CORRUPT OR COLLABORATIVE?

An Assessment of Regulatory Capture

CFA Institute

compliance risk concepts

CFA Institute

CORRUPT OR COLLABORATIVE?

An Assessment of Regulatory Capture

CFA Institute is the global association of investment professionals that sets the standards for professional excellence. We are a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community.

Our mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

ISBN: 978-1-942713-28-9
July 2016

Contents

Executive Summary

Regulatory capture refers to the corruption of the regulatory process such that the public good is sacrificed in favor of the commercial interests of the regulated entity. The global financial crisis of 2008 reignited questions about whether regulation of the financial markets had been compromised, or "captured." CFA Institute wanted to assess practitioner perspectives on the degree of any such capture, with a view to understanding where the regulatory process might be strengthened.

Study Design

The study comprised a series of structured conversations regarding regulatory capture and regulatory conflicts of interest in the financial industry, specifically relating to large banks, broker/dealers, and investment advisers globally. We sought to interview those with functional responsibilities close to the regulatory process, including some of the leading global regulators, CEOs, chief compliance officers, general counsels, and chief risk officers in the United States, Canada, the United Kingdom, and Asia. To encourage maximum candor from those we contacted, CFA Institute retained outside consultants with deep knowledge of the regulatory and compliance process to conduct the interviews and promised that responses would not be for attribution and that interviewees would not be identified either to CFA Institute or in this report.

The Potential for Regulatory Capture

Interaction between regulators and the financial industry reflects the asymmetric character of the industry, in that industry participants have more information than either clients or regulators. As a result, necessary dependencies exist between regulators and firms, dictating a high degree of interaction between regulatory staff and firm staff in order for regulatory mandates to be fulfilled. It is difficult to objectively characterize these relationships as being either essential or corruptive to the public good, although it is easy to understand how the appearance of some of these relationships creates public doubt as to the integrity of the regulatory process. This effect suggests a need for regular examination of standards of conduct that govern how firms and regulators interact and who has access to information about those interactions.

Summary

The majority of those we spoke with do not believe that regulatory capture exists as a persistent or harmful feature of the regulatory landscape. Interviewees did not offer many examples of the diversion of public interests in favor of industry priorities through corruption of the regulatory process. There is more agreement about the appearance of corruption. Especially in the United States, participants expressed a significant sense that political influence from the legislative branch of the government, rather than direct industry influence on regulators, exerts increasingly outsized pressure on financial services regulation.

Most interviewees acknowledged that personal relationships between the regulatory and industry staff involved in a regulatory interaction are important. But they also cited the quality and rigor of the arguments as an important factor in influencing regulatory decisions.

Those we interviewed believe that conflicts of interest between regulators and firms are mitigated by procedures adopted by both the industry and regulators. Despite the potential appearance of conflict of interest, the practitioners and regulators we spoke with are in general agreement that more interaction leads to better regulatory outcomes, perhaps in recognition of the inherent asymmetry of information between financial services firms and their clients and regulators. Many of those we spoke with believe that in the years since the global financial crisis, the tendency has been toward less collaborative relationships between firms and those who regulate them, at least in part because of suspicions that the crisis was evidence of corruption of the public interest.

Suggested Response to the Comprehensive Findings

We find the idea of constructive interaction between regulators and industry personnel to be compelling as a factor in effective regulation. We also acknowledge that many such interactions create either the appearance of a conflict of interest or actual divergent interests that can compromise regulatory effectiveness and public confidence in the integrity of the system. Accordingly, we suggest the following actions in response to the study's findings:

- The conflict-of-interest policies of regulators should be reviewed regularly, and exceptions to these policies should be granted infrequently.
- Regulated firms should supplement existing conflict-of-interest policies with language that specifically addresses interactions with regulators.

- Regulators and firms should continue ethics training that develops meaningful ethical "muscle memory" and that includes a section on appropriate interaction between regulators and firms.
- Regulators and firms should endeavor to provide more transparency in their interactions for public consumption. Audio or video recordings of interactions should be maintained as part of the public record.
- Regulators should be recognized as professionals with compensation that reflects the complexity of their task and the opportunity costs of a career in public service. Appropriate compensation will attract and retain qualified experts with fewer incentives to seek opportunities outside of government.

Overview

Since the financial crisis of 2008, numerous commentators in the media and academia, as well as elected officials, have remarked that the crisis was brought on by regulations developed during a long period in which deregulatory initiatives were in favor. These commentators have suggested that deregulation was a result of regulatory capture, an economic theory that suggests "regulation is acquired by the [regulated] industry and is designed and operated primarily for its benefit" (p. 3).[1] Moreover, popular opinion holds that subsequent efforts to "fix" the regulation of financial services have been ineffectual or imperfect.

CFA Institute sought to examine perceptions of regulatory capture by soliciting feedback from an international cross section of the financial services industry—incorporating buy- and sell-side professionals, including chief compliance officers, general counsels, compliance consultants, and former regulators in North America, the United Kingdom, and Asia—on what could be done to mitigate the tendency toward regulatory capture. Although viewpoints differed on whether, or the degree to which, regulatory capture exists, interviewees expressed a concern that regulatory reforms and enhancements need to be developed in an environment of cooperation and compromise among elected officials, regulators, and industry professionals.

Since the financial crisis, journalists, academics, and populists have tended to view the tight relationships between the industry and regulators as partially responsible for the crisis. Industry professionals expressed concern about future interactions with regulators and offered a number of suggestions to reduce the perceived degree of influence that the

[1]George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, vol. 2, no. 1 (Spring 1971): 3–21.

industry may have on regulators. Notably, interviewees supported efforts (1) to enhance training at regulatory agencies to develop better institutional knowledge of the operations of and products offered by financial firms, (2) to enhance and increase industry ethics training, (3) to increase pay to encourage longer tenure for agency employees, and (4) to strengthen agencies' policies regarding ethics and conflicts of interest both during and after government service.

1. Regulatory Capture: Private Distortion of Public Purpose

"We have ideological and social capture of the top regulators. This is an issue that trumps what can be a model regulator at the bottom where the line people are quite competent, able and uncaptured, but the message from the top skews their effectiveness."[2]

"Some contend that it is the regulators' responsibility and fault that there was cheating on Libor. It is certainly the case that there was regulatory capture at work—that is, officials in Britain, the United States and perhaps elsewhere should have been paying closer attention. . . . The mystique of the financial sector wowed many people—including many prominent policy intellectuals, Democratic and Republican—in the years before 2008. But who does the capturing in regulatory capture? Big banks work long and hard and lobby at many levels to push regulators toward paying less attention."[3]

"A king has his retinue, a celebrity his entourage, and Pig-Pen his cloud of dirt. Washington has The Blob. The Blob (it's really called that) refers to the government entities that regulate the finance industry—like the Banking Committee, Treasury Department, and SEC—and the army of Wall Street representatives and lobbyists that continuously surrounds and permeates them. The Blob moves together. Its members are in constant contact by e-mail and phone. They dine, drink, and take vacations together. Not surprisingly, they frequently intermarry. Indeed, a good way to maximize your family income in DC is to specialize in financial issues and marry someone in The Blob."[4]

"Over the course of three decades, the concept of the government as an active player had been tarnished in the minds of the public and the civil servants . . . working inside the agency. . . . Regulatory capture is a psychological process in

[2]Steven Davidoff Solomon, "The Government's Elite and Regulatory Capture," *New York Times* (11 June 2010): http://dealbook.nytimes.com/2010/06/11/the-governments-elite-and-regulatory-capture/?_r=0.
[3]Simon Johnson, "The Market Has Spoken, and It Is Rigged," *New York Times* (12 July 2012): http://economix.blogs.nytimes.com/2012/07/12/the-market-has-spoken-and-it-is-rigged/.
[4]Jeff Connaughton, quoted in Noam Scheiber, "The Man Who Took on the Wall Street Blob," *New Republic* (9 September 2012): https://newrepublic.com/article/107074/ted-kaufman-man-who-took-wall-street-blob.

> which officials become increasingly gun shy in the face of criticism from their bosses, Congress, and the industry the agency is supposed to oversee. Leads aren't pursued. Cases are never opened. Wall Street executives are not forced to explain their actions."[5]

Is the regulatory process captured to the detriment of the public good? Or are the interactions between industry personnel and regulators specifically designed to ensure effective public policy that reflects a sophisticated understanding of a complex industry? Or does the current state of affairs represent some gray area between total corruption of the process and strong regulatory oversight? Because definitive answers to these questions are elusive to outside observers, we wanted to test the perceptions of finance practitioners close to the regulatory process.

An economic theory of regulatory capture was first proposed over four decades ago by George Stigler in his seminal work "The Theory of Economic Regulation,"[6] which offers alternative explanations for the causes and effects of regulation. Stigler examined the supply and demand of regulation and advanced the idea that firms desire and shape regulation to suit strategic interests, including creating barriers to competition. In the context of financial services, "regulatory capture" has come to mean the potential for the public interest to be diverted in favor of commercial interests that have undue influence on the regulatory process.

Since the global financial crisis, the media, academia, and elected officials have mostly viewed the interactions between financial regulators and the industry in a negative light, holding that pre-crisis rule making and light-touch regulation in principles-based regimes produced a regulatory environment that favored the industry. Law professor James Kwak,[7] for example, writes:

> Financial regulation, where different interest groups advance competing plausible conceptions of the public interest, is more likely to be the rule than the exception in regulatory policy. In this context, the key question is why agency policies generally ended up favoring the financial sector, with the outcomes we

[5]Jesse Eisinger, "Why Haven't Bankers Been Punished? Just Read These Insider SEC Emails," ProPublica (21 April 2016): www.propublica.org/article/why-havent-bankers-been-punished-just-read-these-insider-sec-emails?utm_source=pardot&utm_medium=email&utm_campaign=dailynewsletter.

[6]George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, vol. 2, no. 1 (Spring 1971): 3–21.

[7]James Kwak, "Cultural Capture and the Financial Crisis," in *Preventing Regulatory Capture: Special Interest Influence and How to Limit It*, edited by Daniel Carpenter and David A. Moss (New York: Cambridge University Press, 2014): 71–98.

> know too well—in other words, what mechanisms of influence enabled regulated industry to get its way. (p. 75)

In addition, a revolving-door phenomenon—which "shuffles former federal employees into jobs as lobbyists, consultants and strategists just as the door pulls former hired guns into government careers"[8]—has further raised suspicions about the integrity of the regulatory process.

Elected officials have a bully pulpit and can make provocative statements. US Senator Elizabeth Warren, for example, has said that "we need to demand that the Justice Department, our state Attorneys General, and federal regulators do more to push back on the big banks and their lobbyists."[9] The prospect of conflicted regulators has attracted media attention in the United States, reinforcing the perception that competing interests are tipping away from the public good.

The fact that regulators interact with the firms they are charged with overseeing does not prove that the process is captured, however. In a complicated industry like modern finance, which is characterized by asymmetry of information between firms and regulators, a good argument can be made that interaction and collaboration are necessary and desirable for good outcomes. In addition, many Western political systems are designed to allow commercial interests to have a voice in legislative and regulatory processes. Accordingly, given the design of the federal regulatory process for financial services in the United States, for any given rule or law, regulation falls somewhere along a spectrum between the public good and the interests of the industry. The situation is similar in the United Kingdom.

[8]The Center for Responsive Politics (www.opensecrets.org/revolving/; retrieved 23 December 2015).
[9]Elizabeth Warren, "Leveling the Playing Field" (http://elizabethwarren.com/issues/leveling-the-playing-field).

2. The View from Inside: Candid Conversations with the Industry

CFA Institute undertook this study of regulatory capture to understand the views of some of the most senior financial industry practitioners and regulators with regard to the integrity of regulation. Journalists, academics, and politicians have been provocative in their theories regarding regulatory capture, and we believe that providing an industry perspective could either substantiate or negate the existence of regulatory capture within the financial industry.

Study Design

Our objective was to have candid conversations with senior officials with practical knowledge of the regulation of large banks, broker/dealers, and investment advisers to discern whether and/or how the regulatory process has been captured by commercial interests. In recognition of the need for candor, CFA Institute retained Compliance Risk Concepts LLC (CRC) to conduct a series of structured interviews with regulators, CEOs, chief compliance officers, general counsels, and chief risk officers in the United States, Canada, the United Kingdom, and Asia. **Table 1** shows the distribution of those interviewed among buy-side, sell-side, and regulatory professionals for the regions studied.

CRC was chosen for its network of industry and regulatory contacts and to put deliberate distance between those interviewed and CFA Institute. CRC did not disclose to CFA Institute the identities of those interviewed beyond information related to each

Table 1. Distribution of Participants: Sell-Side, Regulatory, and Buy-Side Professionals

	Sell Side	Buy Side	Regulator
United States	18	11	12
Canada	1	0	2
Asia	6	6	3
United Kingdom	6	3	5

interviewee's country, type of business, and functional role. The interviews were conducted on a not-for-attribution basis. A total of 73 individuals were interviewed over the course of seven months in 2015.

Interview questions included the following:

> What are your views on regulatory capture generally, and to what extent do you think it occurs in the financial industry?
>
> In your experience, which of the following is the most useful when it comes to influencing regulators: seniority, relationships, or friendships?
>
> Please share any instances that you feel demonstrate and/or counter the notion of regulatory capture.
>
> What are your top recommendations for curbing regulatory capture, if necessary?
>
> To what extent are conflicts of interest an important component of the regulatory capture phenomenon? For example, describe your experiences with individual regulators and whether their focus seemed to be on enforcing and promoting regulation or on fostering a good relationship and personal reputation with the regulated entity.
>
> Please share any instances where regulatory conflicts of interest were apparent. What was the nature of the conflicts?
>
> Where there was an apparent conflict of interest, did it affect the regulatory decisions? Were there instances where conflicts of interest were dealt with directly and effectively to set proper boundaries?
>
> What are your top recommendations for improving how conflicts of interest are identified and dealt with?
>
> In your view, has the increased regulation of the investment industry been excessive or too weak? Given your view, what has been the impact on both the business and the public interest?
>
> Will the current regulatory environment be adequate for dealing with the next financial crisis?

What skills or competencies are you not seeing in regulators that you think are necessary?

Insights from Interviewees

"Politicians are captured by the industry, and in the United States, the system is completely corrupt. Banks give so much money to politicians, and of course, that has an effect on regulation. The connections between politicians and industry are very, very strong. If the banks don't get their way, they go directly to the politicians."

"To me, the most famous example of regulatory capture is the Volcker Rule, and every time it [Volcker] gets pushed off, it is capture."

"The SEC Equity Market Structure Advisory Committee and SEC working group composed of SEC and industry reps to help implement tick size pilot data requirements are examples of capture."

"Currently, an SEC pilot program for tick test on trading is an example of capture. The point is, there are senior people from the banking business who pushed this agenda with the SEC and now sit on this committee of industry participants. This will go into effect in October 2016."

"Capture is something we are always wondering about; it is wondered about and talked about, and it is extremely rare. Capture is something commentators and journalists discuss, but I don't find it something that I have dealt with."

"Capture is unavoidable because if you look at the principal of regulating, they must do so in a way that isn't unnecessarily burdensome on the industry. How would they know without speaking to someone in the industry?"

"I am more concerned about large companies within the industry influencing legislation and rules than smaller firms. Rules are crafted in a manner that minimizes the pain to the larger firm."

"Based on recent SEC enforcement actions, it is interesting that in smaller firms, individuals are more likely to get named."

> "Capture goes in cycles. I think when markets are good and everything is calm, regulators have a revolving-door policy and you really have friends in the street and you socialize with them. When things are calm, there is a tendency for regulatory capture. When things go bad, like in 2008, regulators are put under a microscope and then they react in an extreme manner."

Subject to Influence but Not Corrupt

Our interviews revealed wide acknowledgment of commercial influence on public policy, but only one interviewee believes that the industry or individuals have the ability to capture the regulators. Not a single interviewee could describe fully an incident of capture whereby an industry representative set out to corrupt the regulatory process by taking advantage of conflicted interests; more often mentioned were viewpoints of outsized influence based on regulatory outcomes. This finding would suggest that those closest to the process do not feel it is corrupt but rather see the results of varying degrees of industry influence on rules and regulations through legitimate channels.[10] As the saying goes, the squeaky wheel gets the grease. When we asked interviewees to identify specific instances of regulatory capture, several (from the United States, the United Kingdom, and Asia) singled out the Dodd–Frank Wall Street Reform and Consumer Protection Act and the Volcker Rule as instances in which they believed the industry had little or no influence over politicians or regulators and wound up with unworkable regulation. However, a single respondent pointedly remarked that Volcker is now chaotic precisely because the industry twisted it to such a degree that it is not workable. Most of the participants believe that the new capital requirements are mainly positive. Interviewees in Asia overwhelmingly pointed to the repeal of the Glass–Steagall Act as an example of regulatory capture. However, the repealing of Glass–Steagall could be an example of the democratic process in the United States and not capture. A handful of US interviewees believe that the Tick Size Pilot Program, the SEC Equity Market Structure Advisory Committee, and the loss of state bank charters might be instances of regulatory capture.

Professionals we spoke with believe that regulators, firms, and individuals within the financial services industry's regulatory regime have a high standard of ethics and integrity. We note that this view is in stark contrast to the public perception. For example, the 2016 Edelman Trust Barometer asked a sample of the informed public globally whether they

[10]A growing academic focus has been on "institutional corruption," in which legal means divert the public interest. For examples, see the Edmond J. Safra Research Lab website (http://ethics.harvard.edu/lab).

trust a variety of institutions to "do what is right": Only 51% trust government to do so, and just 51% trust the financial services industry to do what is right.[11]

Either the financial services industry suffers from a massive communication failure in which public perception is completely at odds with reality, or our interviewees resisted complete candor in defense of their own interests. Based on the conversations, we believe that the truth is somewhere in the middle. The financial services industry may not recognize the appearance of conflicted interests as having the damaging impact it does on public perceptions of integrity. But the financial industry is not completely rigged, as public intuition might have it. The inability to bridge the gap between public perception and industry self-awareness is itself dangerous and could harm faith in the societal purposes of capital markets, dissuade essential retirement investing, and inspire additional regulation that would create little marginal benefit.

A US Phenomenon?

Most interviewees in the United States noted the existence of cooperation or coordination, but not in the extreme, corruptive form that is portrayed in the media and by some politicians. Outside of the United States, those we spoke with are not as concerned about the potential for regulatory capture.

Interviewees in Asia noted that regulators tend to be career bureaucrats who remain at agencies and do not cycle through industry positions. They also stated that favorable regulatory pay structures, as well as Asian cultures, influence individuals to remain with a single employer. Interviewees in the United Kingdom believe the media's influence on politicians, as well as the financial industry, is so strong that regulatory capture is difficult to achieve. This version of the media as watchdog is different from the media's role in the United States, where it has been a force in diagnosing the problem but not in preempting it. In the United Kingdom, regulators are often transferred to financial institutions for training. Interviewees in Canada believe that cooperation is part of the process; the Canadian financial industry includes only a handful of substantial institutions, which regularly advise and consult with regulators. The interviewees do not perceive that interaction as capture.

US interviewees believe that the mechanisms for regulatory drafting and development encourage the participation of interest groups (from both the public and the industry), including such mechanisms as cross-functional working groups and the comment process

[11]Edelman, "2016 Edelman Trust Barometer Global Report" (2016): www.edelman.com/insights/intellectual-property/2016-edelman-trust-barometer/global-results/.

embedded in the rule proposal system. One individual went as far as to say that the interactions are necessary and that without such interactions, regulation serves little purpose. More than one interviewee in the United States remarked on the advantages (funds and manpower) that large firms have in influencing the regulatory process. It is difficult to characterize the rule-making process as capture when the democratic system is meant to give everyone a voice. However, the concern in the United States remains whether it is the best voice money can buy.

In the United States, the majority of participants believe that the regulatory process is most susceptible to influence through political pressures on the US Congress. Interviewees in other regions also focused more on politics than capture. But in the United Kingdom, the interviewees overwhelmingly believe that the industry has little to no ability to influence regulators. A counterpoint to this belief is that in the United Kingdom, as well as in the EU and Asia, there is more of a drive for the regulators to formulate regulations to assist the local industry in being globally competitive. All agree that the voice of the investor is generally underrepresented in nearly all markets.

Regulatory Structure Matters

Generally, the experience of the participants led them to state that self-regulatory organizations (SROs) and exchanges with regulatory responsibility are more susceptible to capture. SROs are financed by the industry, and exchanges are for profit. Several interviewees tend to think that prudential regulators and the SEC are the least susceptible, but a few participants think the Federal Reserve banks, the Office of the Comptroller of the Currency, and the SEC are susceptible.

Exerting Influence

When asked whether seniority, relationships, or friendships are most useful for industry professionals in influencing regulators, participants in all regions overwhelmingly cited relationships, often also mentioning seniority and credibility.

Several people noted that an individual's seniority within a financial institution plays some part in that person's ability to establish relationships with senior personnel within a regulatory agency. More important, however, is the ability of an individual to develop and maintain relationships and credibility; hence, those personal skills and experience are deemed most effective in influencing regulators.

Notably, most regulators did not respond to the question. One US regulator did respond with the following commentary:

> They are all important (seniority, relationships, and friendships); however, relationships should be most important and seniority or friendships shouldn't matter. I did see some improper influence. At times, friendships receive responses and meetings that otherwise wouldn't occur.

Another former US regulator stated, "Seniority or relationships; friendships are good and helpful for information, but senior relationships are what you need to effect change within the industry."

The notion that relationships are the strongest method of influence seems to be acknowledged by recent actions on the part of regulators. For example, New York Fed President William C. Dudley recently announced plans to have examiners spend less time onsite at the banks they supervise.[12] Several interviewees noted that many agencies, such as the Fed, rotate personnel to mitigate the potential for growing friendships to give rise to conflicts of interest that could facilitate capture.

Conflicts of Interest

A number of interviewees did focus on potential conflicts that arise as a result of the revolving-door phenomenon, whereby career regulators move to positions in the industry or industry practitioners serve on regulatory bodies and then return to the industry. It should be noted that many of the interviewees had been both regulators and industry employees. Interviewees endorsed the idea that regulatory agency personnel need actual business experience, noting that conflict-of-interest rules exist to mitigate the potential for conflicts. Some academics who have studied regulatory capture support this view. Law professor Lawrence G. Baxter, for example, notes:

> As both our need for expert regulators and the skill of regulators increase, the doors between regulators and the industry will spin faster. If we are to engage

[12]Ian Katz and Matthew Boesler, "Fed Weighs Steps to Prevent 'Regulatory Capture' by Banks," Bloomberg (20 April 2015):

www.bloomberg.com/news/articles/2015-04-20/fed-said-to-weigh-steps-to-prevent-regulatory-capture-by-banks.

> in technical regulation at all, this is not only unavoidable, but sometimes even desirable. (p. 197)[13]

In contrast to the concerns expressed by US and UK participants, one interviewee in Asia noted that regulators are paid very well there, have less incentive to enter industry, and thus tend to be career bureaucrats relatively free from conflicts of interest.

Participants were also asked to share and discuss any instances in their experience when a regulator's conflict of interest was apparent. Former regulators strongly defended what they characterized as strict mechanisms at agencies for preventing conflicts. Some of the examples they provided included supervisory processes, internal peer reviews, and look-back reviews of examinations performed by the Financial Industry Regulatory Authority (FINRA) when an employee on the examination team leaves to join a regulated firm. Overall, the former regulators seemed confident that current policies are sufficient and do not need changing. Former regulators did note that many senior regulators often seek to avoid conflicts by placing assets in blind trusts, even though agency rules do not require such actions.

Notwithstanding this confidence, one participant remarked, "You can still have bad apples even with the best of policies." An analysis done by the Project on Government Oversight revealed a high number of waivers granted for rules designed to mitigate the conflicts of interest posed by regulators who join the industry.[14] The existence of rules means very little if they are not applied consistently.

Industry professionals generally responded that they could not recall having encountered specific conflicts of interest. Consistent with these participants' focus on the political aspects of regulatory capture, they highlighted the fact that the US Congress lacks conflict-of-interest and insider-trading rules. Indeed, most industry experts we spoke with believe that in order for industry conflicts to be addressed more effectively, congressional conflicts relating to the industry should be addressed as well.

[13]Lawrence G. Baxter, "'Capture' in Financial Regulation: Can We Channel It toward the Common Good?" *Cornell Journal of Law and Public Policy*, vol. 21, no. 1 (Fall 2011): 175–200 (http://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=1353&context=cjlpp).

[14]Michael Smallberg, "SEC Alumni Help Firms Get a Break," Project on Government Oversight (11 February 2013): www.pogo.org/our-work/reports/2013/dangerous-liaisons/sec-alumni-help-firms-get-a-break.html.

Quality of Regulation

The interviewees were also asked whether the recent increase in regulation was excessive, misguided, or not well thought out. Of the participants who responded to this area of questioning, several, including former regulators and industry professionals, think that recent regulation has been excessive. By far, sell-side professionals were more effusive than buy-side participants in their view that regulation has been excessive. The examples of excessive rule making most often mentioned were Dodd–Frank and the Volcker Rule, but participants also noted that the absence of global coordination has produced conflicting regimes or given rise to such efforts as substituted compliance in the United States.

Many interviewees consider the rules too focused on issues that are not widely perceived as having any impact on or benefit for the public, such as trade reporting and research. Several individuals believe something needs to be done to better coordinate the promulgation of post-crisis laws and rules, including better cost–benefit analysis. Another thinks these rules are too retroactive. One noted a desire to see Glass–Steagall reenacted.

Ten interviewees, however, believe increased regulation has not been excessive or weak. A few cited increased bank capital rules as an example of positive regulatory action. Four participants expressed no opinion or think it is too early to assess the new regulations. Two of these four are former regulators. A recurring theme in this “not excessive” camp is a feeling that with many issues still to be addressed, the further we get from the great financial crisis, the more amnesia sets in about the vast financial disruption it caused.

Avoiding the Next Crisis

Most interviewees stated that many of the regulatory initiatives since the financial crisis have effectively addressed the issues that gave rise to the crisis. However, many interviewees believe that the current regulatory environment will not be adequate to deal with the next financial crisis. Many of the former regulators did not answer this question and instead remarked that current regulations are taking banks in the right direction.

Many interviewees think that the next crisis will not emanate out of the same conditions as the last and that new regulations should, therefore, also consider the regulatory challenges that might emerge in the future.

Three areas stood out as potential sources of the next financial crisis: shadow banking, too much or ineffective regulation, and an entirely unexpected happening.

It is also interesting to note that the regulators we spoke with are mostly of the opinion that the causes of the next financial crisis are unknowable. These views and any consequent sense of helplessness could impact the investing public's confidence in regulators.

Advancing the Public Interest: Prescriptions for Avoiding Capture

We also solicited recommendations for curbing regulatory capture, identifying and dealing with conflicts of interest among regulators, and identifying skills and competencies that regulators should possess or develop. Two themes stood out in the interviewees' responses: limited resources and insufficient training.

First, the interviewees expressed a concern that, in an environment of increasing regulation and relatively static funding and staffing, regulators are taking a check-the-box approach to regulation instead of focusing on the substance of regulation. Participants also noted this problem in the context of enforcement efforts, where regulators are willing to settle matters out of court rather than expend limited budgets on taking those matters to trial.

Second, interviewees tended to believe that regulators and even firm compliance officers generally lack the training to understand complex financial institutions and transactions. Interviewees offered up a number of recommendations on how to reduce the perception that financial industry regulators are prone to capture, including enhanced training, increased regulator pay, and continued strengthening of policies regarding conflicts and ethics (both during and after government tenure).

In the United States, the United Kingdom, and Asia, considerable thought is given to ethics and conflicts of interest regarding regulatory staff. For instance, ethics rules at most regulatory agencies impose post-employment cooling-off periods. Many of the interviewees believe that these cooling-off periods should be lengthened—or established, if none exist. One respondent thinks former regulators should be prohibited from working for industry participants.

Although the United Kingdom has not historically had a significant number of regulators becoming industry professionals—or vice versa—this practice has become more prevalent in the last few years. In the United States, however, this revolving-door phenomenon has a lengthy history. The SEC requires a cooling-off period; however, from 2001 through

2010, 419 former SEC staffers filed a total of 1,948 requests for waivers during the cooling-off period. In several of these instances, the waiver requests came just days after the employees had left the SEC. Many of the waiver requests came from consultants and law firms representing the industry.[15] Asia seems to have the fewest cases of regulators and industry professionals exchanging roles.

Although all firms and regulatory agencies have enhanced their ethics policies regarding conflicts of interest in the past few years, many interviewees noted that continued exposure to sound ethics practices is essential for both industry participants and regulators. Some interviewees argued, however, that when industry participants become regulators, they do so for the public service aspect of the position and that these individuals are among the most ethical.

Almost all US interviewees were in favor of increasing pay for regulatory staff members. In contrast, interviewees in Asia and Canada believe that their regulators are well compensated. All of the interviewees stated that greater equality in compensation between regulators and industry practitioners would motivate agency staff to remain and increase their knowledge and qualifications. One respondent suggested that increased respect for public service would also assist in retaining staff at regulatory agencies.

Interviewees suggested that principles-based regulation, such as that used in the United Kingdom, would engender more conversation between regulators and regulated firms. They also believe that regulators should involve industry practitioners earlier in legislative and rule-drafting processes. These statements again reflect the difficult distinction between allowing for essential discussion to form effective policy and offering access that might unduly influence policy in favor of commercial interests.

Some interviewees suggested that the increased focus on conflicts of interest between regulators and the industry has likely reduced communication, as well as cooperation, between the parties. This tendency could result in firms being less transparent with regulators and regulators being unable to identify risks in a proactive manner.

Acquiring Skills

Almost all interviewees commented that regulators should improve their practical understanding of what they are trying to enforce. The industry perceives regulators as lacking an

[15]POGO, "Dangerous Liaisons: Appendix A," Project on Government Oversight (www.pogo.org/our-work/reports/2013/dangerous-liaisons/sec-appendix-a.html; retrieved 11 January 2016).

understanding of the principles behind the rules and what the rules are trying to achieve. Some participants remarked that since the financial crisis, they have noticed an increasing knowledge gap at agencies. Overwhelmingly, interviewees see a need to train regulatory agency staff in how the regulated businesses operate. Several interviewees noted that they have encountered agency personnel, from junior to quite senior, who do not possess much business acumen and do not understand many aspects of the financial businesses they have cited for both day-to-day and strategic issues. Some interviewees think that regulators need to expand their product knowledge. Although most regulators now understand equities, they lack a thorough comprehension of bank funding, credit markets, and fixed income. One individual even noted that regulators (as well as industry compliance officers) should be required to understand the financial statements, balance sheets, and cash flow statements of regulated businesses. Another suggested that junior regulators should improve their relationship-building skills.

Several interviewees suggested transferring industry personnel to regulatory agencies for one year. These participants believe that such transfers would increase the knowledge base within the regulatory body. Other interviewees suggested recruiting more industry personnel for permanent employment within regulatory agencies. One individual in Canada thinks there is sufficient cycling through the agencies and businesses to prevent a serious knowledge gap. The former regulators who participated generally supported the flow of people between the industry and the government. These perspectives are obviously at odds with the conflicts of interest cited by observers of the "revolving-door" phenomenon and reflect the problem of discriminating between regulators' acquiring necessary intimate knowledge of regulated firms and corruption of the public good through cozy relationships.

Concerns for the Future

The interviewees offered up a broad range of concerns about what lies ahead. They noted that the volume of regulation is too great and that regulations are too complex. Some fear that the public and regulators alike are losing sight of the bigger picture. In addition, some firms are exiting the financial services business because of increased regulation, which may lead to consolidation and reduced competition. The cost of regulation may especially weigh on small firms, potentially leading to even less competition.

Participants also expressed a concern that those developing the regulations do not understand what they are doing and that this failing increases costs. Furthermore, firms are not given enough time to digest new regulations and implement them in a thoughtful manner; the process should be slowed down so implementation can be thoughtful and pragmatic. Almost all interviewees noted a need for better coordination across agencies as well as between countries.

3. Summary and Recommendations

Interviews of 73 individuals closely involved with the regulation of financial services businesses were conducted over the course of seven months in 2015. All of the participants are senior in their field and were guaranteed confidentiality to encourage their candor. The majority of participants do not believe that regulatory capture exists. Even when an interviewee said that capture is a legitimate concern, the individual found it difficult to back up that statement with concrete examples of how influence has been used to deliberately divert the public interest in favor of commercial interests. Interviewees were able to cite policy outcomes that they think reflect political control of some regulatory processes and legal channels of commercial influence over politicians, primarily through the US Congress.

Interviewees noted the essential dilemma involved in encouraging closer interaction between regulators and the industry in order to share knowledge and arrive at effective regulation, considering the potential for conflicts of interest to arise from these closer relationships.

CFA Institute believes that, on balance, the risks and costs of ineffective, burdensome regulation outweigh the potential for excessive control or outright corruption resulting from interactions between regulators and the firms they oversee. To best protect against regulatory capture, we recommend the following:

1. Conflict-of-interest policies and rules at regulatory agencies must be applied and enforced consistently. Waivers should be rare. Rules designed to minimize the immediate conflicts of interest associated with movement of staff between public service and the industry are well motivated and strike a reasonable balance between preserving the public interest and affording individuals opportunities to pursue rewarding careers. But those rules do nothing to uphold the integrity of capital markets if they are easily sidestepped through a liberal waiver process.

2. Compliance rules and procedures at firms should specifically address interactions with regulators, identify potential conflicts of interest, and equip staff with the resources to avoid or mitigate such conflicts.

3. Both industry practitioners and regulators should endeavor to provide ethical decision-making training to their staff that goes beyond rote understanding of compliance rules, helps develop ethical "muscle memory," and includes practice addressing examples of conflicts of interest that staff are likely to encounter. This training should

be one element of a firm's examination by regulators, and it should also be a feature of the documentation in support of appropriations requests by regulators.

4. In recognition of the potential for increased collaboration between industry personnel and regulators to introduce the appearance of conflict of interest, which reduces confidence in the integrity of the regulatory process, all interactions at all levels between regulators and firms should be documented by audio or video recording as part of the public record.

5. There should be broad support of further attempts to professionalize the ranks of the regulatory agencies, including (a) funding mechanisms that allow for compensation competitive with that in the private sector, to minimize the financial motivation for the "revolving door" phenomenon, and (b) access for regulatory staff to high-quality training programs that equip them to better understand the firms they regulate and the context of their businesses.

AUTHORS

Elin Cherry, JD
Principal and Head of
Capital Markets
Compliance Risk Concepts

Robert W. Dannhauser, CFA
Head, Global Capital
Markets Policy
CFA Institute

CONTRIBUTORS

Kurt N. Schacht, JD, CFA
Managing Director
Standards and Advocacy
CFA Institute

Mitch Avnet
CEO and Founder
Compliance Risk Concepts

THE AMERICAS
(800) 247 8132 PHONE (USA and Canada)
+1 (434) 951 5499 PHONE
+1 (434) 951 5262 FAX

915 East High Street
Charlottesville, VA 22902
USA

477 Madison Avenue
21st Floor
New York, NY 10022
USA

ASIA PACIFIC
+852 2868 2700 PHONE
+852 2868 9912 FAX

23/F, Man Yee Building
68 Des Voeux Road
Central, Hong Kong SAR

Si Wei Beijing Enterprise Management Consulting Company Limited
Unit 7, Level 12, Office Tower C1, The Towers, Oriental Plaza
No 1 East Chang An Avenue, Dong Cheng District
Beijing, 100738, China

CFA Institute India Private Limited
Naman Centre, Unit No. 103
1st Floor, Bandra-Kurla Complex, G Block, Bandra (East)
Mumbai 400 051, India

EUROPE, MIDDLE EAST, AND AFRICA
+44 (0) 20 7330 9500 PHONE
+44 (0) 20 7330 9501 FAX

131 Finsbury Pavement
7th Floor
London EC2A 1NT
United Kingdom

Rue du Champ de Mars, 23
1050 Brussels, Belgium

ISBN 978-1-942713-28-9
9 781942 713289 90000 >

CFA Institute

www.cfainstitute.org
info@cfainstitute.org