Regulating Broker-Dealers

And Other Investment Entities

Hosted by

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Research Reporter: Claire Eckstein

The Vincent C. Ross Roundtable (Stern NYU) convened a distinguished panel of leaders representing academia, financial institutions, the accounting and legal professions as well as regulators to analyze the role of regulation in the current crisis and discuss measures to both stabilize current markets and avoid a future collapse. Professor Seymour Jones (NYU Stern) provided the foundation for the discussion by asking: "Do we need more regulation? What kind of regulation are we talking about? Stop talking about the problems and start solving them!"

Mark Lilling (Audit Committee Consulting Team) presented a time-line of wealth creation and a critique of the net-capital rules. Mr. Lilling is a strong proponent of proposed legislation for PCAOB oversight of brokers and dealers. He supported his views based on the fact that broker and dealers are currently responsible for approximately five billion shares of NYSE and NASDAQ shares.

Arthur Felsenfed (Andres Kurth LLP) answered the question of why we care if wealthy *individuals* put their money into risky and unregulated hedge funds. There are two basic reasons: The SEC definition of *client* has included funds. Funds include pensions, universities, and charities which translate into thousands of *individuals.* Furthermore, a market position of $1.8 trillion (after posting losses of $1 trillion in 2008) puts the entire financial system at risk if there is a rush to sell. The proposed regulation, that will include more companies, is a step in the right direction, but emphasized that ongoing oversight is of major import.

Prof. Roy C. Smith (NYU Stern), one of the many distinguished professors who collaborated on the book "Restoring Financial Stability: How to Repair a Failed System", said the book was a ***must read***. The book[1] provides a systematic

[1] In addition to the book, the collective effort yielded a six-week course offered to MBA students

approach to analyzing the causes of the financial crisis, and proposes financial policy alternatives and specific courses of action aimed at restoring the global financial and economic system. He noted that it was the repeal of the Glass-Steagall Act that paved the way for regulatory forbearance and the current relaxation of fair value rules bolsters *accounting obscurity.* When the U.S. Bank holding companies[2] absorbed the large broker--dealers, the ability for auditors to distinguish between *held-to-maturity* and *mark to market* accounts became more difficult. In his opinion, the collapse of high standards by the SEC and the backing down by the FASB on fair-value accounting will make it more difficult to get back to normal. What is needed is to de-conglomerate banks.

Charles Niemeier (PCAOB) posited that poor lending practices, executive compensation schemes, and off-balance sheet accounting that permitted risk to be hidden were the culprits in the current crisis, and **not** fair-value accounting. He urged legislators to carefully address the issues to avoid adding time-consuming efforts that provide little or no benefit.

Prof. Stanley Siegel (NYU Law) predicted both short and long-term changes in regulation at the federal level. The focus should be on preemptive measurements; the justice system is costly with inefficient time lags. The Efficient Market Hypotheses, rational decision making, and the assumption that management's objective is to increase shareholders' wealth are naïve assumptions that do not mimic reality. Failure to fully disclose risk and use fair-value accounting is a recipe for failure. We need carefully crafted regulation and ***enforcement*** of capital levels, conflicts of interest, and executive compensation.

Michael Koblenz's (Mound Cotton Wollan & Greengrass) Madoff *encapsulation* included what should have been a red flag to auditors: $17 billion in assets with only 23 clients. Lack of training by SEC auditors, reliance on "Bernie's" reputation, and the use of *feeder funds* all played a major role in the debacle. He voiced the opinion of so many, "Madoff did not act alone". He strongly urges merger of existing regulatory agencies to achieve systematic risk regulation.

John Biggs (NYU Stern) noted that 10% of GDP is comprised of insurance premiums. Industry giants, e.g. AIG, too big to fail, are regulated by the state. Although the insurance companies are still highly solvent and investment grade,

[2] Bank holding companies account for approximately half of all U.S. accounts.

mergers created complex high-risk institutions[3] that were not regulated in keeping with their structure. To avoid further economic consequences, the industry should be regulated at the federal level.

Prof. Miklos Vasarhelyi (Rutgers U) said we are using stone-age tools to measure highly- complex systems. He noted that the Dutch government has adopted XBRL, which makes it possible to collect, record and exchange financial reports more efficiently and to record data once only. Analytic technology must be placed in the hands of more staff, and indices that achieve standardized measures should be adopted.

Does President Obama have the power to put the new rules into place? Professor Siegel responded that the one who drafts the instrument has "power". Although the power of executive action succumbs to political pressure, it should never be underestimated.

"Do we want such a powerful president?" (Sy Jones). "Rest assured that Barack Obama will follow the rule of law" (Stanley Siegel).

In the discussion that followed there was a consensus of opinion that there have been rampant inefficiencies in communication and oversight. Although not everyone agreed that increased regulation is required, the importance of upgrading the caliber of both the regulators and the enforcement team was uncontested. The importance of not acting hastily was another concern shared by participants. The objective is not to constrain individual risk taking, but to introduce intelligent regulation aimed at reducing risk-taking that could result in a systemic market collapse. It was not *originate to distribute* that was the source of the failure, but rather the *failure to distribute* the risk that originated.

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[3] Some of which ultimately failed, e.g. entry into the CDS market.