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FORUM (FORUM & FOCUS) • Mar. 24, 2009

## Insisting on Reform

### FORUM COLUMN

By Mark Labaton

Nothing fosters respect for financial regulation more than a financial crisis - especially when that crisis is as serious as the current one.

The Bank Panic of 1907 led to the creation of the Federal Reserve Bank and state anti-Bucket Shop laws, which restricted betting on securities; the Great Depression prompted Congress to enact the Securities Act of 1933 and the Securities and Exchange Act of 1934; and, today, sweeping regulatory change appears on the horizon.

Indeed, even advocates of de-regulation just a few years ago now recognize the disastrous consequences of inadequate regulation: the subprime meltdown, the collapse of Bear Stearns and Lehman Brothers and the Bernard Madoff scandal, for starters. Still, much needs to be done to fix an outdated and flawed financial regulatory system.

To begin, aggressive enforcement of existing securities and banking laws will help restore public confidence, and such enforcement efforts would benefit from additional funding and trained personnel.

Enforcement agencies, especially the Securities and Exchange Commission, also must become more responsive to whistle-blowers like Harry Markopolos, who for eight years tried unsuccessfully to persuade the SEC to take action against Madoff.

The reasons for this are clear. Significant investigative news stories start from tips; the same holds true for uncovering financial scandals, where tips especially from competitors or insiders can be golden. For example, the New York and Massachusetts attorneys general have brought major fraud cases based on tips. And the Madoff scandal graphically demonstrated the value of Markopolos' information. Moreover, it demonstrated that ignoring even one credible tip can taint a regulatory agency such that, in the words of former SEC chief accountant Lynn Turner, the "SEC is in worse shape today than the French Army after its defeat at Waterloo."

To better evaluate tips, the SEC could start a section devoted to handling tips and a reward program to encourage whistle-blowers to come forward to expose securities fraud. The SEC also should become more proactive. Thus, although it started the Office of Risk Assessment in 2004 to uncover fraud, that office needs to be better staffed and funded.

But enhanced enforcement of existing laws and greater responsiveness to those who report financial fraud, while essential, is not sufficient. The recent financial crash exposed deep-seated flaws in the financial regulatory system that can only be corrected through substantial changes. As former SEC Chairman Arthur Levitt put it: "We need a dramatic rethinking of our financial regulatory architecture - the biggest since the New Deal."

Hedge funds, for instance, must become subject to greater oversight. They should not be permitted to operate in the shadows based on the excuse that transparency limits their profitability or based on the excuse that the investors in these funds are well-heeled and often financially sophisticated. These are

insufficient reasons for lax oversight of funds that substantially influence financial markets.

Take the example of the Madoff fraud. When the curtain was pulled back, we learned that Madoff was not a financial genius who generated enormous profits because he secretly traded stocks. Rather, he was a villainous financial Wizard of Oz, who stole billions of dollars from individuals, charities and pension funds. Madoff thrived because he could avoid scrutiny. The perpetuation and growth of his massive Ponzi scheme depended on such secrecy. Transparency and regulation should expose or deter similar conduct.

Madoff, and others like him, erode public confidence in the marketplace and destroy lives, causing widespread, enduring and preventable harm. Not only do such crooks deserve severe punishment; more must also be done to deter and curb such market excesses.

More also should be done to regulate credit rating agencies, which played an essential role in creating the super-inflated market for mortgage-backed securities at the center of the current financial crisis.

These credit agencies misuse the First Amendment as a shield. They argue that their ratings are nothing more than opinions and, as such, are protected speech. But these agencies need to be held accountable for their conduct, without which the mortgage-backed securities (referred to as collateral debt obligations) could not have been marketed, much less sold in volume and at inflated prices. In addition, these agencies were compromised by conflicts of interest stemming from their being paid by the companies whose securities they evaluated.

Lawmakers, moreover, should better control the huge financial "supermarkets" arising in the last decade after lawmakers permitted corporate entities to operate for the first time since the Great Depression simultaneously as investment banks, commercial banks and insurance companies.

And Congress should enact legislation - and the Obama administration should put in place regulations - to better control derivative instruments especially credit-default swaps, insurance-like contracts covering losses on r securities such as the mortgage-backed securities. Along with the mortgage-backed securities, the credit-default swaps were largely responsible for the current economic meltdown.

Derivative instruments can be monitored and regulated in a number of ways, including by existing federal agencies or through regulated trading on a newly created derivative exchange or clearinghouse. The credit-default swaps were once regulated by state anti-Bucket Shop laws, but such regulations were eliminated by Congress back in 2000. These financial instruments need to be regulated, perhaps as President Obama suggested by a newly created federal agency that can impose strict rules to control systemic risks.

Ironically, much of the harm caused by the credit-default swaps could have been averted if lawmakers in 2000 were more cognizant of the dangers of de-regulation and respectful of appropriate regulation. That year, Congress passed, and President Clinton signed into law, the Commodities Futures Modernization Act, a law not commonly associated with the current financial crisis. It should be.

This legislation was more than a missed opportunity. Although largely unreported, it is difficult to imagine a better recent illustration of the dangers of deregulation. Subsequent events prove that the consequences of this error were foreseeable and avoidable.

Here's what happened. The Commodities Futures Modernization Act pre-empted state anti-Bucket Shop laws, which would have severely limited the trading of these credit-default swaps, the insidious derivative instruments responsible for the downfall of insurance giant AIG. Worse still, the Commodities Futures Modernization Act was hidden from public scrutiny by being tacked on and buried in an omnibus budget bill.

Yet, prior to the passage of this legislation, Brooksley Born, then chairwoman of the Commodity Futures Trading Commission, unsuccessfully sought authority to regulate derivative instruments. Prophetically, Born warned that unregulated derivatives trading would "threaten our regulated markets, or indeed our economy." Unfortunately, though, she was castigated by policymakers from both parties, and her request was unwisely rejected. The consequences were disastrous. What she had predicted would happen

occurred.

Sobered, chastened, and perhaps enlightened, lawmakers today call for reform, both bold and broad. They are right. As occurred in the wake of the Great Depression, strong words need to lead to significant reform.

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