

## Treasury's Blueprint for Financial Regulatory Reform – What it Means on the Trading Desk

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This Monday, Treasury Secretary Paulson, formerly of Goldman Sachs, released the "Blueprint for Financial Regulatory Reform," a study of U.S. financial regulation by the Treasury Department that began in March 2007.

The study is controversial. The proposed reforms have already been condemned by state regulators and much of the banking industry. Leading commentators, such as Paul Krugman, an economist who writes an influential column for the *New York Times*, has argued that the study represents one more attempt by the Bush administration to appear to be taking action in the face of the ongoing crisis in the credit markets by shuffling agencies around, rather than taking any meaningful action to address the crisis. While I tend to agree with Professor Krugman most of the time, in this case I think he misses the point.

Current U.S. financial services regulation is primarily a product of the 1930s and the horrors of the Great Depression. It is important to understand that the regulation of financial services was something of a sideshow during the Great Depression. The fact is that something more than 25% of able-bodied workers could not find a job for many years during the 1930s. In contrast, the unemployment rate today hovers around 5%. As a result, the politicians of the 1930s were preoccupied with finding something to occupy the mobs of unhappy, hungry, and unemployed workers gathering on street corners in every big city in the United States. The social problems of the day were overwhelming. It is worth noting that many traders were among the unemployed milling about on the street.

Nonetheless, Congress spent a lot of time dealing with financial services regulation, creating among other things, an entirely new agency, the Securities and Exchange Commission. They did this because there was a strong popular belief that the Great Depression was caused by the antics of Wall Street. Whether or not this perception was justified, there was a strong popular cry for reform, and Congress did its best to accommodate the voting public's demands.

In thinking about how to avoid a recurrence of the crisis, Congress eventually decided it was best to regulate through a sort of financial segregation. So, commercial banks were divided from investment banks. Insurance was allocated to state regulation. Investment advisers were divided from broker-dealers. The theory was that, so divided, each of these institutions reflected different regulatory concerns. So each got its own regulator, and each regulator had a different mission.

This theme was repeated when Congress got around to regulating commodities trading. The regulatory concerns presented by commodities trading seemed to differ from those involved in securities trading; so, a different regulator – the CFTC-- was created to serve that function.

The problem with segregation is that the boundaries interfere with business. So, broker-dealers have customers who would like to give them deposits and borrow money, but only banks can take deposits and engage in commercial lending. Banks would like to underwrite securities, an activity assigned to broker-dealers. And all of them would like to sell insurance, which is regulated separately by each State. Now, banks could register as broker-dealers, and vice versa. But, the regulations that apply to banks are sometimes inconsistent with broker-dealer regulation, presenting difficult compliance issues.

As the crisis of the '30s faded from memory, the institutional segregation of financial services seemed less and less to be a good thing. It prevented a lot of useful business activity for no particularly good reason. Banks could not compete with broker-dealers, which among other things, increased underwriting costs. It tended to insulate certain industries and firms from competition, which reduced incentives to innovate and increased consumer costs. There were reports that other nations were introducing services that were unavailable in the United States, so that we were losing our competitive economic edge because of counter-productive regulatory barriers.

In response, lawyers and regulators began to work on ways to break down the barriers that separate one institution from another, while hopefully preserving those parts of the regulatory framework that seemed useful. The problem is that the regulators themselves continued to be segregated according to functional boundaries created a long time ago. As a result, much of the business conducted by financial services firms eventually was not regulated by anyone. The banking regulators didn't think they were responsible for determining the safety and soundness of broker-dealers, even large investment banks, because those institutions belonged to the SEC. This was true even when investment banks began engaging in activities that increasingly resembled the regulated activities of commercial banks. Similarly, it was never entirely clear what the SEC's role was with commercial banks, even when they began to underwrite securities and sell securities to retail customers.

Treasury's blueprint does not propose to put Humpty-Dumpty back together again by recreating the segregation of regulated financial services firms. Instead, Paulson proposes to mash together the regulators. The Fed would have a lot more to say about the conduct of broker-dealers. The SEC would be merged with the CFTC. Insurance would be regulated by the federal government, rather than the states. In general, the role of the states in the regulation of financial services would be terminated. No more Eliot Spitzers.

The blueprint, as proposed, is really neither pro-regulation, nor anti-regulation. European nations are regarded as having much stronger administrative systems than the United States. However, as a general proposition, financial services firms in Europe are regulated by their central bank analog to the Fed. In Britain, for example, all financial services are regulated by the Bank of England, which is Britain's central bank. The FSA, which regulates the securities industry, is part of the Bank of England.

The blueprint does, however, run counter to the American notion of limited government. We have always doubted that the federal government can best determine whether a stoplight should be placed in a particular street in a local neighborhood. We think government works best when it is local and small. Concentrations of regulatory power are regarded as threats to liberty. Americans believe that "power corrupts, and absolute power corrupts absolutely." So, the idea that one monolithic financial services regulator will do a better job for the securities industry than the SEC, which for all its faults, at least is focused on industry concerns, runs counter to our instincts as Americans.

Paulson's proposal, if adopted in some form, concentrates power in the federal executive branch, which is really its point. Larger firms, such as Goldman Sachs, may welcome this development. Smaller firms probably will not like the way this turns out. I very much doubt the blueprint will make things better for the trader trying to earn a few nickels working on the desk.

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