E1FTOC 06/16/2010 16:30:11 Page 7

Contents

vii

Acknowledgments xi	
About the Author xiii	
Preface: In Defense of Regulation (and of Free Markets)	ΧV
In the Beginning, There Was Adam The Shift from Philosophy to Math Can Markets Regulate Themselves? Regulation versus Justice Conclusion	xv xvi xix xx
Introduction: Why Regulatory Reform Matters to You xxi	ii
The Structure of the Book	XXV
Chapter 1: Meltdown in the Markets: Systemic Risk	1
How Systemic Risk Works The Case for Government Intervention Why Hasn't the System Collapsed Before? Conclusion	2 9 10 12
Chapter 2: Can an Institution Be Too Big to Fail?	15
Policy Options Conclusion	17 22
Chapter 3: Moral Hazard	24
The Theory The Reality Punish the Leaders, Not the Organization	25 26 27

viii ■ Contents

The Other Moral Hazard Conclusion	28 30
Chapter 4: Toxic Assets	31
What Are Toxic Assets, and Why Are They Toxic? Building Low-Risk Assets Out of High-Risk Ones Credit Rating Agencies and Structured Finance Products Credit Default Swaps Conclusion	32 33 35 37 40
Chapter 5: Should Regulation Stifle Innovation?	41
Policy Implications Conclusion Chapter 6: Rewarding Success, Rewarding Failure:	44 45
Chapter 6: Rewarding Success, Rewarding Failure: Incentives and Compensation	46
Big Brother is Paying You Regulating the Level of Pay Performance Goals and Risk Methods of Aligning Reward with Risk Who Matters? The 2009 Federal Reserve Guidance Was Adam Smith Right?	47 47 49 50 53 53
Chapter 7: Who Protects the Consumer?	57
Were Existing Regulations Effective? Is a Separate Consumer Regulator the Right Answer? What Powers Would the Agency Have? A Word about Consumer Protection and Systemic Risk Conclusion	59 61 65 67 68
Chapter 8: Transparency: Letting the Sun Shine In, or Sipping Water from a Firehose?	69
Transparency as Regulation	69
Degrees of Transparency What to Consider When Transparency Is the Proposed Remedy	71 73

Con	ntents ix
Chapter 9: Rebuilding the Regulatory Structure	75
Why So Many Regulatory Agencies?	76
The SEC and the Investment Banks	77
The Federal Reserve	78
Other Proposed Changes	79
Consumer Protection	80
Do We Need a Systemic Regulator?	80
To Concentrate or Not to Concentrate	81
Chapter 10: Rating the Raters: The Role of Credit	22
Rating Agencies	83
NRSRO Status	84
How Ratings Are Made What Really Keeps the Rating Agencies Up at Night (And It Is Not Your Mortgage) The End of the NRSRO?	89
(And It Is Not Your Mortgage)	92
The End of the NRSRO?	94
Conflicts in the Rating Agency Business Model	97
Are Rating Agencies Utilities?	97
Conclusion	98
Chapter 11: The Politics of Regulation	100
The Political Process	101
Chantar 12: Nice Law Nav Go Do Its Borrelators and	
Chapter 12: Nice Law, New Go Do It: Regulators and Compliance Officers	106
	107
The SEC Examinations and Inspections	107
Conduct of Examinations	110
FINRA	112
Compliance Departments	113
Conclusion	119
Chapter 13: Cost-Benefit Analysis	121
Basics of Cost-Benefit Analysis	122
The Benefits of Cost-Benefit Analysis	128
Government Use of Cost-Benefit Analysis	129
Cost-Benefit Analysis as a Negotiating Tactic	130
Conclusion	132

x ■ Contents

Chapter 14: It's a Small World, After All	133
Sunday Is the New Monday Overseas Regulators International Organizations Conclusion	133 135 139 141
Chapter 15: Where Do We Go from Here? Conclusions, Observations, and Recommendations	142
Modern Markets Are Too Complex to Regulate Themselves Planning for the Next Crisis The Need for a Professionalized Regulatory Service Creating a Federal Regulatory Service Elevating the Compliance Profession Decisions Are Made by Individuals, Not Organizations Keep the Rating Agencies—But on a Short Leash Put Down the Pitchforks Conclusion Chapter 16: Judging for Yourself Conclusion Appendix 1: Summaries of Regulatory Concepts and Issues	143 144 146 148 151 152 153 154 154 156 161
Moral Hazard, Too Big to Fail, Systemic Risk Unlevel Playing Fields Unintended Consequences Self-Regulation Regulatory Capture Information Asymmetries Conflicts of Interest One Size Fits All	163 165 166 168 169 172 173
Appendix 2: Excerpt from Obama Administration's Reform Proposal, "Financial Regulatory Reform: A New Foundation"	177
Index	187