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TO MARKET, TO MARKET

Now the SEC and other securities regulators will get busy.

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What's in store for securities regulation? A lot.

The Madoff scandal—a giant fraud of sophisticated investors, based on profound and nearly unimaginable breaches of trust—closed the books on 2008. And Madoff is connected to the biggest financial crisis since the Great Depression, a crisis that has already led to the demise of Bear Stearns, Lehman Brothers, Merrill Lynch, Wachovia, and Washington Mutual. As we now know, the crisis was caused in meaningful part by large investments in poorly understood financial products. Many have asked, "Where were the regulators?" The Obama administration will be expected to supply answers and fixes.

First on the front line will be the Securities and Exchange Commission, an agency facing more than its share of public embarrassments. Even though statistics show the SEC's Enforcement Division bringing more actions in recent years (574 in 2006, 655 in 2007), other data tell a different story. Recent congressional hearings have highlighted the drop-off in criminal securities fraud prosecutions, large enforcement cases, and number of enforcement personnel. Especially damaging to the SEC's public image has been a series of critical reports issued by Congress and the commission's inspector general.

But the Madoff affair may be the final nail in the coffin. The SEC's failure to discover Bernard Madoff's multibillion-dollar Ponzi scheme has led to more investigations by Congress and the inspector general. It has also led no less a personage than 7th Circuit Judge Richard Posner to write in his blog: "It is beginning to seem likely that there will be an ambitious reorganization of the financial regulatory system. In the course of that reorganization, the SEC may be abolished. If so, Bernard Madoff and [Bush SEC Chairman] Christopher Cox can share the credit."

All of this has not gone unnoticed by Barack Obama. The new president has put financial regulatory reform on the very top of his agenda. And he wants to move fast. His aides have told the press they hope to have the beginnings of a new regulatory regime ready to present on April 2, when the G-20 (Group of Twenty Finance Ministers and Central Bank Governors) convenes in London.

Three key appointments personify the kind of changes ahead: Experienced regulator Mary Schapiro will lead the SEC, reformer Gary Gensler will run the Commodity Futures Trading Commission, and big thinker Cass Sunstein heads to the Office of Information and Regulatory Affairs to change the world.

What then can we expect to see out of the Obama administration? Here are three stages to watch: immediate efforts, especially in the enforcement area; regulatory reform a little further down the road, such as merging of the SEC and the CFTC; and structural change in the long term.

ENFORCE, ENFORCE, ENFORCE

The first change is among the simplest, offers the most hope for a near-immediate effect, and has already occurred: the appointment of Schapiro as the next SEC chair. Most recently head of the Financial Industry Regulatory Authority, Schapiro has a deep regulatory and enforcement background, having previously served as an SEC commissioner, acting SEC chair, and CFTC chair. In the annals of securities oversight, this experience set is virtually unmatched; it means Schapiro understands the intricacies and nuances of the enforcement process like few others. As such, she has no learning curve and can be expected to quickly unleash an enforcement staff that has felt constrained by Bush-era policies.

On the other hand, some, like *Washington Post* business columnist Steven Pearlstein, have questioned whether she is an adequate change agent given the severity of the crisis,

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and others, like *The Wall Street Journal,* have asked whether she has been sufficiently aggressive on enforcement during her career.

In response, Schapiro promised senators at her Jan. 15 confirmation hearing that she will be "as aggressive an enforcer as anyone has ever been at the SEC" and that she wants to take the "handcuffs" off the Enforcement Division. She also said she would improve internal communications to prevent important items from falling through the cracks.

In the near term, expect Schapiro to eliminate internal procedural hurdles that have hampered enforcement. One likely at the top of the list is the penalty pre-authorization pilot program, a 2006 initiative that required enforcement staff to seek specific authority from the commissioners before trying to negotiate settlements with corporations. That hurdle, as newly confirmed SEC Commissioner Luis Aguilar noted in a Jan. 10 speech, has increased the staff's review burdens, subjected the staff's recommendations to needless micromanagement, and tied up resources that could be used to bring other cases.

A re-energized SEC staff will likely launch varied enforcement initiatives at a rapid pace. New cases will probably focus on issues at or near the center of the financial crisis. They will look at such matters as whether companies accurately disclosed the value of declining assets, whether risk assessments by third parties were appropriate (credit ratings agencies are a probable target), and whether investment risks were properly disclosed to investors.

COMING TOGETHER

After the enforcement efforts roll out, expect to see reforms aimed at what Columbia Law professor John Coffee recently described as the "highly fragmented and arguably Balkanized structure of financial regulation." One idea that seems to have garnered substantial support is a merger of the SEC and the CFTC. This would bring securities and derivatives, including options and swaps, under the jurisdiction of one agency.

Schapiro is especially well-qualified to make such a consolidation work. Given her long history at the SEC and the CFTC, the staffs at both agencies should feel in good hands during the transition.

Gary Gensler as head of the CFTC will fill a different kind of role. Gensler has no history with that agency and few ties to vested interests that might favor retention of the CFTC in its current form. But he does have a history with sweeping reform: As a Treasury official in the Clinton administration, he played a significant role in the industry-changing repeal of the Glass-Steagall Act, the Depression-era law that prohibited bank holding companies from owning other financial entities.

A combined SEC-CFTC would likely be renamed and tasked with investor protection as its primary mission. The enforcement staffs from the two agencies would be combined into a single group authorized by Congress to investigate virtually any kind of financial product or practice that might affect investor confidence. Given the need to inspire renewed faith in financial regulation, such a reorganization would likely be accompanied by enforcement initiatives far broader than we have seen to date.

ROOT CAUSES

The Obama administration is also acutely aware that it must cut to the root causes of the financial crisis, likely through regulation more sweeping in scope than the Enron-inspired Sarbanes-Oxley Act. In recognition that unregulated and lightly regulated financial products exacerbated the crisis, Schapiro testified at her confirmation hearing that all systemically important financial products and systems need to come under the regulatory umbrella, with no gaps.

For instance, there will be a push to federally regulate the activities of mortgage brokers—now subject to limited state or local oversight—who are perceived to be among the key facilitators of the subprime meltdown. And expect to see calls for federal regulation of the insurance industry—a lesson learned from the $150 billion bailout of AIG. But such measures may well encounter fierce resistance from those at the state and local levels who have historically regulated in these areas.

Also expect federal regulation of such unregulated financial products as credit default swaps and collateralized debt obligations. This concept is hardly new. In 1998 then-CFTC Chair Brooksley Born called for the regulation of private derivative contracts, presciently warning they could "pose a grave danger to our economy." But Congress in 2000 exempted such contracts from regulation. The market for credit default swaps and collateralized debt obligations thereafter swelled nearly six times in size. Now, even outgoing SEC Chair Cox has called for credit default swaps and other products to be "brought immediately into the regulatory framework."

Hedge fund registration—the subject of a 2004 SEC rule struck down by the U.S. Court of Appeals for the D.C. Circuit in 2006—is another key intermediate-range fix. Here, too, the Madoff scandal provides inspiration. Although it was apparently little more than an old-style Ponzi scheme, it swept in a variety of players at all levels of investing sophistication. Indeed, Madoff may be used as justification for a range of new regulatory initiatives aimed at hitherto unregulated areas, intended to detect and prevent the next "Madoff scheme."

A NEW FRWAMEWORK

The Sunstein appointment portends even bigger changes ahead. A renowned law-and-economics scholar most recently at Harvard Law School, Sunstein will be running the Office of Information and Regulatory Affairs, the unit within the Office of Management and Budget that oversees the federal regulatory process. As an academic outsider with "big picture" ideas, he will likely weigh in on such sweeping questions as: Given what we've been through, how should the government more effectively regulate the financial system?

Also over the longer term, expect new federal agencies undertaking new tasks or old tasks now the responsibility

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of other agencies. For instance, beyond a combined SEC-CFTC entity focused on investor protection, the Obama administration may want to establish a new entity to oversee market regulation and risk management. Calls for separate securities enforcement and regulatory entities have come from various quarters, including acting CFTC Chair Walter Lukken (he favors a "systemic risk regulator" focused on the kind of risks that could trigger another crisis) and Columbia professor Joseph Stiglitz, a former chair of the Council of Economic Advisers (he wants a "financial products safety commission" to evaluate unregulated financial products). Freeing the enforcement agency from other market regulatory functions would emphasize the message that the Obama administration means business on enforcement.

And finally, in all its financial regulatory efforts, the Obama administration will be emphasizing transparency, for good reason. It is the lack of transparency that led to the massive crisis of confidence that continues to ripple through our financial system. Only when parties in business transactions once again trust each other—a trust born out of transparent dealings—can we expect the crisis to end.

The good news is that change is coming. The bad news is that, for many, it did not come soon enough.

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