regulation in each state. We were one of the few countries that separately regulate securities and commodities. Securities regulation, like banking, occured both at the

national and state level. Insurance was regulated solely at the state level. Housing finance largely was stimulated by the Financial National Mortgage Association (*Fannie Mae*) and Federal Home Loan Mortgage Corporation (*Freddie Mac*) with mortgage design in part subject to federal and state banking regulation. Each of these regulatory systems functioned separate from the other.

We long had a hybrid system of finance, part free market, part regulatory in structure. In the 1930s and for several subsequent decades, we achieved a period of alignment between financial industries, principally commercial banking, securities firms and insurance and regulatory agencies. During this period, this alignment was based upon the atomized regulation of commercial banks, securities and insurance firms, specifically the SEC with investment banking; federal and state banking regulation with commercial banks; and state insurance regulation with insurance firms.

In 2008-2009, the New Deal financial regulatory model failed. Our economy nearly melted down. By 2008, there was an urgent need for a fundamental restructuring of United States financial regulation,

primarily based on three overlapping immediate causes. First, an ongoing economic emergency initially rooted in housing and related credit markets was succeeded by the collapse or near collapse of several leading investment and commercial banks and insurance companies, dramatic declines in stock market indices, a seizing up of debt markets and subsequent rapidly elevated levels of unemployment and a protracted recession.

Second, breakdowns in the enforcement of financial regulation, illustrated by the collapse of Bear Stearns in March 2008, the bankruptcy of Lehman Brothers in September 2008 and the termination of the Securities and Exchange Commission's Consolidated Supervised Enterprise program later in 2008, ending SEC regulation of the five largest investment holding companies. Nearly simultaneously, government conservatorships were created for Fannie Mae and Freddie Mac, which at the time owned approximately 50 percent of the $4 trillion in outstanding residential mortgages, and the Bernie Madoff case, the largest financial fraud in our history, with cumulative losses estimated by prosecutors to be approximately $65 billion.

Third, a belated recognition that United States financial regulation of banking, securities, insurance, housing, commodities and unregulated firms in hedge funds was fundamentally misaligned with then existing federal and state regulation. There long was too little focus on systemic risk. There was poor coordination between the White House, the Department of Treasury, the Federal Reserve Board and other federal and state banking, securities, insurance and commodities regulators. There were serious gaps and omissions in regulation such as those for hedge funds and derivative securities and little effective planning for the internationalization of finance which by then was quite advanced.

To put this in different terms, the structure of financial regulation that was developed during the 1930s did not keep pace with fundamental changes in finance:

- In the New Deal period, most finance was atomized into separate investment banking, commercial banking, or insurance firms. By 2008, finance was dominated by financial holding companies which operated in each of these and cognate areas such as commodities.

- In the New Deal period, the challenge of regulating finance was domestic. By 2008 when credit markets were increasingly reliant on trades originating from abroad; major financial institutions traded simultaneously throughout the world; and information technology had made international money transfers virtually instantaneous, the fundamental challenge was increasingly international.
- In 1930, approximately 1.5 percent of the American public directly owned stock on the New York Stock Exchange. During the first quarter of 2008, approximately 47 percent of U.S. households owned equities or bonds. A dramatic deterioration in stock prices affected the retirement plans and the livelihood of millions of Americans.
- In the New Deal period, the choice of financial investments was largely limited to stocks, debt, and bank accounts. By 2008, we lived in an age of increasingly complex derivative instruments, some of which experience had shown were not well understood by investors and on some occasions by issuers or counterparties.

The history of financial regulation in the United States is a history of crisis reaction – an uncoordinated series of specialized federal and state laws that responded to specific crises in different financial industries with markedly different objectives and methods. Before the New Deal, uncoordinated regulatory systems were established in banking (starting with the 1863 creation of the Office of the Comptroller of the Currency and the 1913 Federal Reserve Act), securities (state or Blue Sky Laws starting with Kansas in 1911) and insurance (state law led by New York early in the 20th century). There was little coordination between federal and state financial regulation.

In the New Deal period, we achieved a long stable model of financial regulation that atomized financial firms and substantially increased investor and depositor protection. For banks, this was largely at the federal level through the Banking Act of 1933 which established the Federal Deposit Insurance Corporation with depository insurance and related legislation that addressed Savings and Loan Institutions (the 1932 Federal Home Loan Bank Act and 1934 National Housing Act). For securities firms, this was through the seven New Deal federal

securities law statutes enacted between 1933 and 1940. Insurance regulation remained at the state level through what are now 56 state and territorial insurance laws and the McCarran-Ferguson Act of 1945 which authorized the states to regulate interstate insurance transactions.

A key to atomizing was the Glass-Steagall Act of 1933, which "divorced" commercial banking from securities firms by prohibiting banks to be in both domains.

For six decades after World War II, the United States experienced sustained growth and only modest economic perturbations through the combination of overall oversight of fiscal and monetary policy administered by the Federal Reserve Board and financial regulation administered by the separate regulatory systems generally aligned with commercial banking and savings and loans, the securities industry and insurance. As Harvard Business School Professor David Moss wrote in 2011:

> The simple truth is that New Deal financial regulation worked. In fact, it worked remarkably well. Banking crises essentially disappeared after 1933 . . . without *any* apparent

reduction in economic growth. Not only was the period 1933-1980 one of unusually strong growth, but the growth was broad based, associated with stable or *falling* income inequality, rather than with the *rising* inequality that took hold after 1980.

After World War II, the New Deal financial regulatory model began to deteriorate. In 1956, the Bank Holding Company Act authorized banks, initially in limited ways, to form affiliates that held non-commercial bank subsidiaries. Step by step the separation of commercial banking from investment banking was eviscerated. For a long time, one generalization was safe – public sale of securities was underwritten by investment banks. National banks, national bank holding companies were prohibited from underwriting the public sale of securities. In 1984, the United States Supreme Court approved the acquisition by a bank holding company of a securities broker. In 1999, the Glass-Steagall Act was repealed by the Gramm-Leach-Bliley Act, ending the historic barrier between commercial and investment banking.

Similar steps were taken to allow insurance corporations to form subsidiaries that operated in investment fields, illustrated by AIG, the

largest property and casualty insurer, that formed a subsidiary that operated ultimately self-destructively in derivative and swap transactions.

Vast areas of finance evolved outside of regulation – including "shadow banking," that allowed largely unregulated transactions by which mortgage originators such as Countrywide to package tranches of mortgages, sell them to investment banks, who in turn would market them to institutional clients. The Commodities Futures Modernization Act of 2000 authorized the trading of specified financial futures in an unregulated environment. Nearly simultaneously, hedge funds, not subject to either banking or securities regulation, became a dominant force in purchasing private businesses.

Compounding an increasingly byzantine regulatory structure was regulatory arbitrage. By 2008, there were several competing bank regulators (including the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and state banking regulators). In some instances, banks could choose to be regulated by the most accommodating regulator. Similarly trading in

securities could be done through financial futures subject to the Commodities Futures Trading Commission, not the Securities and Exchange Commission. Some, but not all, retirement investments were regulated by the Department of Labor, not the SEC.

The New Deal financial regulatory structure deteriorated over several decades, largely because of the transformation of the leading financial firms into financial supermarkets operating simultaneously in banking, securities, and insurance and increasingly also in unregulated areas such as hedge funds, derivative and swap financial instruments simultaneous with the withering of legal restrictions that limited financial firms to a single core industry. Financial regulation became more fragmented, less able to effectively regulate the revolution in the largest financial firms that had gathered force over the past four decades. The countervailing power of federal regulation achieved in the New Deal period was undercut in the last few decades.

No events better crystalize this deterioration more than the financial debacle of 2008-2009, during which stock indices fell close to 60 percent, debt markets did not function for a sustained period,

systematic breakdowns occurred in financial enforcement illustrated by the bankruptcy or near bankruptcy of the five largest investment banks in the United States starting with Bear Stearns in March 2008, the creation of conservatorships for Fannie Mae and Freddie Mac, then responsible for 50 percent of all United States residential mortgages worth over $4 trillion, and the Bernie Madoff case, the largest financial fraud in United States history. To prevent a total meltdown, Congress and the Executive Branch engineered a series of rescue maneuvers including the 2008 Troubled Asset Relief Program of $700 billion and Obama Administration $787 billion stimulus program and provided support for firms as variegated as leading commercial banks, leading securities firms, insurance giant AIG and the auto industry. Ultimately in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted.

There is a myopia that dominates policy and critical analysis of the 2008-2009 meltdown. The meltdown was not ultimately caused by banks too big to fail, corporate cupidity, conflicts besetting credit rating agencies, securitization of mortgages resulting in neither mortgage

originators or securities firms having "skin in the game" or incompetence by the Department of Treasury, the White House or the regulatory agencies. To be sure, these were proximate causes that helped trigger the crisis.

The principal ultimate cause of the 2008-2009 meltdown was the misalignment of the leading financial firms with the federal regulatory structure. This misalignment was aggravated by new financial products which could convert into securities or securitize areas long outside of financial regulation such as home mortgages, the globalization of finance and a technological revolution which made it possible to trade anywhere via computer with breathtaking speed that eviscerated the historic significance of institutions such as the New York Stock Exchange, which in part also had a regulatory role.

The 2007-2009 financial meltdown was in significant part a consequence of the mismatch between increasingly powerful leading financial firms and badly coordinated federal and state regulators.

The primary legislative response to the 2008-2009 financial meltdown was the enactment in 2010 of the Dodd-Frank Wall Street

Reform and Consumer Protection Act. Dodd-Frank is long – some 845 pages in its official version. But the length was explicable given its 16 titles addressing banks and bank holding company securities; commodities and mortgage regulation; novel provisions to prevent banks too big to fail by requiring the adoption of orderly liquidation plans for the banks when they reach specified levels of dysfunction; creation of a new Bureau of Consumer Financial Protection; regulation of previously unregulated areas such as hedge fund investment advisers and derivative securities; strengthening of payment clearance and settlement; tighter regulation of credit ratings, asset-backed securities and corporate governance.

The Act was notable for a change in the objectives of financial regulation to emphasize systemic risk rather than regulation by industry sector. Dodd-Frank created the Financial Stability Oversight Council, with members from each relevant federal regulatory agency and empowered the Council to require new capital, liquidity and risk management standards for banks and other systemically important companies.

Dodd-Frank also directly addressed critical gaps in prior financial regulation by empowering the SEC to regulate investment advisers to hedge funds and other private equity funds and authorizing the SEC and CFTC to regulate swap transactions and enhancing SEC authority to regulate credit rating agencies.

By emphasizing financial stability and risk reduction as paramount objectives, Dodd-Frank stressed the need for regulatory coordination, elimination of regulatory gaps and omissions, and new tools to optimize early warning and prompt response to future crises.

The Act has many laudable features such as those requiring covered institutions to have higher minimum capital and leverage ratios. But Dodd-Frank overall is inadequate for the challenges of a financial system dominated by financial supermarkets.

One key neglected imperative was to create a regulatory system that provides countervailing powers to those it regulated. Dodd-Frank largely builds on the structure of the earlier financial regulatory agencies. The Act strengthens the SEC, the CFTC, the Department of the Treasury, the Office of the Comptroller, and especially the Federal

Reserve System and the FDIC. This is not surprising. Much of the text of the Act appears to have been written by their staffs. Only one agency – the late unlamented Office of Thrift Supervision – was abolished. Only one new agency – the Bureau of Consumer Financial Protection – was established, although within existing agencies and departments, there are a plethora of new required offices as well as broadened jurisdiction.

This then is the paradox of the new federal financial regulatory model: Since the stock market crash of 1929-1933, no set of regulators was so incompetent in predicting a financial catastrophe, so slow in response, so rigid in regulatory approach, so inadequate in enforcing existing law as the regulators in charge during the 2007-2009 crisis. Yet the principal winners in the Dodd-Frank Act are the very same set of regulators who so spectacularly failed.

There remain critical gaps and omissions in the new law. Banking and securities regulation today are subject to a concurrent system of federal and state regulation with the largest and interstate firms subject to federal regulation and most purely intrastate firms subject only to

state law. Insurance, an industry whose assets collectively are larger than those of the securities industry, is largely subject to regulation by 56 state, district and territorial insurance commissions. The logic by which banks and securities firms are subject to federal regulation – the difficulty of a state enforcing laws across state lines, the likelihood that regulated firms would seek regulation from the most accommodating states, the problems of coordinated regulation – is equally applicable to insurance.

A separate key omission was the tentativeness with which Dodd-Frank addressed international coordination of financial regulation. This is the greatest vulnerability in terms of systemic risk to the United States economy. It is an area which historically has been addressed through *ad hoc* approaches with painfully slow implementation of information gathering and enforcement.

Federal and state regulation remains widely disparate in their objectives. Dodd-Frank emphasizes systemic risk reduction, stability of the overall system and eliminating expectations of federal intervention to shield shareholders, creditors and others from losses in the event of

catastrophic failures. Dodd-Frank also has a title dedicated to consumer protection. Bank regulation generally is predicated on protection of the safety and soundness of depository institutions. Securities regulation largely focuses on investor protection. There is a cacophony of objectives, predictable given the crisis response nature of financial regulation over a 160 year period.

Dodd-Frank did not change the structure or objectives of the constituent agencies and departments, but attempted to build a superstructure through the Financial Stability Oversight Council (*FSOC*) to apply systemic risk reduction and other Dodd-Frank objectives to all federal financial regulators. The problem with this approach is that the FSOC is largely a study group with the real power remaining in the Department of Treasury and the regulatory agencies. FSOC's powers are not command and control – but rather the more limited authority generally to make recommendations to resolve a dispute among two or more members when "a member agency has a dispute with another member agency about the respective jurisdiction over a particular bank holding company, nonbank financial or financial activity or product

. . . ." Only once in its first five years did the FSOC used its powers to recommend harmonization of rulemaking at a single regulatory agency and in that case it at best achieves partial success. The FSOC is largely a mediator, rather than a control entity or arbitrator.

A related question unresolved is the appropriate model for regulation in each federal regulatory department or agency. Should financial regulation when avoidance of systemic financial risk now is a priority be centralized and expressly made part of the Executive Branch in an agency such as the current Department of Treasury? Or should the emphasis on attempting to have regulation be apolitical be preserved with independent regulatory agencies such as the Federal Reserve System or the SEC? Dodd-Frank did not effectively address the implications of either model other than the limited Financial Stability Oversight Council coordination.

Several efforts to strengthen the existing regulatory agencies were rebuffed. The Federal Reserve System, for example, is self-funding and can set competitive salary levels for its employees and expand its staff consistent with regulatory needs. The SEC and most other financial

regulatory agencies are subject to annual appropriations from Congress and go through binge-purge cycles in which they are underfunded and have higher staff turnover than the Federal Reserve System. For former Congressman Barney Frank, a legislative leader in the enactment of Dodd-Frank, the failure to achieve agency self-funding was the Act's most important failure.

A separate issue of consequence to federal regulation involves agencies with overlapping or competitive functions. For decades, proposals have been made to combine the SEC and CFTC which regulate financial products which can substitute for each other (securities on the part of the SEC, financial futures and swaps on the part of the CFTC) and frequently are bogged down in jurisdictional disputes or negotiations or litigation brought by covered firms. Similarly, proposals have been made to combine several federal banking or depository agencies including aspects of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Commission and the National Credit Union Administration. Dodd-Frank did end the Office of Thrift Supervision, but this at most was a

partial solution to a broader problem of overlapping regulation. The Department of Treasury's recommendations to create a new regulatory structure, including an optional federal regulatory system for insurance, similarly was not adopted in Dodd-Frank.

Why has federal financial regulation been so hamstrung? The principal culprit has been the committee system in Congress under which several separate Senate and House committees have jurisdiction over competitive regulatory agencies and are unwilling to surrender it. This long has been the explanation why the United States alone among nations separately regulates securities and financial futures – the SEC is subject to one set of Congressional committees, the CFTC is subject to a different set.

Congressional turf battles have made it virtually impossible to enact a coherent legislative model – why do we have 11 federal financial regulators, parallel systems of state banking and securities regulation, exclusive state insurance regulation, additional self-regulatory organizations such as stock exchanges and the Municipal Securities Rulemaking Board? Congress has orchestrated increased limitations on

rulemaking and regulatory agency action through more demanding standards of judicial review that further hamstring the regulatory agencies' ability to respond to crisis.

The Dodd-Frank Act at best is a halfway house which is inadequate to effectively address misalignment. The failure of the Dodd-Frank Act to address the structure of financial regulation was its most conspicuous failure. This volume concludes with a plan for a fundamentally different approach to financial regulation that is more likely to enable us to avoid meltdowns such as 2008-2009 in the future and minimize financial perturbations over time.

It is particularly urgent that our system of financial regulation be addressed now. In May 2018, Congress enacted the Economic Growth, Regulatory Relief and Consumer Protection Act, which accelerated the Trump Administration efforts to dismantle key protections in Dodd-Frank. The Act, among other things, substantially broadens exemptions from Dodd-Frank, including the Volcker Rule which partially succeeded the Glass-Steagall Act separation of commercial and investment banking. Nearly simultaneously with the enactment of the 2018

Economic Growth Act, the Department of Treasury, the Federal Reserve System, the Federal Deposit Insurance Corporation, SEC and CFTC proposed a further revision of the Volcker Rule.

History not only is repeating its episodic atrophy after regulatory strengthening, but remains our best protection against further decline. As John Kenneth Galbraith wrote in *The Great Crash 1929*:

> As protection against financial illusion or insanity, memory is far better than law. When the memory of the 1929 disaster failed, law and regulation no longer sufficed. For protecting people from the cupidity of others and their own, history is highly utilitarian. It sustains memory and memory serves the same purpose as the SEC and, on the record, is far more effective.