

Wall Street Might Make Hot Air Look Like Change

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MARCH 27, 2008

Bloomberg.Com - It took them long enough, but it looks like U.S. politicians have finally noticed that something is very wrong with the way the financial industry is regulated.

It's time for more regulation, said Barney Frank, the Massachusetts congressman and chairman of the House Financial Services Committee, in a speech last week.

Yesterday, Treasury Secretary Henry Paulson chimed in, saying his department will soon release a proposal for regulatory revision.

Thank goodness, you say. Finally, we might fix a regulatory system that lets securities firms be their own cops (self-regulation); lets Wall Street firms run their own courts (mandatory arbitration) and allows hedge funds and other huge traders to engage in business without so much as filing a form with the Securities and Exchange Commission.

It may have taken the near-meltdown of Bear Stearns Cos., the nation's fifth-largest securities firm. But we're on the right track now.

Or are we?

The securities industry won't give up its permissive regulatory environment easily, but it might find a way to let the public and politicians believe that an overhaul would come without really giving up much. Frank, for example, proposed the idea of a new mega-regulator. It sounds good on the surface, but opens an opportunity for brokerage firms to rid themselves of oversight by individual states, who often are the only effective cops on the block.

Art of the Deal

The stakes are high, so expect the industry to be artful in finding ways to address today's alarm without getting stuck with permanent strictures.

If you're looking for change, be wary of proposals for tougher rules that disappear when the crisis is over. In a speech yesterday to the U.S. Chamber of Commerce, Paulson said he'd expect that "non banks," such as Bear Stearns, be "as transparent as possible" in disclosing information to the Federal Reserve if they borrow from the central bank in an emergency.

What he didn't say is whether that transparency would endure when the crisis ends. Temporary rules that let brokerage firms lose the battle but win the war are just the sort of solution Wall Street will go for.

If it all sounds too cynical, consider this: Until panic set in, the business community was issuing studies that said regulation was a problem alright -- we had too much of it. The only uproar from Wall Street has been over a would-be crisis of too many rules that were allowing foreign competitors to steal U.S. market share. The supposed problem: financial firms that are based overseas are more lax about regulation. Ergo, the U.S. should be even more lax.

Fund Regulations

William F. Galvin, secretary of the Commonwealth of Massachusetts, says the financial crisis requires "urgent action" by regulators, including a focus on unregulated hedge funds. We're getting action, but it isn't of the sort that Galvin is hoping for.

Regulators and business have instead been pushing a philosophy known as principles-based regulation, in which overarching principles would trump specific rules in many cases. The strategy may provide just the semantic sleight of hand that gives the public assurances that problems are being addressed while giving financial firms wiggle room for business as usual.

The Financial Industry Regulatory Authority, or Finra, is revising its rules for brokerage-industry members and considering the principles approach. And Paulson has advocated that principles be used in efforts to modernize the U.S. financial system so that it can be more competitive around the globe.

Follow the Principles

The principles philosophy, though, amounts to little more than "rhetorical blunderbuss intended precisely to reduce or eliminate regulation and control," says Lawrence A. Cunningham, professor of law at George Washington School of Law in Washington. He points out that a report in 2006 by the Committee on Capital Markets Regulation, known as the Paulson Report, promotes a principles-based system when it helps securities firms dodge responsibility, while backing off from principles in cases where specific rules are to business's advantage.

For example, the report suggests that the SEC get more specific about what constitutes a violation of its fraud rules, Cunningham says. Isn't it a principle, though, when you say "Don't commit fraud"? The Paulson report is picking and choosing which principles it likes, Cunningham says.

And there's a practical aspect to consider, says Steven Caruso, a New York lawyer who represents investors. "If brokerage firms can't follow defined and specific rules, then how could they be expected to follow theoretical principles?" he asks.

'Real Bloodshed'

A better way to get the financial system back on course would be to regulate hedge funds, says Jacob Zamansky, a New York lawyer. They amount to a "shadow securities system" that can rock the markets yet avoid answering to the SEC.

While politicians and financial firms argue over the details of any new regulation, the current mess will take new forms, says Charles W. Austin Jr., a Richmond, Virginia, lawyer. He expects that some of the most-troubled securities involved in the mortgage meltdown will wind up in the portfolios of small investors.

"We're going to see real bloodshed among the people at the end of the sewer pipe," he says. Brokerage firms know "that all it takes is a few extra million in advertising dollars and a little time, and folks will be back at the slaughterhouse."

By then, we'll have a far better idea of what new regulations, if any, are in place. Don't hold your breath for the principles-based regulators to be waiting with tough rules that safeguard Wall Street's prey.money."