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PROCEEDINGS OF THE 2009 ANNUAL SYMPOSIUM: MODERNIZING THE FINANCIAL REGULATORY STRUCTURE

I.
OVERVIEW

The *NYU Journal of Law & Business* hosted its annual symposium on Friday, February 20, 2009 at New York University School of Law. The event, entitled "Modernizing the Financial Regulatory Structure," focused on the changing conditions in capital markets, banking regulation, and foreign investment and featured a number of prominent attorneys, academics, and financial industry professionals. The program began with introductory remarks by Francesca Mead, Editor-in-Chief of the Journal; Justin Lee, the Senior Developments Editor and Symposium Coordinator; and Chancellor William Allen, the Nusbaum Professor of Law & Business at NYU and Director of the school's Center for Law & Business, who serves as one of the Journal's advisors. Each speaker focused on the timeliness of the program, given the rapid changes occurring in the financial sphere. Chancellor Allen then introduced the day's keynote speaker, Professor Steven Schwarcz of Duke University School of Law. Both Chancellor Allen and Professor Schwarcz contributed essays to this issue based on their speeches at the symposium.

Chancellor Allen moderated the first panel on risk management, which included H. Rodgin Cohen, the Chair of Sullivan & Cromwell; Professor Michael Greenberger of University of Maryland School of Law; Ed Mierzwinski, Consumer Director of U.S. Public Interest Research Group ("PIRG"); James Carlson, a partner at Mayer Brown and an adjunct professor at NYU Law; and Henry Ristuccia, a partner at Deloitte whose

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practice focuses on enterprise risk management. The panelists debated how best to regulate risk and restructure the financial system. The majority of the panel seemed to agree that a central body to oversee all of the disparate financial regulators would bring clarity to the system, including avoid areas with little regulation. Mr. Ristuccia emphasized a need for internal controls and risk management. Mr. Cohen discussed what a central financial regulator would look like but also mentioned some of the problems that might accompany its operations, such as timing. Mr. Carlson promoted continued deregulation and also raised concerns about the investment business moving outside the United States.

Following lunch, Professor Geoffrey Miller of NYU School of Law moderated a panel on Banking Regulation with panelists including two leading banking professors, Henry T. Hu of University of Texas School of Law and Jonathan Macey from Yale Law School, as well Thomas Baxter, Jr., General Counsel and Executive Vice President of the Federal Reserve Bank of New York, and Richard Kim, a partner at Wachtell, Lipton, Rosen & Katz. Following an introduction by Professor Hu on the problems of debt decoupling and how this phenomenon led to the current crisis, Mr. Kim discussed the public's misperceptions about the apparent insolvency of leading financial institutions and what real issues exist in connection with missing equity. Mr. Baxter made a presentation comparing regulatory systems across the globe, including their respective failures, and he explained that central banks play an essential role in these systems by providing the necessary liquidity. Professor Macey talked about the "tyranny of experts" and flawed analytical approaches to the financial crisis, such as how compensation methods have failed in terms of risk and reward.

The final panel of the day was moderated by Professor Kevin Davis from NYU School of Law and featured Joshua Ford Bonnie of Simpson Thacher & Bartlett; Paul Downs of Jones Day; Ronald Gilson of Stanford Law School; Edward Greene of Cleary Gottlieb; and Waajid Siddiqui of Hogan & Hartson. The panelists discussed the rise of sovereign wealth funds ("SWFs") and some typical deal structures. Siddiqui emphasized the fact that two years ago SWFs were still considered a potential threat, whereas in early 2009 they were being viewed as possible saviors. With regard to this potential threat, Professor Gilson pointed out that to no one had seemed to identify

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any harmful behavior by SWF investors. The panelists also spoke about unique aspects of dealing with sovereign wealth funds, especially given the political pressures on both sides of the transaction. For example, Mr. Downs explained that there is an inevitable political component to each SWF transaction. The panelists also commented that the strategic behavior of sovereign wealth funds could be separate from their investment strategies.

II.

INTRODUCTORY REMARKS BY CHANCELLOR WILLIAM T. ALLEN*

There is an expression—a happy expression in the English language that we hear sometimes: "Everything old is new again." It, of course, speaks of a renaissance, a rebirth, a reinvigoration, a time when things seem new, extraordinary moments, a religious conversion or falling in love—"Everything old is new again!" In our economy, for a substantial period commencing sometime in the mid to late 1990s, it seemed that everything old was new again. The combination of technology, modern finance, and market-centric regulation allowed us to feel that we had re-invented the economy—that which had been old was reborn. That feeling began to fade in the Fall of 2007 and disappeared in the Fall of 2008. Now, for the moment at least, everything new seems old again.

When I was an undergraduate student at New York University studying Economics, an important field of study was the business cycle. Scholars investigated savings rates and investments to try to predict or to see the effects of growth on total production in the next period. Books were written about the business cycle, and there is a long history of the study of the business cycle. In fact, we have not heard much about the business cycle as an academic field of study or as a journalistic study since, I would say, 1982.

1982 was the beginning of what was called the "Ronald Reagan Bull Market." It built upon the work of our last great crisis hero, Paul Volcker, who, as Chairman of the Federal Re-

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serve Board, had the political courage to do a very unpopular thing: he pushed interest rates to very high levels in order to wring inflation expectations out of the economy. His work laid the foundation for a long period of economic growth. There were mild recessions between 1982 and December 2007, but they were generally neither long in duration nor deep.

From 1982 to 2007, the stock market rose secularly. There were interruptions: a very brief one in 1987 that lasted a few months; in 2002, there was a serious one, but the Federal Reserve flooded the market with liquidity and possibly laid the predicate for current problems. But the business cycle seemed to be vanquished. So courses on the business cycle became rare, almost quaint. Now there were, I think, three things that contributed to the belief that we could successfully avoid the great painful falls in production that seemed inevitable to economists and business people in the past. And in my role as a professor, I want to try to step back for a second and identify some large forces that seemed to vanquish the business cycle because, at the end of the day, of course, the business cycle has not been vanquished.

The first factor was the development and acceptance in the late 1970s and the 1980s of the economic theory of how financial markets function. This is the efficient capital markets hypothesis. Acceptance of the soundness of the semi-strong version of the efficient capital market hypothesis was so extensive and strong 10 or 15 years ago that most economists believed that the efficient capital market hypothesis, in fact, was a very good description of how markets work, particularly how the New York Stock Exchange works. (And not only professors of Finance believed this—it was widely thought to be the case.) Importantly, acceptance of this efficient capital market hypothesis—this academic, intellectual idea—allowed other financial economists—Nobel prize-winning economists—to produce a series of subsidiary tools, such as the capital asset pricing model, which allowed economists, for the first time really, to make what they thought were highly reliable estimates of the cost of equity component in the capital structure of a firm; or the Black-Scholes option pricing model, which for the first time allowed financial economists to make sound estimations of the value of an option. Prior to this innovation, it just seemed conceptually impossible to know the value of something that was going to be exercised in the future. These sub-

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sidiary tools of the efficient capital market hypothesis were not just academic creations, but they were used, as will be discussed below, by financial experts in financial markets.

The second development that contributed to our forgetting about the business cycle was the development and spread of computer power and speed. Not only were computers thought to be a great source of the productivity gains that were assumed to lay beyond the astonishing performance of the U.S. stock market during the 1990s, but more interestingly, they supplied the hardware that permitted the extensive deployment in the real world of these tools that were invented by economists—the option pricing model, cap M, and other intellectual creations. The combination of computer power and the intellectual technology of modern finance permitted financial market professionals to estimate values and risks in ways that allowed them to slice and dice financial risk beyond what any earlier generation could have conceived. This allowed the evolution of vast new financial markets—those for securitization of myriad assets from credit cards to mortgages to almost anything else you could imagine. Assets were taken, were sliced up into different tranches, and we used the technology that the efficient market hypothesis permitted us to develop to price these things. This, in turn, transformed the banking system from a system in which loans are originated and held to a system in which loans are originated and sold.

So we have transformed the financial system, and in part—in large part—it is through this intellectual development of the efficient market hypothesis. The evolution of these new markets allowed us to deal with risks in new ways and allowed our banking system to morph into something new, and we thought, maybe something very beneficial. During this happy period—let's say between 1980 and 2007, with little blips—productivity rose, consumption rose, and savings utterly disappeared. Among economists, I used to complain, "you know, this country doesn't save anything, this is very worrying," and my economist friends in the Finance department (one in particular who will remain nameless) would say, "oh no, we're saving, because the difference between net wealth at the beginning of a period and the end of a period is savings, and if you look at asset values, you see that the asset values of the average household in the country is going up because house values are going up." So while we were dissaving, if we

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look at income and consumption, because of the asset bubble in real estate, it looked like we were saving to some economists. But we were eating our seed corn, blissfully thinking that we had invented a new model for growth. Asset prices were going up, money flowed from the Fed, bonuses on Wall Street were phenomenal, it was a great time to be alive—I remember because it was not so long ago. Everything old seemed quite new then, and there was no talk about the business cycle.

The third force that allowed us to forget about history was the belief that we had learned a great deal about the management of the financial system since the dark days when a series of central bankers around the world, working on gold-standard bred instincts, stumbled their way into the Great Depression, and Congress responded, of course, with a great panoply of complex regulatory regimes of the financial system. In the new age, the Fed knew more. Mr. Bernacke had been a student of the Depression, so he knew, following 9/11, that the correct response was to flood the economy with liquidity. And what happened to the economy and the stock market following 9/11 was an 18-month dip, and then it continued to rise. So we had great confidence, we knew a lot, and that confidence caused us in 1999, led by Congress, to release the banking system from the restraints or constraints of the Depression era legislation—the Glass-Steagall Act, particularly—that separated financial institutions into specific functions.

In 1999 came the Gramm-Leach-Bliley Financial Services Modernization Act, which envisioned a new world of banking and financial market structures. In this new world, we could have such innovations as Citigroup, which joined together Travelers Insurance Company, Smith Barney brokerage firm, and Citibank into a modern universal bank that could compete around the world. And Sandy Weil, the visionary who produced this creature, was seen as the greatest businessman of the moment. Now everybody thinks that Citigroup is probably insolvent. Because it made bad loans? No, that is the old banking system, the boring old system. Because it invested in some proprietary accounts in subprime mortgages and had apparently very little idea as to how to value them appropriately, given that real estate markets could decline if you looked long enough into the past.

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So we have been forced to wake now from a debt-fueled binge of the last fifteen or twenty years. Everything that seemed so shiny and new seems old again: old questions come back; the business cycle has come back. This may be the biggest downturn since the Depression, so maybe in a year or two people will begin writing PhDs on the business cycle—I don't know. These old questions include: How do we ensure prudent risk-taking by our depository institutions while leaving room for sensible innovation? How do we assure sufficient domestic savings so that we make productive investments in our domestic economy without growing increasingly dependent upon foreign countries' willingness to buy our treasury bonds? And how, in dealing with what looks like a bad example of the business cycle, can we balance fighting deflation without running the risk of hyperinflation, or more likely, of stagflation—a combination of high inflation and low economic growth, which is quite a risk, I think.

Moreover, while our banks remain at the heart of our current problem, our financial markets are vastly more complex than banking alone these days. What should be done to regulate the functioning of other sources of systemic risk, such as credit default swaps and collateralized debt obligations? How are we supposed to deal with them? Apparently, some of us made a decision in the last six or seven years not to regulate them at all or very much. What should we do going forward? Do we need a new super-regulator of financial markets? Or does the complex division of jurisdiction that exists—the FDIC, the Comptroller of the Currency, the Federal Reserve Bank, the SEC, the Commodities Futures Trading Commission—does that pattern seem sensible? Functional? Or is it just a historical accident and should be revised? These are some of the many, many questions that our current global situation brings to mind for U.S. policy.

We were very fortunate to have a wonderful group of informed individuals participate in the symposium. We had an optimistic title for this conference—Modernizing the Financial Regulatory System—which might suggest that what we need is just to rehabilitate the system, paint it, knock through some walls, put in some better electrical wiring, make it a little brighter, and then we'll be okay. The fact of the matter is that we had—and to some extent still have—no real idea how this modernization should occur. It is a contentious issue, which

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will involve political trade-offs, as well as technical problems. It is a difficult process, but we were, and remain, in a difficult spot. We are going to be dealing with the financial crisis politically—and our leaders will be dealing with it—for years to come.

III.
KEYNOTE ADDRESS: THE CASE FOR A MARKET LIQUIDITY PROVIDER OF LAST RESORT**

STEVEN L. SCHWARCZ***

A. *Introduction*

The real economy—meaning the way the economy personally affects us all—relies critically on credit. The current financial crisis, it has been observed, began in the credit markets, and eventually will end there. Diminished credit harms the real economy because firms need credit to operate and grow and individuals need credit to buy homes, cars, and other consumer goods.

Many think that the story of the credit crunch fundamentally is a banking story. Yes, there is now a severe lack of confidence in banks; but the credit crunch predated and contributed to this lack of confidence—although the lack of confidence, in turn, is now making the credit crunch worse.

Let me tell the story from the beginning. The credit crunch started with the collapse of the securitization and other debt markets. Securitization is a process whereby consumer financial assets (like mortgage loans, credit card receivables, and automobile loans) and corporate financial assets (like accounts receivable, lease rentals, and licensing fees) are financed through the issuance of debt securities backed by the financial assets. These securities—the most recognizable these days being securities backed by mortgage loans or "mortgage-backed securities"—are sold to institutional investors in both U.S. and worldwide capital markets. I loosely will refer to capital markets in which securitization and other debt securities are issued and traded as securitization markets.

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