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Toward Better Financial Market Regulation

On June 4, 2009, a group of twenty people comprised of senior business and law faculty and business practitioners (and including among their numbers a small contingent of former senior government officials) was jointly convened by The Aspen Institute and New York University with support from Ernst & Young to discuss responses to the current economic crisis and to explore the role of financial market regulations in fostering economic recovery and growth. (A list of those in attendance is appended to this paper.)

This document represents a preliminary synopsis of some of the ideas that emerged from the gathering. A longer document, which will treat the topics of the day in more depth, is forthcoming. However, given the Obama administration's recent release of its White Paper on Regulatory Reform and the continued negotiations that are likely to occur in the coming weeks, the conveners of the event have opted to issue this paper now in the hopes that it can make a useful contribution to that process.

The discussion centered largely around ten recurring issues.

1. **Applying better regulatory attention to systemic risk**
2. **Creating risk-pricing mechanisms to ensure that the cost of systemic risk is borne by the firms that create it**
3. **Regulating financial institutions according to their true role in the market**
4. **Recognizing the destructive potential of derivatives and insulating the larger financial system against it**
5. **International cooperation in creating regulatory and corporate governance requirements**
6. **Adequate resources, talent and enforcement capacity for financial market regulators**
7. **Firm- and market-level systems to create a culture of personal accountability and responsibility in business**
8. **The need for critical thinking about the real benefits and drawbacks of so-called financial innovations**
9. **Fostering a long-term focus among all market actors**
10. **Attention to the interests of investors, and an appreciation of their role in supporting economic growth**

Perhaps due both to the complex nature of the questions at stake, and to the broad scope of the discussion—which touched on practical issues relevant to a number of different sectors as well as on core philosophical questions underlying different notions of the role of markets in society—the gathering did not yield any single consensus. However, throughout the lively discussion, the participants agreed that the proper resolution of these ten issues is key to optimal refashioning the U.S. regulatory system.

The discussion's ten themes can be loosely grouped into two categories—specific responses to events, and broader principles that will help to set the tone as industry and regulators alike move forward toward healthier and more productive market functioning. Below is a summary of the major points that were raised around each topic.

Responses to Events

1. **Regulatory attention to systemic risk**: Participants explored the possibility of a systemic risk regulator, with the power to maintain overall market stability. They debated the merits of a centralized authority, versus authority spread across multiple agencies, as well as the possibility of creating a new agency or agencies versus amending the mandates of existing agencies. Almost all agreed that it was essential that the agency or agencies that serve this role have a clearly defined mission vis-à-vis systemic risk, as well as significant enforcement capacity.

2. **Incentivizing responsible behavior by pricing systemic risk:** As an additional method of fostering system-wide stability, participants discussed the possibility of pricing systemic risk so that the market actors that create systemic risk would be required to bear a financial burden for the risk they create. Suggestions included requiring companies to pay a fee for access to a lender of last resort, as well as requiring companies to buy government-overseen insurance on risky transactions, with the stipulation that if a company is unable to afford the insurance, it will not be allowed to complete the deal.

3. **Aligning regulation of institutions with their true market roles**: Participants discussed whether and how to regulate companies and activities that are currently either unregulated or regulated in ways that are out of step with their true role in the broader economy. Most agreed on the need for better regulation of non-bank financial institutions (NBFIs), in particular insurance companies.

4. **Better attention to potentially destructive financial products**: Participants were varied in their thoughts on how to address the destructive potential of derivatives, which played such a central role in bringing about the current crisis. Some participants suggested that because their use is so widespread and so potentially harmful to the broader market that derivatives should be regulated, or at minimum that a clearinghouse should be established to keep track of over-the-counter derivatives. Others argued that derivatives are inherently so destructive that the cost necessary to regulate them would simply be a waste of taxpayer dollars. Still others suggested that derivatives should be left unregulated, but that the institutions that use them should not have access to depository institutions or to taxpayer money so as to minimize effects on the broader financial system. Participants discussed the idea of a dedicated financial products safety commission to test and evaluate new financial products for their safety to the buyer and to the market at large.

5. **Possibility of international cooperation:** Participants debated the need for and potential efficacy of international cooperation around regulatory and governance issues. It was pointed out that most major companies are international in scope, but are not regulated as such. Some participants were emphatic that global cooperation on regulation and/or global standards for corporate governance are essential to preventing further large-scale crises, and to blocking regulatory arbitrage. Others felt that attempts at international cooperation would create the need for consensus among so many different parties and with such different interests that any results on which all could agree would be functionally meaningless.

Principles for Moving Forward

6. **Strengthening regulatory capacity**: Most participants agreed on the need not only for stringent enforcement mechanisms but also for access to adequate talent and resources for whatever regulatory body ultimately emerges from the recovery effort. They acknowledged that strengthening regulatory capacity can be stymied by the disparity between public and private sector salary levels. A requirement was suggested that for anyone to reach a senior level in a major financial institution he or she must first work as a regulator for some predetermined number of years (although participants also noted the necessity that regulatory agencies not be seen as a "revolving door," thereby damaging their credibility).

7. **Mechanisms to foster and enforce accountability**: Participants differed on means, but agreed on the need for fostering and enforcing accountability. While some felt that the search for people to blame for the current crisis detracted from a reasoned search for solutions, others felt that it was critical to send a public message that certain kinds of destructive behaviors are unacceptable—either by banning culpable individuals from certain professions, or by exacting fines. A number of participants also felt that some mechanisms currently in place detract from a general culture of accountability. Participants noted the moral hazard to which rating agencies were subject, and contrasted the limited liability corporation with a partnership model of the firm, which some believe fosters a culture of ownership, stewardship and care among employees. One participant also pointed out that in certain situations regulation itself can undermine accountability, when regulation is used as a shield for bad behavior, and regulators are blamed for having failed to apprehend market actors' shenanigans.

8. **Rethinking the nature, role and value of innovation**: A recurring theme in the conversation was the notion of financial innovation. While some participants averred that innovation is categorically and always good for the market, others disagreed, and called for critical thinking about the role of innovation in the broader markets, particularly so as to ensure that the costs of innovation are not externalized onto parties who do not receive its benefits.

9. **Promoting a long-term focus**: Most participants agreed on the need to foster a long-term focus among corporations. Attention was given to the need to align compensation of

executives, managers and analysts with long-term company goals, particularly with regard to stock options.

10. **Staying mindful of investor interests**: Some participants spoke of the need for attention to the interests of investors, and in particular long-term investors. One participant spoke of breaking down the false dichotomy in the public discourse between "taxpayers" and "investors," when in reality, the two groups overlap. It was suggested that the current moment might be opportune for a renewed focus on questions such as proxy access and say on pay for investors. Given the role that investors play in economic growth, it was pointed out that their interests should play a central role in plans for economic recovery.

This summary of the June 4 joint roundtable was prepared by The Aspen Institute Center for Business Education (Aspen CBE). To learn more about this project or about Aspen CBE, please visit wwww.aspencbe.org, or contact Rachel Shattuck at rachel.shattuck@aspeninst.org.

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