

iNET Conference on  
Finance and Society  
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I am delighted to participate in this iNET conference on Finance and Society, particularly because some of the other participants are women who have made a real difference in the oversight and regulation of the financial sector, which is still male-dominated. They have faced and overcome special challenges in their careers, and their achievements are especially notable.

A major issue facing the country today is whether we can structure a regulatory regime for our modern financial markets that adequately protects the financial system, the economy and the American people. Enactment of the Dodd Frank Act in 2010 was certainly a good first step toward doing so and the most significant financial regulatory reform since the Great Depression. However, despite the passage of almost five years, the jury is still out on whether Dodd Frank will be fully implemented and rigorously enforced. Also, it may well be that Dodd Frank did not go far enough to protect against another devastating financial crisis.

Why is fashioning this regulatory regime so important? The 2008 financial crisis demonstrated the catastrophic results of inadequate

business regulation in the financial sector. As documented in the report issued by the Financial Crisis Inquiry Commission on which I served, decades of deregulation and failure to regulate newly emerging financial markets, firms and products led to a financial system that was extremely fragile and vulnerable to a full blown crisis when the U.S. housing bubble collapsed in 2007 and 2008. The financial sector had poured billions of dollars into convincing federal policymakers of the need for such deregulation, supported by the fallacious beliefs--championed notably by Alan Greenspan--that financial markets are self-regulating and that financial firms are able to police themselves. As found by the FCIC, the resulting failures in financial regulation and supervision, along with failures of corporate governance and risk management at major financial firms, were the prime causes of the crisis.

I am concerned that the political and financial power of our largest financial institutions continues to be an obstacle to effective regulatory reform. Some of these firms are larger and control more resources than ever because of mergers and concentration resulting from the crisis. The financial sector continues to be the largest source of federal campaign contributions and reportedly fielded five lobbyists per

member of Congress during its Dodd Frank deliberations. As Senator Dick Durbin of Illinois said at that time, “[T]he banks . . . are still the most powerful lobby on Capitol Hill. And they frankly own the place.” (Huffington Post, Dick Durbin: Banks “Frankly Own the Place”, 5/30/09.) They used their political power to weaken, eliminate or create exceptions to many provisions of Dodd Frank.

The esoteric and complex nature of the markets, products and institutions makes it difficult for policymakers and the public to fully appreciate and understand the need for and likely impact and implications of various types of regulation. And of course, the financial sector’s officials, lobbyists, lawyers, economists, accountants and public relations firms dominate the discussion of these issues.

Since Dodd Frank’s enactment, financial services firms have continued to resist effective reform, pouring enormous resources into challenging agency action implementing its provisions by delaying the issuance of regulations, watering down the terms of the regulations issued and contesting regulations in court. It is no wonder that after five years some important regulations under the Act have not yet been adopted, let alone implemented and enforced.

And the statute itself may be in danger. In December one or more of our largest banks used political power to get Congress to adopt a repeal of the derivatives push-out provision of the Act, a provision designed to protect against risky derivatives transactions by banks with government-insured deposits. Many fear this is the first step in a broad-based industry effort to repeal important protections of the Act.

The power and influence of the financial sector threatens a continuation of the regulatory capture that contributed to the financial crisis. Financial firms too often have significant say in the appointment of high federal regulatory officials. The tendency of some former federal officials to obtain highly lucrative positions in the financial sector after leaving government may well act as an inducement to those remaining in government to serve the interests of the financial sector rather than the public. Moreover, financial sector pressure has restricted the amount of appropriations for the SEC and the CFTC and thus limited the agencies' ability to exercise their new regulatory powers

Furthermore, there has been little accountability imposed on the firms, their executives and their boards of directors in the wake of the financial crisis. The crisis was caused in large part by reckless behavior and significant failures in corporate governance by our largest financial

institutions. A number of them were bailed out with government funds with limited repercussions for their management. The crisis also involved what may have been the most pervasive investor fraud in history in the sale of mortgage-backed securities and CDOs without adequate disclosure of the poor quality of the underlying mortgages. While civil penalties have been imposed on some firms, there have been virtually no criminal prosecutions of institutions, and responsible officers and employees have faced few prosecutions or civil penalties. Investors, homeowners and taxpayers have been left to bear the major brunt of the financial crisis.

It is clear that the problems with the financial sector are not behind us. Since the enactment of Dodd Frank, we have seen many egregious examples of fraud, manipulation and other illegal or reckless behavior on the part of financial institutions. They have been involved in significant price manipulations of interest rates and foreign exchange markets. We have recently learned of allegations that high frequency trading in S&P futures was used to manipulate the securities markets during the 2010 flash crash. Large financial institutions have been involved in significant cases of currency fraud and aiding money laundering and tax evasion. With respect to derivatives trading, JP

Morgan lost \$6 billion through the speculative trading of the London whale, and both MF Global and Peregrine Financial went bankrupt after allegedly engaging in misappropriation of customer funds.

In light of all this, we must ask ourselves whether the financial and political power of our largest financial institutions poses a threat to policy making on financial regulation and seriously undercuts the administration of justice. In my view, these institutions continue to be too big and interconnected to be allowed to fail without serious repercussions for the financial system and the economy as a whole, despite provisions in Dodd Frank meant to alleviate this problem. They are also arguably too large and complex to be susceptible to meaningful management, supervision or regulation.

Let me comment briefly on the current state of regulation of the over-the-counter or OTC derivatives market. Dodd Frank gave the Commodity Futures Trading Commission an enormous new responsibility to impose regulation on this previously unregulated market, which is currently estimated to be \$400 trillion in notional amount in the US and almost \$700 trillion globally. The CFTC has performed a Herculean task in finalizing more than 50 new rules required by the Act. It still has some significant work to do, including

establishing position limits, as well as fully implementing and enforcing the rules already adopted.

The jury is still out on whether the regulatory regime under Dodd Frank will be adequate to address the dangers of this market, which contributed significantly to the financial crisis by helping to fuel the housing bubble and amplifying and spreading the losses when the bubble collapsed. The Act provides for centralized clearing by regulated clearing operations, thus reducing counterparty credit risk such as that caused by AIG's threatened default during the financial crisis. It also provides for trading of cleared derivatives on regulated exchanges or swaps execution facilities, which should provide essential price discovery and government oversight for fraud and manipulation.

However, because Dodd Frank expressly provides for some significant exemptions from clearing and exchange trading, a substantial portion of the market will likely remain over-the-counter. For example, under authority in the Act, the Secretary of the Treasury exempted foreign exchange swaps from Dodd Frank requirements. As I noted earlier, since that exemption was adopted, there have been revelations of massive price manipulation and fraud in that market. In addition, swaps transactions by commercial entities for hedging purposes are

expressly exempt from clearing and exchange trading, and indeed such entities will not even be required to post margin on their uncleared transactions. So a significant portion of the US market will not have the very important protections of central clearing, exchange trading and margin requirements.

New rules under Dodd Frank governing this remaining OTC market are intended to reduce its risks. OTC derivatives dealers will have to meet minimum capital and collateral requirements and will be subject to business conduct rules. Swap data repositories will facilitate transparency and government surveillance, and the Act forbids fraud, manipulation and excessive speculation. Whether the continuing OTC market will be adequately regulated under this new regime remains to be seen.

The OTC derivatives market is a truly global market, and many of the firms involved in the market have worldwide operations. While there has been international consensus that central clearing and exchange trading are essential to protect the financial system, most other countries have not yet adopted laws implementing those requirements. It is essential for the US to work closely with other



sovereign states to ensure the cooperation, coordination and harmonization needed for effective oversight of this global market.

While the task is not easy, it is imperative that we keep working on improving and implementing our regulatory regime. We must muster the political will to do so in order to try to mitigate the impact of future financial crises. The American public deserves no less.