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Coping with Change:

Corporate Governance in a Time of Crisis

The Flaws of Value at Risk: Tracking a True Culprit

A Single Global Regulatory Framework: Solution, or Problem?

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A PERIOD OF INTERLUDE AS REFORMERS CONSIDER THE PROPER FORM OF MARKET REGULATION

The primary currency of the capital markets is . . . *trust*. When trust is broken between corporate issuer and investor, or investor and asset manager, things can go terribly wrong. That's the summation of the capital market woes of the past year, and the prolonged sitting on the sidelines in summer 2009, as many institutions have "parked their money" for now. And when trust is broken, calls for "reform" are heard from far and wide.

We write this commentary from our base in New York City, which of course is very much a money town, with banking and financial interests making up a sizeable base of the local economy. Market buzz is everywhere. Everything that goes on these days on "Wall Street"—the shorthand term for the financial services sector that is now geographically spread wide and far from that narrow lane in the downtown area—can be big news.

New York City is also the nation's media capital, which can be a dangerous thing for Wall Street if things go wrong in the markets.

Take this front page, bold headline from the tabloid owned by News Corp, the venerable *New York Post:* "Not So Fast You Greedy Bastards." The paper was reporting on the plans for the payment of bonuses to AIG staff. The issue was filled with article headlines such as "Bonus Bozos May Cough Up 100%," "Spare Us Your Fake Fury, DC Hypocrites," and so on.

All of this reflects the popular anger at Wall Street interests for the damage inflicted on investors, portfolios, public finances, and the US economy as a whole by the leaders of financial services companies who too often disregarded risk for short-term rewards and led their institutions to the point of failure. The results of that disregard or misunderstanding of risk are now far and wide. In some cases, huge financial firms failed and disappeared—Bear Stearns, Lehman Bros, and even Merrill Lynch, which disappeared into Bank of America. How could so much go wrong so quickly and cause such widespread damage?

It is often said that in recent years the best and brightest have gone to work on Wall Street—hundreds of PhDs bringing their skill sets to the Street to build fantastic analytic models and devise trading methodologies to generate tens of millions of dollars in gains for their respective employers. How could such smart people have missed the warning signs and abandoned the traditional risk-management programs as they built sophisticated new systems for asset creation, aggregation, and management? The answers may take years to determine.

Public sector reaction: reform now!

The short-term response of government to all of this has been quickly to propose reform regulation. The suggestions for new laws cover a wide range of issues. Public anger and media agitation have helped to keep the flames of reform alive; the continuing malaise of the capital

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PERHAPS THE MOST IMPORTANT CALL FOR REGULATION CONCERNS THE CREDIT RISK AGENCIES, WHICH SO DISASTROUSLY, CRITICS CHARGE, CONTRIBUTED TO THE FINANCIAL CRISIS BY DISREGARDING RISK AND ISSUING HIGH RATINGS FOR SUBSTANDARD PRODUCTS.

markets and the current recession have served to spur the public sector reformers to action. As this issue of *Corporate Finance Review* reaches the reader the serious inquiries into the financial debacle of 2008–2009 will be getting underway. Already, the reform draft legislation is making the rounds of the US Senate and House of Representatives.

So we may call this period one of parenthesis, an interlude between the familiar and well-settled statutes and implementing regulations of the 1930s still in force, and the future regulations to be ratified, which are virtually impossible to predict as to their shape, form, and impact.

Prior statutes have been layered and built on over ensuing decades. In 1938, for example, self-regulatory organizations were authorized by Congress to regulate activities in their respective marketplaces. Much of the sweeping reforms enacted in 2002 as the Sarbanes-Oxley legislation specifically built on the 1934 Act provisions. So the key question for finance professionals in 2009 is what will we see as reform legislation and subsequent regulations as the debate gets underway in earnest?

And the key issue for everyone may be whether the reforms that are enacted serve to build trust in the capital markets. Again . . . only time will tell.

Going back to the question of how this could happen, and whether the smart people of Wall Street could have or should have seen the debacle awaiting the horizon: The Financial Services Forum, an elite group of financial services CEOs (only 150 can serve at a time, by invitation only), each year sets out a list of CEO member concerns for discussion and action. It's interesting to look back (with the benefit of our 20/20 hindsight) to see what the Forum members identified as key issues in October 2006. What were the key issues to watch over the coming year or two?

Number 1 was terrorism. Next was trade protectionism. Then, closely related, the political instability of certain nations (Iran, North Korea). The US housing market, about to crash and slide down 30% in valuations, was number 5 on the list; this even as risky mortgage and securitization activities were at their frenzied peak. Number 8 on the list was the likelihood of an "uncertain major financial crisis," something along the lines of the 1997 Asian financial crisis. And number ten was potential of a bird flu pandemic.

The CEOs of Wall Street and the banking world were very optimistic: Would there be continued growth of the US economy over the next two or three years? Twenty percent said yes, some growth. Forty percent said there would be growth and the same number said there would be very strong growth. What happened? Soon after, the credit markets seized up, the housing market took a deep dive, and foreclosures began to rise. And then collateralized mortgage securities began to default (bringing down Bear Stearns and Lehman Bros in the process).

Trust was shaken and then broken.

Reforms already underway

Responding to both public (voter) anger and the demands of institutional investor reform forces, the Securities & Exchange Commission amended the New York Stock Exchange rules to eliminate broker discretionary voting in board of director elections. This pleased the activist shareholders, of course, and disappointed or alarmed corporate managers and boards. Unless brokers are instructed otherwise by the asset owner, "uninstructed" votes will automatically be "no" votes in director elections. If there is a large retail base, advises the Conference Board, it may not be possible to gather enough votes to elect the board of directors! This is but one step in the journey of reform that the United States has embarked on.

What's ahead? The talk is of regulation of hedge funds, private equity investment organizations, short-sellers, and newer forms of investment management. Perhaps the most important call for regulation concerns the credit risk agencies, which so disastrously, critics charge, contributed to the financial crisis by disregarding risk and issuing high ratings for substandard products.

The Obama administration released its comprehensive report on planned (or

desired) financial services regulations calling for the most important updating of regulations since the 1930s era.

Among the most important elements is a call for financial organizations to "hold" a meaningful portion of the securities they issue—in effect, having skin in the game as they market, say, collateralized debt obligations.

Other provisions call for "incentives" for market participants to best serve the interests of clients, borrowers, investors, and so on. These are expressly designed to build trust in the markets and market players.

Banking institutions are carefully watching the reforms proposed; the report addresses Basel II Capital Accord issues, including leveraging and off-balance sheet vehicles.

Corporate managers and boards are watching "say on pay" populist measures in the Congress—broken trust helps to propel this issue forward.

There may be a "super regulator" imposed on the already complicated system of financial sector regulation—the "risk regulator" concept would assign new responsibilities to the Federal Reserve, raising concerns among state-level regulators who would lose their powers.

Will all this build or restore investor trust in the markets? The months ahead will be filled with talk and action related to financial services and banking regulation. The underlying theme will be that we are doing this to "rebuild trust" in the nation's capital markets. The passage of time will also help, as in past bear markets and periods of economic recession. But the important determinant may well be that of public opinion, as the "wrongdoers" are put in the dock in public hearings reminiscent of the intense public inquiries conducted by prosecutor Ferdinand Pecora (of New York) for the Senate Banking Committee in 1932. The anger rose as the testimony of the capital market leaders of the time were put in the dock. If that happens again in 2009, regulatory reform will follow . . . and the effort to rebuild trust may take a very long time. ■