Americans for Financial Reform
Accountability, Fairness, Security

Regulating the Shadow Markets

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Financial oversight has failed to keep up with the realities of the marketplace, characterized by globalization, innovation, and the convergence of lending and investing activities. This has allowed institutions to structure complex transactions and take on risky exposures without fulfilling the regulatory requirements Congress deemed necessary to prevent a systemic financial crisis after the Great Depression. These unregulated and under-regulated activities and institutions, the "shadow financial system," were permitted to become so intertwined with the real economy that the government has chosen to use taxpayers' money to bail them out when they failed.

As President Obama said during the campaign, "We need to regulate institutions for what they do, not what they are." This means that hedge funds, private equity funds, derivatives, off-balance-sheet lending vehicles, structured credit products, and other shadow markets actors and products must be subject to transparency, capital requirements, and fiduciary duties befitting their activities and risks.

Shadow market institutions and products must be subject to comprehensive oversight. We need to return to the broad, flexible jurisdiction originally provided in federal securities regulation, which allowed regulators to follow activities in the financial markets. This means ensuring that all institutions that are active in the shadow financial markets provide regular information to regulators and the public about their activities and their counterparty relationships, requiring derivatives to be traded on regulated exchanges that are transparent and impose meaningful margin requirements, and requiring money managers to provide comprehensive disclosures and to act as fiduciaries for their investors.

The opaque, over the counter derivatives market has evolved into a multi-trillion dollar casino for wealthy investors and should be eliminated altogether. Derivatives that are used for legitimate hedging purposes must be traded on open exchanges, using standardized contracts.

Unregulated pooled investment vehicles, including private equity and hedge funds, have been major participants in the shadow financial markets. Private equity and hedge funds and their managers should be subject to more stringent oversight that, at minimum, requires greater transparency, ensures that managers act in the best interest of investors, and subjects the funds to capital adequacy requirements and leverage limits.

Self-regulation is a myth. Sophisticated investors cannot and should not be relied upon to protect their own long-term financial interests or to avoid overly risky activities that can threaten the health of the financial markets and the global economy. This does not necessarily mean that all participants in the financial markets must be subject to identical regulatory requirements. But regulators must ensure a minimum level of transparency, accountability, and mandated risk management across the financial markets.

Some have suggested that certain aspects of the shadow financial markets, particularly hedge funds and derivatives such as credit default swaps, should be overseen by a systemic risk regulator instead of being subject to comprehensive regulation. This would be a terrible mistake. The shadow financial markets must be subject to comprehensive, routine oversight appropriate to the activities involved. Systemic risk regulation should function as an addition to this oversight, not a replacement for it, focusing on problems that arise from interactions among institutions regulated by different regulatory bodies or emerging risks not fully addressed by the other regulators.