

# DMACommentary

by David E. McClean  
David E. McClean & Associates // DMA

January 7, 2009

## What Regulators Should Do Now

During the past several years, we have witnessed many scandals and abuses in and by corporate America and, more specifically, “Wall Street” – that catch-all label for the financial services industry. One hears many demands for “more regulation” in the wake of these scandals and abuses. But what is needed isn’t necessarily *more* regulation, but rather targeted regulation that speaks to the specific issues that lead to scandal and the less sensational abuses of investor and public trust. What follows are four specific regulatory reforms that can be implemented quickly (by mid-2009), and implemented without very much cost or difficulty.

**Regulation of Hedge Fund Managers.** A few years ago, the courts vacated a new SEC rule that required many hedge fund managers to register with the SEC, leading many hedge fund managers that registered under the rule to de-register (and become, once again, largely unregulated). This was because the SEC had exceeded its authority in the way it drafted the rule. However, it is not in the public interest that no new rules to regulate these powerful market players have been proposed since then. Hedge fund regulation (whether regulation of the funds themselves or the managers of the funds) will serve to set a tone of accountability in what is now an industry separate and apart from the mutual fund industry, which is *highly* regulated.

The burdens imposed under the vacated rule were not onerous, and the public (via the SEC staff) would get some transparency regarding the activities of hedge funds and their managers if a similar rule were introduced today. Many hedge fund managers do not have a problem with at least some regulation, and their investors most certainly would prefer regulation. So what is the hold up? How is it that a “mom and pop” investment advisory business that manages (merely) tens of millions of dollars has to register with the SEC, yet investment advisers that manage billions or tens of billions of dollars are able to avoid registration altogether? Of course, there are technical answers to these questions. But they are answers that defy logic when public policy considerations are included in the discussion.

**Codes of Ethics for Brokerages.** Brokerages (a.k.a. investment banks and broker-dealers), unlike their registered investment adviser cousins (which manage mutual funds and (some) hedge funds), are not required to have codes of ethics. This is curious, given the number of significant client abuses that take place in the securities brokerage industry each year.

While brokerages may weave ethics education into their professional education initiatives, there is no requirement that they do so. So not only don’t brokerages have mandated codes of ethics, they don’t

have mandated ethics education or training either. Given the transaction-based compensation model (pay-per-trade) that is still in place (a model that has been criticized, sharply, by such industry leaders as John Bogle and Arthur Levitt), the fact that brokers, investment bankers and many research analysts are not held to a written standard of conduct by the firms they work for is scandalous in itself. True, codes of ethics are no panacea (Enron had one), yet they set a tone and some established policies regarding conduct, beyond mere compliance, and actual ethics education would serve as a reminder that certain conduct will not be tolerated.

In addition, brokerages should have Chief Ethics Officers who report directly to (and give recommendations to) the top executive or board of directors (preferably the latter). This should be an office separate and apart from other “Chief” officer positions. Such would allow for an independent hand in reviewing and critiquing firm practices from a purely ethical perspective. The Chief Ethics Officer and Chief Compliance Officer would work in tandem to oversee firm conduct and head-off (not just remedy) abuses.

**Credit Default Swaps.** In addition to the need for clearing houses for these contracts (already in the works, although there are some false starts), market players, and banks and brokerages in particular, should be required to index to capital the insurance protection they are offering. Firms should not be permitted to write whatever level of protection (insurance) they want to without having to look over their shoulders at their capital positions. The reason that they would not want such indexing to capital has to do with the enormous profits (premiums) they receive from “writing” protection. Indexing to capital will limit those profits. It will also help to reduce the risk that tail events, such as what developed in 2006-2008, will not cause the ruin of large and important institutions. As we have come to appreciate (I hope), that has to matter more than short-term profits.

**Risk and Compliance.** Finally, senior risk and compliance officers must be given more autonomy and authority within banks and brokerages – autonomy and authority that will permit them to report their concerns directly to the board of directors (if there is one), without interference from business units. Risk officers, in many cases, have a kind of presumed authority in firms, but often get out-manuevered by production personnel (traders, mostly) who live and die by short-term results. Chief Risk Officers should have the authority to shut-down or wind-down trading strategies or market exposures that they believe place the firm at risk in the long-term. This means that these professionals should be “off the desk” – not unduly influenced by the demands (and sometimes ravings) of traders and other producers in the firm. Also, there should be a rebalancing, as shift of emphasis from quantitative risk measures toward qualitative ones (such as conflicts of interest, dubious reporting lines, poorly established authority among business unit personnel, and subjective, professional assessments of conditions that are not captured by quantitative risk models. This means moving toward an Enterprise Risk approach, and away from a mere portfolio risk approach.

There should be a rebalancing , a shift of emphasis from quantitative risk measures toward qualitative ones

These four changes in regulation should be accompanied by a new round of soul-searching among American business executives, and Wall Street executives in particular. For that to happen, they need to understand that there is a tie that binds business to civics – a tie that many (although not all) have been too blind to see.

Copyright © David E. McClean, 2009. All Rights Reserved. [www.dmaconsultinggroup.net](http://www.dmaconsultinggroup.net). Tel.: (516) 680-6630.