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THE RIGHT WAY TO REGULATE FROM BEHIND

BY FRANK PARTNOY*

Frank Partnoy argues that financial regulators inevitably will "regulate from behind," but could do better. Partnoy proposes that we move to an ex post regulatory approach coupled with enforcement in order to account for the extremely complex and rapidly changing financial market. He advocates for open-ended standards, and greater coordination between securities and financial regulators. Additionally, Partnoy suggests that allowing voluntary disclosures, increasing criminal prosecutions, and lessening the mental state needed for conviction of financial crimes will lead to more effective regulation of the financial marketplace. In conclusion, he argues that future financial regulation would be more useful if subjected to a slower, more thoughtful deliberation process.

In his remarks for this symposium, Judge Sporkin argued that the Securities and Exchange Commission should no longer permit the financial industry to "do anything they want, and only stop them when they have gone so far as to bring about a financial crisis."¹ In other words, the SEC should not "regulate from behind."

I want to offer a friendly amendment to Judge Sporkin's remarks by focusing on two important regulatory distinctions and trends. First is the crucially important distinction between ex ante regulation (often based on rules) and ex post adjudication (often based on standards). Second is the distinction based on the twin pillars of the historical approach to securities regulation: between disclosure and enforcement.

My argument is that both securities and other financial regulators inevitably will "regulate from behind," but could do so better. Regulators have fallen behind – and regulation has been ineffective, and even counterproductive – in significant part because they have

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emphasized an ex ante approach and disclosure, instead of an ex post approach and enforcement. Policy makers should reverse this course.

One of the primary reasons the SEC and other financial regulators have favored an ex ante approach and disclosure is financial innovation and complexity. The assumption is that market participants need specific rules in order to conduct modern financial business and further that the most important regulatory objectives can be achieved if material information and risks are disclosed. However, because modern financial instruments and strategies are so complex, market participants have a significant informational advantage over regulators. Moreover, to the extent rules apply to particular products, private parties use regulatory arbitrage transactions to avoid rules. Disclosure requirements alone will not lead parties to reveal material information, and information alone is not sufficient to create adequate knowledge of risks among regulators and investors. Given this complexity and behavior, the SEC cannot keep pace and inevitably will fall behind.

I will not attempt to be comprehensive with respect to all or any of these issues, but hopefully I can sketch out enough of an argument to provide a useful roadmap for future thinking and research. In general, market regulation has been moving from ex post adjudication to ex ante rulemaking, with an emphasis on disclosure over enforcement. There also has been a fracture between securities and other financial regulation, with little useful coordination. The remedies are apparent: legislators and regulators should embrace ex post adjudication and be skeptical of the potential for ex ante rulemaking; likewise, they should embrace enforcement as a key objective and become less sanguine about disclosure as a cure-all. Finally, additional coordination is needed between securities and other financial regulation, and various government actors need to consider regulatory overlap and competition more than they currently do.

First, one lesson from the recent wave of financial innovation is that specifying securities disclosure rules in advance can be both ineffectual and dangerous. As the system of securities disclosure has become more complex, it has led to the generation of less useful information. Jesse Eisinger and I recently attempted to demonstrate this simultaneous complexity and lack of transparency as applied to financial institutions in our Atlantic cover story, What's Inside
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America’s Banks.2

We showed, as a preliminary matter, that trust in banks has declined even as the amount of disclosure has increased.3 Ex ante disclosure rules generate huge swaths of information, yet that information does not include descriptions of the most important risks and financial variables. The result is a lack of trust. According to various surveys and polls, a substantial majority of both individual investors and sophisticated institutional investors do not trust major banks. Even five years after the crisis, bank financial statements and footnotes remain opaque.

Eisinger and I sought to demonstrate this opacity by looking in detail at one bank.4 Instead of taking on the relatively straightforward task of critiquing JPMorgan, Goldman Sachs, or Morgan Stanley—the more “sophisticated” and complex financial institutions—we decided to examine the apparently most conservative of the major financial institutions, the one Warren Buffett owns eight percent of, the one where I have a checking and savings account: Wells Fargo.5

Our journey was a Dante-esque decent into hell. We found, among other things, that Wells Fargo has a huge derivatives portfolio and earns substantial yet poorly described profits from trading activities of various kinds. The bank makes huge profits from what it calls “customer accommodation trades,” which include, among other things, trading based on “expected customer flow” (their words not ours). Perhaps some of the offsetting derivatives trades that are part of customer accommodation are hedges, but it is not possible to tell from the bank’s disclosures how much or to what extent. In any event, taking on exposure based on expectations about customers is probably not a conservative business.

Wells Fargo also reports substantial interests in Variable Interest Entities (VIEs) representing over a trillion dollars of assets. VIEs are the new versions of the Special Purpose Entities, step-cousins of the vehicles that brought down Enron. In addition, Wells Fargo has $53

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3. See id.
4. Id.
5. Id.
billion worth of Level 3 assets, those assets that are valued based on mathematical models and unobservable inputs. These instruments are incompletely described, and their valuations are dubious. Overall, Wells Fargo’s derivatives portfolio reflects more than a trillion dollars of off-balance sheet obligations.

Our examination of Wells Fargo illustrates how regulators have embraced a predominantly ex ante disclosure-oriented approach. Bank managers argue that their approach to risk and derivatives is fully compliant with securities regulation because it satisfies specific disclosure rules. But what if, instead of specifying in advance what banks should disclose, the SEC simply said that banks should disclose anything material and left it to the banks to figure out what to say? Would bank disclosures be any more opaque under such a regime? Might banks decide to disclose less information, but in a way that investors would find more useful?

Banks might insist they need ex ante rules, but given the amount of financial innovation, they will have incentives not only to influence ex ante rules through lobbying, but also to comply in ways that satisfy the letter of the rules and do not provide meaningful disclosure of important risks. Instead, consider a disclosure regime that attempted to harness the Holmesian definition of law as a prediction of what a judge will do. Imagine that the SEC instructed bankers to describe in ten pages of plain English what their risks are, including worst-case scenarios. That information is what sophisticated investors want to know in any event and, interestingly, some bank executives might prefer to make these more limited disclosures instead of being bound by the more onerous extant disclosure regime (though no one bank would want to be a first mover; thus, regulatory “encouragement” would be necessary).

The robustness of such disclosures would then be assessed after-the-fact, either by regulators or judges as part of some kind of adjudicatory process. Instead of regulators attempting to comb through or comment on detailed disclosures in advance, an adjudicator would assess them later. The beauty of this approach is that the fact that the disclosures would be assessed later would be an information-forcing mechanism to incentivize bankers to try to imagine subsequent adjudication and then disclose the relevant facts that they believe would pass muster after-the-fact. Given the pace of financial innovation, this
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approach is more likely to lead to meaningful disclosure because it can internalize and reflect the preferences, expectations, and knowledge of bankers, and it can do so in a less resource-intensive way than detailed regulatory assessments in advance.

This after-the-fact proposal necessarily involves questions of enforcement. As a logical matter, enforcement is primarily done ex post, though to an increasingly common extent regulators are erecting ex ante hurdles designed to achieve enforcement objectives. Licensing and monitoring have not been particularly effective enforcement tools, even as they have become more common, and it is difficult to predict ex ante which individuals or institutions will become enforcement risks. Moreover, regulators’ attempts at early examination of reported violations has not been effective: consider the SEC’s inability to respond to reports about pyramid schemes or wide-ranging frauds, or the Office of the Comptroller of the Currency’s failure to spot risks, losses, and other problems at banks. Likewise, to the extent whistleblower regimes are likely to be effective, they will depend on how disputes are adjudicated ex post, not whether regulators have been able to specify the most suspicious areas in advance.

Perhaps the most important element of enforcement is criminal responsibility. Although federal prosecutors have cited numerous settlements during recent years, their enforcement priorities have been directed primarily at insider trading and relatively straightforward financial prosecutions. Critics continue to complain about the dearth of complex or difficult prosecutions, and the lack of arrests of senior officials for conduct at the core of the recent financial crisis. However one might measure criminal cases related to the crisis, there are either zero prosecutions of high-ranking bank officials or a very small number of such prosecutions. Looking back, complex financial crisis cases obviously were not a priority.

One concern with enforcement, and a reason prosecutors cite in declining to bring cases, is the difficulty of establishing the required criminal mental state beyond a reasonable doubt. One possible reform related to this concern would be to require only proof of recklessness for some financial crimes, instead of requiring proof of criminal intent. For example, Congress might adopt a new “mini-fraud” statute, with a lesser mens rea requirement and lesser jail time and/or fines. This mental state requirement might be in line with recklessness, which is a
required mental state for crimes in other substantive areas. The key question in such cases is what a defendant "should have known," not what the defendant actually knew.

Such a lesser mental state requirement might resurrect the approach of *United States v. Simon*,\(^6\) in which a standard is established in advance and then a wide umbrella of conduct is criminally proscribed by that standard, even though the precise boundaries of what is prohibited and what is not are not drawn in advance.\(^7\) Although some financial market participants might object to such a broad standard-based approach, it likely would pass constitutional scrutiny. Such a lesser mens rea requirement might be applied to areas such as market practice standards, fiduciary duties for broker-dealers, and some areas of the Dodd-Frank legislation. Instead of a lengthy rule writing and rulemaking process designed to specify what is illegal in advance, an applicable statute or regulation could simply have one sentence that essentially states that a specified category of conduct is illegal. Then, judges or regulators would decide whether particular conduct fell within the ambit of this category after the fact. Legislators or regulators might provide some guidance in advance, perhaps with hypothetical cases, as in the *Restatement of Laws*.

Essentially, the idea is to explore returning, as much as possible, to a regime of common law. There are numerous new areas of financial market practice where this kind of approach might be preferable to establishing detailed rules in advance. (This is particularly true if future rulemaking will be subject to a detailed scrutiny of cost-benefit analysis, including judicial assessment of that consideration based on *Business Roundtable*.\(^8\) Ex post assessment might more easily pass, or at least avoid, this kind of cost-benefit scrutiny.) For example, with the proliferation of structured notes being sold to retail investors, the SEC might consider new rules designed to require disclosure and impose specific standards, such as suitability. But alternatively, the SEC might simply shelve rulemaking in this area and instead bring a few enforcement cases against the sellers of structured notes. Through the


\(^7\) *Id.*

\(^8\) *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (striking down the proxy access rule giving certain shareholders access to the corporate proxy on the grounds that the SEC’s cost-benefit analysis fell short of the statutorily mandated standard).
adjudication of these cases, regulators—and judges—might establish new ex post standards to govern not only the conduct of the actors in those cases, but other future actors as well.

Similar conclusions apply to financial regulation outside of the securities area. Here, the ex ante regulatory approach is hugely complicated and deeply broken. For example, the notion of net capital requirements remains seriously flawed. The idea of banks tweaking their risk-weighted asset models in response to new Basel requirements is itself troubling. Consider the recent survey by the Basel committee, which asked fifteen different institutions to examine a hypothetical group of assets and determine a valuation for those assets.9 The valuation spread was a factor of eight. In other words, some bank managers said the specified assets were worth eight times what other managers said they were worth. Simply put, bankers game these kinds of ex ante rules. Instead of identifying specific rules in advance, financial regulators should adopt some sort of a common sense standard that holds across the board for these uses of models internally. It would hold for “value at risk” measures as well. In terms of financial disclosure, gaming goes on with respect to risk-weighted assets, and the idea is to get away from the ex ante specificity of rules and instead move in the direction of ex post vagueness. Business people do not like vagueness, but the regulation of complex finance requires a greater degree of vagueness.

As one final example, consider the Volcker rule.10 Imagine if, instead of trying to specify what constitutes “proprietary trading” through an advance rulemaking, Congress instead had adopted a different version of the Volcker rule as just one sentence: “Banks are not permitted to engage in proprietary trading.” Then, adjudicators would decide later what that sentence means and whether particular conduct fits within the rule’s scope. One advantage to this common law-style process is that it would minimize the influence of lobbying and short-term politics. Instead, the development of the meaning of the rule would take place slowly, over the course of years, as both market

participants and regulators came to define the details of what it means to engage in "proprietary trading" as the borders of the rule evolved and were tweaked over time.

A similar conclusion holds for worst-case scenario analysis. Having banks articulate and understand worst-case scenario analysis is an important part of disclosure. Investors want boards of directors to grapple with questions about risk management, including what risks could cause the institution to incur massive losses. Bank risk managers could be required to engage in something like what the psychologist Gary Klein has called a "pre-mortem," to try to isolate what factors might lead to a bank's hypothetical collapse.¹¹ (Some banks engage in this sort of thinking, but many do not.) What if a bank's directors and officers were required, once a year, to envision that their institution has become insolvent, and ask the hard question about how that might have happened? Then, they could describe those possibilities to the public, so that investors would have a better sense of the bank's risk profile. If boards needed assistance in understanding these risks, perhaps because bank managers are overly optimistic or are reluctant to describe the bank's downside potential, directors might elect to receive annual presentations from those individuals and institutions that hold the largest short positions in their stock. Short sellers might provide bank boards with useful information they otherwise would not receive, and then they could incorporate that information, with whatever degree of skepticism is appropriate, into their "pre-mortem" assessments.

Ultimately, the optimal financial regulatory approach must involve some degree of private action and ordering, particularly by the boards of financial institutions. The question is not merely regulatory, but is also one of corporate governance. A handful of courts have recognized that boards are subject to heightened duties when making decisions about and/or monitoring financial risks. These courts understood a fundamental and crucial point: that financial risk is different from other aspects of corporate governance. However, the Delaware Chancery Court decision in the Citigroup derivative case rejected that approach and instead held Citigroup's board to a lax standard of liability for risk-related decisions and monitoring.¹² Future


cases will give judges an opportunity to determine if the earlier cases were the correct approach, or whether they should follow \textit{Citigroup}. If future courts recognize that financial risk presents a unique question for boards, then the jurisprudence might evolve to hold that boards need to be sufficiently aware of risks and have engaged in adequate risk management activities in order to satisfy their \textit{Caremark} monitoring duties.\textsuperscript{13} Ideally, judges who understand financial risk will reject \textit{Citigroup} and adduce a board's monitoring of financial risk more critically after the fact, thus returning to the Holmesian notion of what law is.

Given that I have recently published a book called \textit{WAIT: The Art and Science of Delay},\textsuperscript{14} I cannot resist concluding by mentioning the importance of timing with respect to all of these issues: we do not need to reach any conclusions now, or even anytime soon. I hope what we all will do in response to this symposium is take some time to wait, and think. If you have been nodding and thinking that something I have said is right, resist that. Or if you have been thinking what I've suggested is entirely or in part foolish, resist that as well. Instead, take a month and just think about all these issues. Decide later. Our decision making in the financial context would be better if everyone—Congress, regulators, bankers, and investors—took longer to consider the relevant issues, and if we all avoided the crush of technology and the temptation to make quick decisions and reactions.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{13} \textit{Id.}
\item \textsuperscript{14} \textsc{Frank Partnoy}, \textit{WAIT: The Art and Science of Delay} (2012).
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