Roundtable White Paper

A Second Special Study of Capital Markets: Whether, What and How?

On June 4, 2013, a diverse group of more than two dozen lawyers, academics and policy makers* convened in Washington, D.C. for a four-hour roundtable focused on the desirability and possible content of a study akin to the historic 1963 SEC Special Study. The Special Study was in response to a perception not only that there been dramatic changes in securities markets but also that the changes had outpaced regulators, creating uncertainty whether regulators had sufficient tools and capacity to fulfill their missions. In addition to describing how markets had changed, the Special Study recommended a range of regulatory changes that were thought to be probably necessary.

The earlier study was carried out by a team of lawyers, economists, financial analysts, and statisticians, with leadership by regulators who could draw on deep experience at the SEC. The resulting report entailed three distinctive contributions that occurred in phases over the life of the project. The first phase involved mapping and evaluating changes in capital markets. The second phase reviewed the then existing regulatory structure of capital markets. The third phase of the Special Study raised questions about overall institutional design. The Special Study was a

* A list of the Roundtable Participants appears as an appendix to the Whitepaper.

mix of qualitative and quantitative analyses, surveys, case studies, and statistics to present a broad overview of financial markets, their participants, trading strategies, the roles of government regulators and their performance as well as a set of policy recommendations.

Among the findings of the Special Study were the enormous growth in securities markets had led to destabilization, that there had been a rapid increase in brokers so that many were inexperienced, the industry was increasingly impacted by anti-competitive practices; there were inefficiencies in "back-room" practices; and there existed troubling practices by floor traders and specialists. The Special Study is credited with placing the Commission on a firm intellectual footing equal to Wall Street so that it was better able to carry out the mandates of the laws entrusted to it. The Special Study is also credited with setting the policy trajectory for both the Congress and the SEC, especially in areas of disclosure for then unlisted securities as well as a range of broker-dealer practices.

The earlier study was undertaken with a special appropriation from Congress, about $5.3 million in 2013 dollars, and was conducted entirely by the staff of the SEC. While dramatic changes in U.S. capital markets had prompted the study in the early 1960s, even more dramatic changes have transpired since then posing the question whether another such study should be undertaken. This question is especially timely in light of the rapid changes in capital markets resulting from advances in information technology, significant global capital flows, and such regulatory changes as Graham-Leach-Bliley Act and the historic Dodd-Frank Wall Street Reform and Consumer Protection Finance Act.

Given the diversity of the roundtable participants, views and areas of emphasis varied across the topics examined. Nonetheless, there were broad areas of consensus that emerged in the discussions that are set forth below. Also identified in this report are areas where the group appeared to have notable differences of opinion.

Strong sentiment was expressed for the view that the cause of regulation and the position of regulators would benefit from a comprehensive a study of capital markets, perhaps producing benefits on a scale believed to have accompanied the earlier SEC Special Study. The focus of the study would be descriptive having the broad objective of providing a topology of how our capital markets work, how they have evolved, and, importantly, the inter-connectedness of all its parts in the U.S. and globally (including, where appropriate, international entities and international counterparties). An important dimension of the global feature of capital markets is how domestic market regulation is influenced by the mobility of financial activity and the potential for that activity to seek the most favorable regulatory regime. The idea of interconnectedness is new and was not part of the earlier SEC Special Study. Only in the recent financial crisis of 2007-09 did we realize that interconnectedness between financial institutions is highly important to study in order to understand vulnerabilities in the financial system and particularly systemic risk. This study can concentrate on different types of interconnectedness, not just between financial institutions, but among different capital markets, securities and products. The study could focus on how flows of capital expand, disappear, and form new connections over time.

From the outset such a study will face challenging definitional questions, as well as tensions with respect to what methodologies should be employed. Several participants argued that the study's coverage should be broad, including not just capital formation and trading but also setting forth the linkages between traditional capital formation and trading and derivatives markets and products. Derivatives markets are complex, extensive and an integral part of capital formation, especially in the debt markets. We recognized that a broader scope would make the work more challenging, but our general view was that no study would be complete without taking into account the effects attributable to and the challenges posed by the global derivatives markets. An important focus should also be on how various entities in the market are connected and how their roles have evolved and are continuing to evolve, since interconnectivity is critical to understand when making policy. The focus recently on shadow banking (by the G-20, the Financial Stability Board and the EU, among others) highlights this critical issue. Thus, the study would be a robust and dynamic mapping of U.S. capital markets that could support a variety of interests and provide a foundation upon which future regulatory decisions could better be made, especially were there to be another financial crisis.

An enormous amount of work has been produced over recent years describing the multiple facets of the U.S. capital markets. Hence, it is likely that much of the study would be synthetic in the sense of integrating in one location a vast amount of information that we do know about capital markets; the study would then identify areas where not enough is known and, within the constraints of time and budget, set forth what issues or areas data would be expected to illuminate and why the identified issues are important to the study.

To provide a complete mapping of the inter-connected pieces of the market and among institutions, the study should include descriptions of how U.S.-based markets and transactions in the U.S. have been impacted by foreign markets and technology, along with informed projections of likely future trends. Unlike the earlier Special Study, this study should not be SEC-centric but instead should seek to encompass capital markets as broadly and practicably as available data permits.

It would also be important to inventory significant areas where the scope for inquiry is limited or where too little is thought to be known for the formulation of regulatory policy. For example, some important components of derivative markets are not transparent and, therefore, there will be challenges in accessing sufficient information to fully describe such markets adequately, and their probable impact on capital formation and market participants. Thus, the study should proceed with an awareness that there will be areas where the information at hand does not allow as complete a treatment as would be desired. A contribution of the study may therefore be to explicitly identify areas where information is not available areas and discuss the possible implications.

It would be important that the study capture how dynamic capital markets are, that is how they have rapidly evolved, and how they continue to transform themselves at an ever-increasing pace. To this end, the study should have a historical dimension, likely beginning where the earlier study ended and proceeding from there to chronicle and map changes that have since occurred, with great care to identify the forces that have propelled their change over time. In this description it will be important to link how technology has contributed to the on-going evolution of markets. There are likely other changes that will mark the market's rapid evolution. In this regard, Roundtable participants noted the profound changes created by the development of securitization, derivatives and the role of banks, what Roundtable participant referred to as the "bankification" of the markets.

The participants also discussed what perspective and disciplines would be best drawn upon to carry out the study. Both investor protection and capital formation may well be important areas of inquiry and perhaps emphasis. Focusing on these regulatory objectives, however, does run the risk of politicizing the study given the conflicting tugs of these historical objectives; a more neutral description of background may be less likely to result in political intrusions which seem to be happening today in connection with regulatory discussions. It would also be relevant to understanding the functioning of capital markets to focus as well on how investors reach their investment decisions and interact with markets in addition to why issuers and others enter into transactions to amass capital. While much of the study would be data-driven, it would be useful for the study to reflect a range of perspectives such as financial historians, economic sociologists, and behavioralists. Ultimately, the rich and dynamic topology produced by the perspectives of such disciplines could be the basis for future collaborative efforts with lawyers to develop effective regulation that would reflect the complexities of recent financial innovations.

A study focused on describing the evolution and present state of today's U.S. capital markets would likely be less impacted by special interests than if the study were to include features that were prescriptive or otherwise evaluative of the current regulatory approach. This concern, plus the magnitude of even a descriptive study of contemporary capital markets, led many roundtable participants to believe that, at least as an initial matter, the focus should be solely on a description of U.S. capital markets and not involve regulatory questions. While a second phase could be identifying gaps in regulation suggested by the description, and possible alternatives debated, the strong sentiment of the roundtable discussion was to contemplate at this time a study with a single stage - mapping capital markets in the manner described here. However, several roundtable participants stressed crucial differences between the current political context and the political context surrounding the earlier SEC Special Study. In the early 1960s it was probably appropriate to believe there was consensus that policing markets was a desirable role for government; today, there is reason to believe we do not find same level of support for this proposition.

The real challenge is one of funding; a study similar to the Special Study would require full time staff if the study is to be completed on a timely basis and be helpful. It is doubtful that public funding, certainly funding through a congressional appropriation as occurred with the SEC Special Study, would be possible. Thus, support of the endeavor will have to come through other means. And it will be important to involve academics, practitioners, and former government officials in the team assembled to conduct the study, with consultation throughout the process with relevant current government officials. Based on updating for inflation the costs of the prior special study, and the increased complexity of capital markets, we estimate that a full-blown descriptive study might well require between $10 and $15 million, which is not an insignificant sum. We are, however, pursuing means to move forward with substantially less funding, such as the use of conference and symposia formats that would produce an initial set of synthetic essays that pull together the disparate strands of current scholarship, and specify more concretely the pivotal questions that remain in need of further research and analysis. We are optimistic that such a format could achieve a extremely useful dynamic mapping of capital markets consistent with this report. Ongoing input from the group as to whether there is any realistic chance of securing such funding in this environment would be very helpful.

Appendix
Participant List
Roundtable on the Advisability of a Special Study Of U.S. Capital Markets

June 4, 2013
Washington, DC

Ed Balleisen	Duke University
Lawrence Baxter	Duke University
David Becker	Cleary, Gottlieb, Steen & Hamilton
Alan Beller	Cleary, Gottlieb, Steen & Hamilton
Greg Berman	Securities and Exchange Commission
Robert Colby	FINRA
Rodgin Cohen	Sullivan & Cromwell
Jim Cox	Duke University
Stephanie Dumont	FINRA
Merritt Fox	Columbia University
Andrew Green	Senate Subcommittee on Economic Policy
Michael Greenberger	University of Maryland
Ed Greene	Cleary, Gottlieb, Steen & Hamilton
Mark Jarusilik	Better Markets
Dennis Kelleher	Better Markets
Andrei Kirlenko	Massachusetts Institute of Technology
Donald Langevoort	Georgetown University
Mark Levonian	Office of the Comptroller of the Currency
Andrew Lo	Massachusetts Institute of Technology
Gert Luiting	Netherlands Authority for the Financial Markets
Brad Miller	Center for American Progress
Richard Reid	University of Dundee
Mila G. Sherman	University of Massachusetts, Amherst
Akhtar Siddique	Office of the Comptroller of the Currency
Damon Silvers	AFL-CIO