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STRIKING REGULATORY IRONS WHILE HOT

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We are in the midst of what might end up as the most significant change to financial regulations since the Great Depression. This is because the financial and economic crisis that continues to engulf us is the most severe crisis since the Great Depression. The markets for houses, mortgages, and derivatives linked to them have played critical roles in the crisis, and debates about the shape of future financial regulation have led to intense focus on these markets. In this paper we place the current debate about regulatory changes within a larger frame. We present a framework based on capture theory and fairness where regulatory irons are heated by changes in financial markets such as a plunge from exuberant booms to frightening crashes, changes in the economy such as a fall from heady job creation to dispiriting unemployment, changes in technology such as an innovation in information technology which enables banks to substitute the Internet for tellers, changes in politics, such as one party displacing another, or new rulings by the Supreme Court, such as the one that opened the door to interstate banking. We discuss the fires that heat regulatory irons, the craftsmen standing ready to strike them, and the process by which they are struck, in credit card and bank regulations, insider trading regulations, Regulation FD, trading halts, the Global Settlement, and the Sarbanes-Oxley Act. We conclude with our prescriptions.

1 Introduction

Craftsmen who want to strike irons into shapes that suit them know that the iron must be hot and their hammers must be ready. This is true for craftsmen of financial regulations as well. Financial craftsmen include interest groups of many kinds, from bankers who stand ready with their hammers to strike regulatory irons into shapes that permit high credit card interest rates, to consumer groups which stand ready with their hammers to strike regulatory irons into shapes that place low caps on interest rates. There are many competing teams of craftsmen in the regulatory irons workshop, each aiming to strike the iron into a shape that suits it, and each battling other teams which try to strike the iron into shapes that suit them.

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unemployment, changes in technology such as an innovation in information technology which enables banks to substitute the Internet for tellers, changes in politics, such as one party displacing another, or new rulings by the Supreme Court, such as the one that opened the door to interstate banking.

Some sources of heat make it easier for one team of craftsmen to strike the regulatory iron into a shape that suits it while blocking competing teams. Public outrage over high credit card interest rates heats the regulatory iron in a way that makes it easier for consumer groups to strike it into a shape that caps interest rates while blocking bankers who want to guard its current shape which places no caps on interest rates.

In what follows we describe the fires that heat regulatory irons, the craftsmen standing ready to strike them, and the process by which they are struck, in credit card and bank regulations, insider trading regulations, Regulation FD, trading halts, the Global Settlement, and the Sarbanes-Oxley Act. We place our discussion within a framework of capture theory and fairness, and conclude with our prescriptions.

2 Capture theory, fairness, interest groups, politicians, and regulators

Interest groups regularly enlist politicians and regulators in their battles with one another over the shape of the regulatory irons. Stigler (1971) described this enlistment in "capture theory." He noted that each interest group, including bankers, lawyers, union members, and employers, wants regulations that maximize its wealth. Politicians have the power to direct regulators to benefit one interest group or another. At the same time, politicians need resources such as campaign contributions to maximize their chances at re-election. Similarly, regulators want to steer the regulatory process in directions that benefit them, in prestige or industry jobs once they leave public service. The political process involves competition among interest groups each attempting to capture politicians and regulators by some combination of votes, contributions, and favors in exchange for enacting and executing regulations which transfer wealth to them.

Stigler emphasized that an interest group is likely to capture its regulators when the per-capita benefits to the members of the interest group are large relative to per-capita benefits to the general public. Peltzman (1976) augmented capture theory, noting that interest groups would not capture their regulators when the total benefits to the general public are sufficiently large, even if the per-capita benefits are relatively small. Politicians and regulators who allow interest groups to capture them under such circumstances might lose more political support than they gain.

Politicians and regulators have limited power to tilt regulation toward interest groups and their power varies by the environment in which they operate. Economic booms and rising financial markets placate the general public, reducing its vigilance and making it easier for politicians to tilt regulations toward interest groups. However, recessions and declining financial markets enrage the general public, increasing its vigilance and its clamor for regulatory protection from interest groups. Public outrage is a fire which must be hot enough for a period long enough to shape regulations into a form that benefits the general public. Stoking the fire of public outrage is often difficult because the cost of public mobilization is relatively high. In contrast, interest groups have ready mechanisms for lobbying which they can mobilize quickly to take advantage of even small changes in the economic, financial, political, legal, and technological environments.

While self interest usually underlies battles over the shape of regulations, their usual language is the language of fairness. Fairness has many meanings

and it is embedded with many, often conflicting, rights. Freedom from coercion is one of seven fairness rights identified by Shefrin and Statman (1992, 1993). The others are freedom from the following: misrepresentation, impulse, inefficient prices, unequal information, unequal information processing power, and unequal bargaining power.

3 Credit card regulations

Credit card regulations were a hot iron in 2009 and Congress and the President struck it fast to shape the Credit Card Accountability, Responsibility and Disclosure Act of 2009 (CARD). The Act favors cardholders over credit card companies, and represents one event in a dynamic involving capture theory and fairness.

Consider first the issue of fairness. Those advocating lax regulation of credit cards emphasize the right to freedom from coercion. They note that credit card companies do not coerce anyone to hold their cards and argue that regulatory restrictions on credit cards would also deprive potential cardholders of freedom from coercion as restrictions preclude them from obtaining credit cards. Moreover, those advocating lax regulation add that credit card companies have always offered the right to freedom from misrepresentation and unequal information. All the terms of the cards, including the criteria determining penalties and interest rate increases, are noted in pages that accompany cards, even if in small print and in words that only lawyers can comprehend.

Those advocating restrictive regulation of credit cards note that credit card companies violate the rights to equal processing power and freedom from impulse since many cardholders cannot process the information in the credit card contracts they sign and are unable to control the impulses that induce them to spend money they cannot repay before high interest rates and penalties are imposed. Critics of credit card practices complained that credit card statements do not inform cardholders how long it will take them to pay off their balance in full if they choose to pay only the minimum monthly payment.[1] Critics also noted that credit card companies have more power than many of their cardholders. Cardholders with little money have little power when unemployed or facing onerous medical bills.

The 2009 Act strengthens the fairness rights of equal processing power and freedom from impulse by restricting the offerings of credit cards to people younger than 21 who likely have weaker processing power and lower resistance to impulse than older cardholders. The Act also augments the right to equal power by restricting fees charged by credit card companies and limiting their ability to increase the interest rates they charge.

The language of fairness can be discerned in the bill signing ceremony for the Act on May 22, 2009 when President Obama recounted stories he heard during the Presidential campaign from people "chocking backs tears" as they recounted credit card predicaments imposed by unforeseen medical bills or mortgage payments. Obama accused credit card companies of writing contracts "designed not to inform but to confuse." Noting that one provision of the law requires credit card companies to inform customers in advance of changes in payment due dates, he added his personal experience as a cardholder: "This always used to bug me."[2]

While the regulatory iron was struck in favor of cardholders in 2009, its shape favored credit card companies in the decades before. Capture theory provides insights into how the financial, economic and political environments combined to enable credit card companies to impose sizable fees and dramatic increases in interest rates even when cardholders missed no payments.

Lenders were restricted by state usury laws during most of the twentieth century. The laws placed upper limits on interest rates lenders could charge

borrowers. For example, usury laws in South Dakota mandated interest rate limits which varied by type of loan, lender, and borrower. But a 1978 Supreme Court decision opened the door to changes favorable to credit card companies. The Marquette National Bank v First of Omaha Services Corp decision stated that interest rate limits are determined by the law in the state where the loan is made rather than by the law in the state where the borrower resides. The Marquette decision allowed lenders to charge high rates of interest to its customers, no matter where they reside.

The late 1970s were a time of rapid inflation and banks and other lenders were squeezed as their borrowing costs climbed dramatically while the rates they could charge were capped by usury laws. Economic activity, including building activity, declined as credit shrunk. In a bold move, Citibank made a proposal to then South Dakota Governor Bill Janklow to relocate its credit card division to his state, creating a large number of jobs, in return for setting very high interest rate caps in his state. The capture process had begun. Delaware soon followed South Dakota's example, and the two states became magnets for credit card companies.

Over time, credit card companies introduced increasingly complex contracts specifying late fees, penalties, and interest rates. These were facilitated by the 1996 Smiley v Citibank Supreme Court decision which lifted restrictions on penalties for late payments. Penalties which rarely exceeded $15 soon exceeded $30. Clauses in contracts gave credit card companies wide discretion in resetting interest rates. Introductory 9.9 percent interest rates might soon reset above 20 percent, sometimes surpassing 40 percent.

Credit card debt grew very rapidly over the years and now approximately half of Americans are paying interest on credit card debt. Credit card profitability increased as cardholders increased the amounts they owed, but cardholders' outrage about high interest rates, penalties, and fees increased as well. In accordance with capture theory, credit card companies had greater political sway than cardholders since companies are few and cardholders are many. The voices of consumer groups such as the U.S. Public Interest Research Group (U.S. PIRG) and the National Association of Consumer Advocates were barely heard. Elizabeth Warren, a professor of law at Harvard, called for a Financial Product Safety Commission, analogous to the Consumer Product Safety Commission. She argued that such an agency would protect consumers from risky financial products. But her voice was barely heard as well. In contrast, the loud voices of credit card companies were amplified through large political contributions and influential lobbying groups such as the American Bankers Association.

The power of the credit card industry was apparent in the Fair Credit Reporting Act of 2004. The Act limited the ability of states to regulate the practices of credit card companies. By way of background, the industry has channeled most of its political contributions at the federal level. Yet many of the efforts at regulatory control of credit card debt, such as usury laws, emanate from the states. States sought to impose tighter restrictions on credit card companies as outrage increased about high interest rates and fees. The entire financial industry, including credit card companies, banks, trade associations, automobile finance companies, mortgage companies, and insurance companies, all lobbied for permanent restrictions on state authority to enact laws favoring borrowers. The Fair Credit Reporting Act prevents states from imposing usury and fees limits. This means, for example, that consumers in California cannot ask their state's legislators for stronger protection from lenders than the protections specified in the laws of South Dakota and Delaware where lenders are based. The language of fairness is central in the regulatory process, and it is in the name of the Act, the Fair Credit Reporting Act. But while

the Act was 'fair' to lending institutions, it was not as fair to borrowers.

The role of regulatory agencies in the regulatory process conforms to capture theory. One of the major agencies regulating the credit card industry is the Office of the in Conptroller of the Currency (OCC). The OCC actively supported the industry's lobbying efforts for the Fair Credit Reporting Act. In 2003, the OCC asserted that the National Bank Act gives it the power to exempt national banks and their nonbank subsidiaries from state laws used to address predatory mortgage lending. In 2004, the OCC finalized a rule which spelled out its expansive view of its rights of preemption. In 2005, the conptroller declared that New York State's attorney general (first Eliot Spitzer and then his successor, Andrew Cuomo) could not investigate national banks that were suspected of violating state laws against racial discrimination in lending because federal law gives the OCC the power to enforce state laws applying to national banks.

Consumer groups argued that the OCC has been captured by the industry, doing its bidding. For example, PIRG consistently criticized the OCC for failing to respond appropriately to consumer complaints about credit card abuses, and for not providing meaningful federal protection to substitute for the state protection which the Fair Credit Reporting Act prevents. In April 2009, the State of New York argued against OCC's position in court (Cuomo v. Clearing House Association). House Financial Services Committee Chairman Barney Frank, Democrat from Massachusetts, signed on as a friend-of-the-court brief supporting Cuomo. He was quoted in the press saying: "The problem was that they pre-empted state laws and put nothing in their place." Another amicus brief in the Cuomo case, filed by a group of state attorneys general, stated: "As subprime mortgage lending abuses became epidemic, the OCC and other banking regulators were criticized for their slow response" (See Kosterlitz, 2009).

The OCC is not the only regulatory agency accused of being captured by the industry. So is the Office of Thrift Supervision (OTS) which oversees depository institutions and whose focus is savings and home purchases. An investigation by the Treasury's inspector general indicated that OTS allowed some thrift institutions to backdate capital infusions on their quarterly financial statements.

Capture theory applied in full force to bank regulation because there is a patchwork of federal and state financial regulators who compete with one another. Banks and other depository institutions can choose to operate under one of several federal and state charters. State banking departments, the Federal Reserve Board, the OCC, and the OTS compete with one another to attract banks under their authority. When the OCC attempted to restrict lending it deemed imprudent, some banks chose to amend their charters to be regulated by the OTS instead. The OCC and other regulatory agencies have strong incentives to be captured by bank and serve their interests if they are to retain, if not expand, their jurisdictions.

The political balance changed in 2007 when the Democratic Party gained control of the House of Representatives. Representative Barney Frank, chairman of the House Financial Services Committee, was highly critical of the Federal Reserve for neglecting consumer protection. In the Senate, the Permanent Subcommittee on Investigations, chaired by Carl Levin, worked to expose industry-wide credit card abuses.

The temperature of the credit card regulatory iron soared in 2008 as the financial crisis and associated recession fanned public outrage at credit card companies. Barney Frank began an effort to reverse the impact of the Fair Credit Reporting Act and return consumer protection regulatory powers

to the states. Advocates for consumer protection joined forces in 2009 to enact the Credit Card Accountability, Responsibility and Disclosure Act.

4 Insider trading regulations and regulation fair disclosure

Insider trading regulations and regulation FD (Fair Disclosure) exemplify the importance of political leadership in mobilizing the intense but isolated fires of outrage of many individuals into a combined intense fire which can counter the fire of corporations and Wall Street and shape regulatory irons.

Haddock and Macey (1987) developed a capture-theory based model to explain the existence of insider trading regulations. In their model there are two interest groups, corporate executives and Wall Street professionals, such as investment bankers. Haddock and Macey noted that each group is cohesive and well-organized "when compared with ordinary shareholders, not to mention the general public." (p. 314). Therefore, only the interests of executives and investment bankers matter in determining regulations. If executives are prohibited from using their inside information, the group standing first in line to receive it, for free, are investment bankers. It is no wonder then that investment bankers and other Wall Street professionals have an interest in prohibiting insider trading. But what is in it for corporate executives who are now forced to give away for free their valuable inside information? According to Haddock and Macey executives receive as compensation from investment bankers the benefits of the Williams Act which forces investment bankers and other bidders in hostile takeovers to reveal their intentions well before they have accumulated enough shares for a successful takeover. Executives are most interested in their jobs while investment professionals are most interested in inside information. Thus a bargain is struck between the two groups where each gets what is most valuable to it.

The Haddock and Macey story, however, is not complete since individual shareholders and the general public can be mobilized into a powerful interest group under good leadership, illustrating the crucial role of politics in the regulatory process. William Cary proved to be such a leader when he initiated insider trading regulations, and Arthur Levitt proved to be such a leader when he initiated Regulation FD (Fair Disclosure). We begin with insider trading regulations.

Trades by corporate officials possessing inside information were not regarded as fraudulent when the Securities Act and the Securities Exchange Act were passed in the 1930s. But William Cary, who was appointed Chairman of the SEC in 1961, soon wrote the decision *In re Cady, Roberts, and Co.*, where the SEC first contended that insider trading constitutes federal securities fraud. In this case, a stockbroker was selling stocks after being tipped by a director of the Curtiss-Wright Corporation that the company was about to reduce its dividend.

Cary believed strongly that insider trading is unfair, but this was not his only reason for acting to make insider trading illegal. Cary understood that dependence on funding from Congress and the executive branch placed the SEC in a precarious position and sought to use insider trading laws to mobilize public support for the SEC and, through it, gain support from Congress and the executive branch. In *Politics and Regulatory Agencies*, Cary (1967) wrote that "government regulatory agencies are stepchildren whose custody is contested by both Congress and the Executive, but without much affection from either one… Without the cooperation of both Congress and the Executive, little constructive can be achieved. To reemphasize the point, an agency is literally helpless if either branch is uninterested or unwilling to lend support." Langevoort (1999) wrote that "One reason why insider trading regulation takes on such prominence in contemporary securities enforcement is its seemingly unique

ability to interest the public and hence operate as a vehicle for the SEC to seek both visibility and support for its mission. Insider trading stories are wonderful drama: When they involve the rich and famous like Ivan Boesky and Michael Milken, they tap into images of power, greed, and hubris…" (p. 1329)

Arthur Levitt, Chairman of the SEC from 1993 to 2001 mobilized the public more directly than William Cary. Levitt's signature accomplishment is Regulation FD (Fair Disclosure) which compels corporate executives to release information to everyone simultaneously rather than leave the general public in an information dark while favored Wall Street few receive, in essence, inside information. Levitt was passionate about his desire to "Take on the Street" on behalf of individual investors and chose these words as the title of his memoir. But Levitt (2002) understood his weakness in the contest with corporations and Wall Street. He wrote "The vast and growing number of individual investors…lacked focus, direction, or leadership to make much of an impression on Washington policy makers. I often wondered how to empower this expanding group that cut across economic, ethnic, and political lines. I knew that politicians, no matter where they were located on the political spectrum, understood the power of the people and would respond favorably to policy proposals if millions of investors supported them. Promoting the interests of the average investor made good policy sense, but it also made political sense." (p. 13)

Levitt recounted the great pressure against Regulation FD from Wall Street. "As I walked to the SEC's public room… an aide rushed to hand me a pink message slip. Hank Paulson is trying to reach you from China. He strongly urges you to vote no." Levitt noted his reaction: "While the timing of the call from Paulson, the chairman of the investment bank Goldman Sachs Group, was a surprise, the message wasn't. He and the rest of the securities industry thought I was about to apply the executioner's noose to Wall Street's way of life." (p. 87)

Levitt understood the power of the language of fairness and chose the name Regulation Fair Disclosure to appeal to the public and "make our opponents think twice about fighting it." (p. 93) The SEC received more than six thousand comments on the proposed regulation, almost uniformly negative from the industry and almost uniformly positive from the public, and Regulation FD was enacted.

5 Banking regulations

The Riegle-Neal Act illustrates how changes in technology, such as the availability of automatic teller machines, and changing economic conditions, such as bank failures in the 1980s, fan the fires that heat regulatory irons and facilitate their shaping.

The Riegle-Neal Interstate Banking and Branching Efficiency Act, implemented in June 1997, permits banks to establish branches and buy other banks across the country. Jayaratne and Strahan (1997) wrote that the Act capped a quarter century of efforts to gain such permission. No state allowed out-of-state bank holding companies to buy in-state banks before 1975, but by 1990 all states but one allowed out-of-state bank holding companies to buy in-state banks, and all but three states allowed statewide branching. The Riegle-Neal Act removes the remaining restrictions.

States began imposing restrictions on branching in the nineteenth century. Such restrictions were justified in part by the argument that allowing banks to branch within a state and especially out of state could give strong banks excessive financial power. Weak banks supported these restrictions because they limited competition and state governments supported them because restriction gave them power over the supply of bank

charters. A few states allowed branching after 1975 and in the mid-1980s, the Office of the Comptroller of the Currency allowed nationally chartered banks to branch in some areas, introducing statewide branching. Kane (1996) suggested that bank failures in the 1980s taught the public that large banks might have advantages. Kroszner and Strahan (1997) suggested that the introduction of new technologies, such as automated teller machines and money market funds, reduced the effectiveness of restrictions on branching and interstate banking. Jayaratne and Strahan also noted that "new information technologies diminished the value of the specialized knowledge that long-established local bankers might have had about the risks of borrowers in the community. This change enhanced the ability of banks to lend in more distant markets." They found that banks performed more efficiently when they were permitted to operate statewide branch networks and to build multi-state bank holding companies. Bank borrowers paid lower loan rates and banks did a better job distinguishing good borrows from borrowers likely to default. Writing in 1997, not long after the Riegle-Neal Act was enacted, Jayaratne and Strahan argued that the Act "may produce benefits similar to those achieved through state deregulation — reduced bank costs, lower loan rates, and accelerated economic growth." They cautioned, however, that "[w]hether there is additional room for improved efficiency through the process of selection remains to be seen." We know now, from the vantage point of 2009, that the Riegle-Neal Act was not an unmitigated blessing and that banks which are 'too big to fail' can precipitate a collapse of the entire financial system.

The banking arena offers an illustration of the need for a fast strike at a hot regulatory iron. Public outrage against banks over the disastrous consequences of credit-default swaps and other derivatives in 2008 and 2009 mobilized the public in a drive toward stricter banking regulations. But as Morgenson and Van Natta (2009) wrote: "Even in crisis, banks dig in for battle against regulation." They noted that in November 2008 the nine biggest participants in the derivatives market, including JP Morgan Chase and Goldman Sachs, created a lobbying organization, the CDS Consortium, to counter the expected attempt to rein in credit default swaps and other derivatives.

Morgenson and Van Natta added that "To oversee the consortium's push, lobbying records show, the banks hired a longtime Washington power broker who previously helped fend off derivatives regulation: Edward J. Rosen, a partner at the law firm Cleary Gottlieb Steen & Hamilton." They added that "Mr. Rosen's confidential memo…recommended that the biggest participants in the derivatives market should continue to be overseen by the Federal Reserve Board. Critics say the Fed has been an overly friendly regulator, which is why big banks favor it."

6 Trading halts, global settlement, and SOX

A comparison of events in the aftermath of the Crash of 1987 and in the aftermath of the Crash of 2000 illustrates the importance of finding an iron which is truly hot rather than lukewarm, and striking while hot. The fire of public outrage must be sufficiently hot and long lasting to bring about major regulatory changes. The fire in the aftermath of the 2000 crash was hot, but the fire in the aftermath of the 1987 was merely lukewarm.

The battle in the aftermath of the Crash of 1987 was waged between two interest groups, the New York Stock Exchange (NYSE) and the Chicago Mercantile Exchange (CME). It centered on program trading. But the program trading iron was lukewarm and the quick recovery from the 1987 crash afforded little time to strike it. The stock market surpassed its pre-crash level by 1989. In contrast, the Crash of 2000 heated the regulatory iron to a

very high temperature and the iron remained hot for a long time.

Stock market participation was more widespread in 2000 than in 1987, bolstered by 401(k) and similar investment programs, and the public was outraged by the substantial losses in their portfolios. The stock market did not reach its bottom until early 2003, and while the DJIA and S&P 500 Index surpassed their pre-crash levels several years later, before their recent dip, the NASDAQ has never come close to its pre-crash level.

Two groups of villains were clearly visible after the Crash of 2000. The first consisted of investment companies and researchers who praised stocks in public communications as they sold stocks to individual investors, while denigrating the same stocks in private messages. The second consisted of corporate executives who issued misleading accounting statements. The battle in the aftermath of the 1987 Crash resulted in rules for trading halts on the NYSE, a relatively small change when compared with the Global Settlement and the Sarbanes-Oxley (SOX) regulations in the aftermath of the 2000 Crash. We begin in 1987.

Trading halt are temporary interruptions of the normal course of trading. The original justification for such halts was "to prevent fraudulent, deceptive, or manipulative acts or practices." (See Loss and Seligman, 1989). Debates about trading halts were renewed in the wake of the 1987 Crash as the NYSE blamed the Crash on 'program trading' facilitated by the CME. Traders sought to profit from discrepancies between stock prices on the NYSE and futures prices on the CME through program trading, buying the relatively cheap and selling the relatively expensive. Traders who wanted to rid themselves quickly of stocks during the Crash of 1987 sold futures contracts on the S&P 500 Index at the CME. The resulting relatively low price of futures made it profitable to buy futures at the CME and sell stocks on the NYSE. The NYSE 'specialist' market making system was not well adapted to the fast pace of program trading. Specialists suffered substantial losses during the Crash of 1987 and some went bankrupt. It is little wonder that the NYSE wanted to slow the pace of trading through trading halts on both the NYSE and the CME.

To investigate the role of program trading, the NYSE formed a blue-ribbon panel on market volatility and investor confidence, headed by Roger Smith, former chairman of General Motors. Trading halts in the form of 'circuit breakers' were implemented on the NYSE, but the NYSE failed in its attempt to extend them to the CME. The NYSE report contains two clues to NYSE's failure. First, the program-trading iron was never very hot. A survey included in the report showed that investors placed program trading and index futures and options trading at the bottom of their list of concerns. Their first concern was the honesty and ethics of stock brokers, followed by interest rates, inflation, and insider trading. (p. B1-23). Second, even if the program trading iron were hot, it was never hot long enough for a good strike. The NYSE report was completed only in May 1990 and published in June. By then, the stock market recovered from its 1987 losses.

The iron of the Crash of 2000 was hotter than the iron of the Crash of 1987 and it remained hot longer, long enough for the enactment of the Global Settlement and SOX. The Global Settlement involved investment companies and SOX involved corporations.

The Global Settlement centered on the conflicts of interest between the investment banking and research sections of investment companies such as Merrill Lynch and Salomon Smith Barney. The conflict involved pressure on researchers to issue flattering appraisals of companies so investment bankers might snag their business. A joint press release by the State of New York Attorney General,

the SEC, the NASD, NYSE, and NASSA on April 28, 2003 described some of these conflicts:

"Bear Stearns, CSFB, Goldman, Lehman, Merrill Lynch, Piper Jaffray, SSB and UBS Warburg issued research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies, and/or contained opinions for which there were no reasonable bases…
"UBS Warburg and Piper Jaffray received payments for research without disclosing such payments …"
"CSFB and SSB engaged in inappropriate spinning of "hot" Initial Public Offering (IPO) allocations in violation of SRO rules requiring adherence to high business standards and just and equitable principles of trade…"

The Global Settlement included approximately $1.4 billion in disgorgement, penalties, and money to promote investor education. It also mandated changes in structure and conduct, including physical separation of research and investment banking departments and a prohibition of analyst efforts to solicit investment banking business or analyst compensation based on the success of investment bankers.

The Global Settlement illustrates the necessity of an iron which is hot enough for a long enough period if change in regulation is to be accomplished. It also illustrates the crucial role of politicians who are willing and able to strike that iron. Eliot Spitzer, the then Democrat Attorney General of New York was that person, initiating legal proceedings against investment companies. The SEC was by then under a Republican administration, effectively captured by investment companies and reluctant to join in Spitzer's actions. It joined only later, forced by public outrage. The Global Settlement was one regulatory change prompted and facilitated by the Crash of 2000, and SOX was the other.

Prior to the passage of the Securities Exchange Act of 1934, companies whose securities traded on exchanges were not required to release financial statements to investors. Investors accepted the statements of companies in the spirit of *caveat emptor*. The passage of the 1934 Act, mandating quarterly financial statements submitted to the SEC, and annual audits of financial statements by accounting firms, reflects the change in political environment as Franklin D. Roosevelt assumed the Presidency, the economy in the form of the Great Depression, and financial markets in the form of the 1929 Crash and subsequent plunges in the stock market.

Several regulatory institutions and standards developed during the following year such as the Financial Accounting Standards Board (FASB) and generally accepted accounting principles (GAAP). The effectiveness of these institutions was called into question after a series of high profile accounting frauds came to light following the Crash of 2000, such as those at Cendant, Enron, WorldCom, and Healthsouth.

The widely publicized accounting frauds kindled public outrage. The iron was hot and Congress struck it, enacting the Sarbanes-Oxley Act of 2002 (SOX). SOX mandates higher proportions of independent directors on corporate boards. It mandates that board audit committees include at least one financial expert. And it encourages independent directors to meet separately from management on a regular basis.

SOX consists of several sections (See Jahmani and Dowling, 2008). Section 302 of SOX stipulates that the SEC require the chief executive officer and chief financial officer of every publicly traded firm certify, under oath, the veracity of their companies' financial statements. Section 401 stipulates that all material off-balance sheet transactions and relationships with unconsolidated entities which can have economic effects on the company be disclosed in

quarterly and annual reports. Section 403 stipulates that any transaction involving management or principal stockholders be disclosed by the second business day of the transaction. Section 404 stipulates that management issue a statement in each annual report on its responsibility for the company's internal control structure along with an assessment of the effectiveness of those controls. Section 404 also stipulates that the company's auditor attest to management's assessment in accordance with the Public Company Accounting Oversight Board (PCAOB) which oversees accounting firms.

Whether the net benefit from SOX has been positive is a subject of some controversy, illustrating the more general observation that it is difficult to strike the iron with the right force, especially when the right force is obvious only in hindsight. In hindsight, a strike might turn out to be too forceful even in the eyes of those who struck it.

Defenders of SOX point to its benefits, such as increased information stemming from improved internal controls and greater activity on the part of boards and audit committees. Critics of SOX point to its costs, especially the costs associated with Section 404. The SEC's initial estimate for the average annual cost of complying with Section 404 of SOX was $91,000. In the first year SOX became effective the actual costs for companies whose market capitalization exceeded $700 million were higher by a factor of 80, averaging $7.3 million. For smaller companies, actual costs were 16 times the initial estimate.

Defenders of SOX argue that compliance costs would decline over time, as companies put their compliance systems in place. Critics counter-argue that although costs did decline, the rate of decline was less than initially estimated, and that the first-year cost was exceedingly high. Moreover they pointed to the disproportionate impact of costs on smaller companies.

Critics of Section 404 do not deny its benefits, but instead argue that its requirements have not been carried out well such that it costs exceeded its benefits not only at the margin, as required to achieve a regulatory optimum, but in total and by a large amount. Critics' main concern had been with what was known as Auditing Standard No. 2 ("AS2"), which the PCAOB adopted and the SEC approved. AS2 placed an exceedingly low threshold for detecting fraud, thereby causing auditors to focus their examinations on fraud stemming from events that are rare and remote. Critics of 404 likened AS2 to a medical system which routinely runs exceedingly expensive diagnostic tests to minimize the probability of misdiagnosis.[3]

Accounting firms are one interest group and they had at least three reasons to favor the adoption of SOX's strict standards. First is the opportunity to restore trust in accounting firms which have failed to detect major frauds at corporations such as Enron and WorldCom. Second is the shift in responsibility and liability for detecting fraud from accounting firms to corporations. Third is the enhanced profitability of accounting firm which comes from extra mandated audits.

The public did not complain about SOX. However, industry executives complained loudly, pointing not only to the direct costs of implementing it but also the indirect costs associated with the diversion of time and attention away from business operations.

The political environment changed in 2006 as the SEC was chaired by Christopher Cox who favored looser regulations. The PCAOB began to rewrite AS2 as AS5, which it adopted in April 2007. AS5 was shortened by a third and its definition of problematic events and their probabilities has been changed. For example, AS5 replaced the term "more than remote" used to describe the probability of fraud with "reasonable possibility." AS5 also dropped the requirement that auditors issue an

opinion on whether management's assessment of its internal controls was fairly stated. Management only needs to issue an opinion about whether the internal controls are effective. AS5 also removed the disproportionate impact of 404 on smaller companies. In July 2007 the SEC approved AS5.

7 Descriptions of hot irons and prescriptions

Our approach so far has been descriptive, focusing on how capture theory and notions of fairness combine to describe the shaping of regulatory irons over time. Here we offer some prescriptions. By their nature, prescriptions are subjective, reflecting values and beliefs as much as they reflect facts. Therefore, we make explicit our own ranking of fairness rights, aware that our ranking is not shared by all.

We rank high the fairness rights of equal processing power and freedom from impulse. This places us in the paternalistic camp, away from the libertarian one. We see people who are beset by imperfect processing power which leads them away from the fine print about high fees to be imposed when they go over their credit card limits, and we see people who lack the self control necessary to avoid racking up more credit card debt than they can afford. Libertarians believe that the responsibility for reading print, even if fine, always rests with each of us, and that internal self-control debates about whether to buy cars and houses we cannot afford is a debate left for each of us to resolve. We believe that there are times when we should have paternalistic protection from ourselves, protection provided by governments and civic organizations.

We also rank high the right to equal bargaining power. Bankers have more power than the general public and we believe that governments and civic organizations should restrain those with much power, and empower those with little. We do share some, but not all, of the libertarians' high ranking of the right to freedom from coercion. Restraining bankers from employing high leverage violates their right to freedom from coercion. However, using public money to bail out bankers who have employed high leverage violates the public's right to be free from coercion. We see a need to violate the right to freedom from coercion in some circumstances, especially where one's freedom from coercion threatens another's freedom from coercion.

The dynamic nature of the hot-iron framework assures that there will be future changes in regulations, slow at times and swift at others. The changes in the shapes of regulations would continue to be affected by changes financial markets and the economy and changes in distributions of political power, technological change, and social norms. This suggests that moves toward stringent regulations following the current crisis are likely to be followed by looser regulations.

Our prescriptions are similar to those of Elizabeth Warren, expressed in Rather (2009). Warren noted that a financial crisis, including a credit squeeze, accompanied the 1792 crisis, the first economic crisis in U.S. history. Major financial crises occurred every 15 to 20 years between 1792 and 1929. The Crash of 1929 and the following Great Depression heated regulatory irons to extremely high temperatures, facilitating strikes that changed their shapes radically, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Glass-Steagall Act which separated commercial and investment banking. No major financial crises occurred between 1934 and the 1980s that were comparable in scale to those occurring before the Great Depression.

However, in 1980 the savings and loan (S&L) industry started to strike regulatory irons into shapes that suited it. Between 1980 and 1985 the Federal Home Loan Bank Board which regulated S&Ls reduced net worth requirements for insured S&L institutions, removed limits on the amounts of brokered deposits an S&L could hold, and permitted lax accounting standards. Moreover, the

regulatory and supervisory staff of the Bank Board declined at the time. These changes occurred during a time of dramatic growth in the S&L industry. Many S&Ls invested in ventures that were low in quality and high in risk. Indeed some of the most problematic S&Ls were able to exploit the weak regulatory structure to portray themselves as being very sound and extremely profitable. The end result was a financial crisis in the second half of the 1980s, requiring the government to step in and restructure the industry at a cost to U.S. taxpayers of about $150 billion.[4]

Deregulation continued during the subsequent decade with the passage of the Gramm-Leach-Bliley Act in 1999. This Act not only allowed commercial banks, securities firms, and insurers to compete against each other directly as financial supermarkets, but fragmented regulatory oversight so that no regulator had a comprehensive picture of each company. In 2000, Congress passed the Commodity Futures Modernization Act, which effectively left the derivatives market without regulatory oversight. In additions to legislation which weakened regulation, the effectiveness of agencies, such as the SEC, were compromised through a combination of budgetary pressures and political leadership which sought to constrain its reach.

We see that the financial services industry wields the biggest hammers shaping regulatory irons most of the time, until crisis ensues, turning some of these hammers into the hands of the general public. For this reason we favor strong regulations and urge policy makers to strike while the regulatory iron is hot. In June 2009, President Obama proposed a broad new regulatory framework for financial markets, emphasizing a centralized structure for oversight, with the Federal Reserve Bank playing a central role. Among the other proposals is the creation of a consumer protection agency, suggested by Elizabeth Warren. We endorse this regulatory framework.

The SEC's Division of Enforcement Management is in the process of developing a plan to restructure its approach through five new specialized units. These units would focus on investment companies (including hedge funds and private equity firms), market abuses, complex derivatives, the municipal securities market, and bribery issues in foreign countries involving U.S. companies. We support the general thrust of the SEC's plan.

Almost all of the changes in the SEC plan are reactions to the current crisis. As with the S&L crisis, these events involved large investments in securities with poor quality and high risk. Regulatory weakness, as with the S&L crisis, stemmed from a combination of deregulatory legislation and low budgets of regulatory agencies.

It took several decades for the regulatory iron to heat up. It is hot now. Politicians and regulators can shape it well if they have the will to wield their hammers high and strike the iron forcefully.

8 Conclusion

'Do not waste a crisis' has become the rallying cry in 2009 as the Obama administration and Congress are working hard and fast to change structures and regulations ranging from health care to finance. A crisis is a hot iron which must be struck fast with heavy hammers before its heat evaporates and its potential wasted.

Changes in regulations can advance efficiency and fairness, but not all do. Politicians often make mistakes in setting regulations, hitting the iron too softly or too hard. Public outrage often prompts regulations that are overly stringent, diminishing economic activity and some aspects of fairness. Public indifference allows regulations that are excessively loose. Uncertainty about the future makes it difficult to identify and enact the best regulations.

We have illustrated regulatory dynamics and the role of financial, economic, political, legal, and

technological environments in credit card regulations, bank regulations, insider trading regulations, Regulation FD, trading halt regulations, the Global Settlement, and the Sarbanes-Oxley Act. These dynamics are evident as we write. Paletta (2009) noted in late July 2009 that "The effort to revamp financial regulation has lost considerable momentum since it was proposed in June, despite President Barack Obama's call for quick action. It has been hindered by political and industry criticism and overshadowed by a larger political debate over health care. It has also ignited a turf war between federal agencies that stand to gain or lose significant authority."[5] (p. A4)

Notes

[1] In late 2009, this particular situation began to change in an important way. Chase introduced a major new program to provide cardholders with the kind of information critics had asked for, such as how informing cardholders about the length of time it will take them to pay off their balance in full, if they choose to make only the minimum monthly payment. This information is part of a wider offering of website tools to help cardholders manage their credit card debt, and improve other aspects of their financial planning. These changes relate to the notion of fairness defined relative to information processing power.

[2] http://www.whitehouse.gov/videos/2009/May/20090522_Credit_Card_Reform.mp4

[3] See Grunfest and Bochner (2007) for a discussion about the benefit-to-cost ratio of SOX 404. See Hirshleifer (2008) for a general argument about excessive regulation.

[4] The $150 billion is according to the National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE). See Black (2005).

[5] http://online.wsj.com/article/SB124844131710678963.html

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