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IS THERE ANY ROOM LEFT FOR FEDERALISM IN FINANCIAL SERVICES?

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PANELISTS:

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DR. MICHAEL S. GREVE, John G. Searle Scholar, Federalism Project, American Enterprise Institute

MICHAEL ROSTER, General Counsel, World Savings Bank

JOHN RYAN, Senior Vice President for Policy, Conference of State Bank Supervisors

JUDGE FRANK H. EASTERBROOK, United States Court of Appeals for the Seventh Circuit (moderator)

MR. ROCKETT: I'm Jim Rockett and I'm the chairman of the Financial Services and E-Commerce Practice Group of the Federalist Society. I want to welcome you here to our presentation for the annual meeting. We've got a spectacular program and a group of panelists who are particularly knowledgeable about issues of federalism as they relate to financial services. I want to thank the members of our executive committee for coming up with this panel and bringing together this very talented group of speakers.

Andy Cochran actually had the idea for this panel. It really does truly fit in to the whole Federalist Society issue of where the states' rights and the national preemption work in. So we're going to hear from a group of exceptionally talented people. Our moderator today has probably been one of the foremost individuals in our society talking about issues of federalism. He's a judge in the Seventh Circuit Court of Appeals and a member of the faculty of the University of Chicago Law School, Judge Frank Easterbrook. Thank you.

JUDGE EASTERBROOK: Thank you and welcome to the panel on federalism and financial services. We have, or at least we're scheduled to have, six distinguished speakers. It is one of the chances of fortune in Washington that although a federal judge can always be counted on to be here, members of the Executive Branch are not necessarily so reliable. There is one down there at the end of the table I am told has just left the Department of the Treasury, and will be here eventually. I don't know whether we'll be able to hear his helicopter coming to the roof. So there may be some reordering of the presentation today.

I will introduce each of the speakers in turn rather than trying to introduce all six now, because with six on the panel you will doubtless have forgotten who they were by the time they stand up to speak.

We will start this afternoon, with Joseph Borg, who is the director of the Alabama Securities Commission, a past president of the North American Securities Administrators Association, and who also teaches banking and securities law.

MR. BORG: Thank you. Good afternoon, and it is a pleasure to be here. This is my first trip to the Federalist Society, but I can tell you after this program it will not be the last. It has been quite, not only entertaining in some panels, but quite informative. The topic we have today, "Is there room for federalism in financial services?"—well asking a states' securities regulator what he thinks about states' rights is like asking a fish if he can live without water. Certainly, we believe that there is plenty of room for good federalism doctrine in states' securities regulation. But let's talk about what we have going on in the markets today. It seems like any particular day of the week, if you want to read about crime stories, turn to the business page of the *Wall Street Journal*. There's more of that going on than on the front page of the Daily News, it seems.

It certainly looks like in the last three years we have witnessed some true soap operas, some real epics of corporate wrong-doing, and you know what I'm talking about. We've had such soap opera epics as the WorldCom Turns. We've seen Dark Enron Shadows. The favorite that's playing in Alabama right now is Health South General Hospital.

Let's go back a little bit. Since the late 1970s, Congress has had a taste for deregulation and preemption, with the resulting effect, especially on the preemption side, of undermining state economic regulatory authority. Although it has done deregulation in certain areas, including technology and some telemarketing, the primary target of preemption has been state regulatory authority in financial services: banking, insurance, and securities. From the National Bank Act through the Nationals Securities Markets Improvement Act of 1996, known as NSMIA, all the way through the Graham-Leach-Bliley Act of 1999, Congress has continued to pursue its preemption agenda. The corporate scandals of the last two years have given rise to some questions about whether we should revisit the Graham-Leach-Bliley provisions overturning the Glass-Steagall restrictions, as to affiliations between banks and securities firms.

During the debate on Sarbanes-Oxley, which was the law to fix the problems, there was a preemption move. Now, I find that somewhat axiomatic. How do you say you're going to protect the public and restore confidence and at the same time take securities cops off the police beat? Well, that section did not make it into the Sarbanes-Oxley through efforts of the states' securities regulators' lobbying efforts. Still, that attempt to preempt the states brings up the fact question of why is that the case? You have the National Securities Markets Improvement Act, which preempted state authority with regard to, among other areas, mutual fund merit review.

Let's go back a little bit. The short term prosperity in business during the '80s and '90s turned CEOs into rock stars and cult figures. It made buying IPOs chic. That was the thing to do. And the Business Interest Act as to the federal level had some unusually broad authority. Not only authority, but autonomy in crafting preemption proposals.

Corporate influences in the '80s and '90s in financial services to me seemed somewhat reminiscent of the old Standard Oil era of large corporations, and probably immediately prior to the antitrust legislation.

According to the United States Sentencing Commission, their annual report says that a total of 238 organizations were fined or were required to pay restitution in fiscal year 2001. That number's going up. The excesses of Wall Street have created a backlash of public policy. The outpouring of corporate governing legislation is a result of that public outcry.

With the passage of Sarbanes-Oxley, the compliance cost of corporate interest has gone up. There's no doubt. But taken in the context of the losses suffered by the general public, it's relatively small in comparison. And yet attempts persist to preempt state authority.

Historically, corporate crime enforcement has been lax, and as pointed out by Professor Frank and Professor Lynch, in Corporate Crime, Corporate Violence, "Enforcement has been traditionally symbolic, and generally against smaller firms." Perhaps we are starting to see the beginnings of a change in corporate thinking, maybe a recognition that the cost of doing business may be going up, and that may be directly attributable, not so much to fines, but to criminal enforcement activity. Maybe this new way of thinking will have some affect.

The role of states' securities regulation has been on the wane since the early '80s, and suddenly were now pushed into prominence due to the global settlement and the research analyst conflicts of interests cases, and more recently, the interest in the mutual fund trading practices. We could go into NSMIA and some of the things they did, but let me make a few commentaries.

We started with the meltdown in 2000, whatever the cause of that was. You might say some had to do with the research analysts conflicts, the accounting scandals later on that were discovered. But let's look back. The accounting scandals involved a conflict of interests between the auditors and the consultants in the same firm. Compare that to the conflict of interest situation between the research analysts and the investment bankers. Research analysts were supposed to give a fair, unbiased opinion. Audits were supposed to be a fair and unbiased picture of the company. Investment bankers were trying to make a profit, the consulting arm wants more fees.

Now we have mutual funds. Do we have another parallel? Investment company managers want to make more money, more fees. The mutual funds wants to keep costs down. The more trading that goes on, the more fees for the investment side, investment management side, and more cost for the mutual fund side.

SEC Chairman Donaldson pointed out that states' securities regulation has been around since before the SEC was even created. We've generally had a complimentary system of working with the federal regulators. Unlike the banking side, which is a parallel track, this has been complimentary. Very rarely do states' securities regulators overlap federal states' securities regulators, except in a case like the research analysts situation, where you will have some conflicts and some competition, which competition is not necessarily bad when it comes to straightening out the markets.

Earlier this year we heard talk of balkanization, 50 sets of rules, each state having different standards. I'm here to tell you, that's a solution in search of a problem. It hasn't occurred, and it doesn't exist. The SEC has not been the one trying to preempt state authority, if you historically look back. This has been Wall Street excesses. If we accept the principles of federalism that assigns certain duties and responsibilities to the federal government and reserves the balance to the states, then should not Congress limit the scope of its activity to those areas that are enumerated and delegated to the federal government by the Constitution?

Now in those special cases, where Congress determines that federal preemptive action of state laws is in the national interest, then should not the federal statute accommodate state actions taken before its enactment? That's where the gaps appear. The resources are understated. We'll have to fill those in with some law.

I know my time's up, so in the scramble for less regulation by Wall Street, let's not forget that the entire basis of existence of our business of financial services lies on Main Street, one-to-one with the American investor. If you are asked the question, "Is there room for federalism in financial services?" it's the complimentary nature of securities regulation and Main Street that will demand it be so. Thank you.

JUDGE EASTERBROOK: Thank you, Mr. Borg. We'll hear next from Michael Greve, who is the Searl Scholar at the American Enterprise Institute, where he directs its federalism project. He founded the Center for Individual Rights, a public interest law firm, about a decade ago, and he is the author of books on federalism and the environment.

MR. GREVE: Thanks, Judge. We're talking about a lot of industries here and half a dozen federal agencies, so I wondered whether one can say anything interesting and provocative about federalism in that context. Over the whole range of industries and agencies, I'll try. That will force me to be somewhat abstract, but you're all smart guys, and you're all smart enough to think up examples as I go along.

I think the federalism debate in all of these areas, from mutual funds to securities regulation, as traditionally conceived, to banks, mortgage lending, and so forth is somewhat confused because we are bred on the basis of the New Deal.

Presumptions? What are those presumptions? First, we need the federal government in here because otherwise the states will have a race to the bottom. Second, we need to encourage those brave states of Justice Brandeis' imagination. In order to encourage them and give them something to do even after the federal government is already in here, we have to expand their extraterritorial powers over interstate commerce, especially the power of state courts. And the third thing we have to do under this new deal model is we have to prohibit contractual choice of law, if need be by statute, because otherwise people who do not like these overlapping regimes will opt out of all of them and we can't have that.

What are the results of those presumptions? Well, first federal and state power now run concurrent and overlap over the entire range of corporate conduct, within their respective domains. You have concurrent regulation all across the board from merely local activities to gargantuan national things.

And the second thing is that everybody is subject to at least two regulatory regimes and possibly 51 of them. Does that make any sense? No, of course that doesn't make any sense. First, you get conflicts and duplications out the whazoo. Second, you guarantee practically the most intervention-minded regulatory authority always wins. And third, you allow people no way out.

The only presumption on which that regime makes sense is that there is never enough regulation. That was of course the New Deal's belief. On that I think Janice Brown was exactly right. But nobody else believes it. And in fact we've always tried to constrain and discipline those sorts of pure New Deal models at the margins.

But it seems to me that unless you question the underlying presumptions that I've just stated, all of these efforts to discipline the regulatory system are so many attempts to rearrange the deck chairs on the Titanic. There are better and worse deck chair arrangements. I have my own favorites, but the icebergs will always be there.

I'll run you through the leading arrangements here. First option, the federal government should act, should establish a minimum floor, so that you don't get these races to the bottom, and then above that the states should be free to regulate as you see fit. But it seems to me solves only the race to the bottom problem. It solves nothing else. It doesn't solve your problems with duplication and multiplication, and it doesn't solve the problem of the most restrictive jurisdiction. What you get under this regime is a form of regulation where you say, as Judge Posner has put it, "Well, car companies should compete, but they're only allowed to compete by building cars with more horsepower, not less, all in one direction."

Second model, the federal government should establish uniform rules and then the states should enforce them. That's not really federalism, that's more decentralization. But I suppose it's a model, and there's nothing wrong with that model of decentralized law enforcement so long as (a) the rules are relatively clear, (b) you're reasonably confident that the rules aren't over-inclusive, such that their enforcement would create more harm than good, and (c) the enforcers can be controlled and reined in by the central authority when that need arises.

And I submit to you that none of these conditions obtain in any of the areas that we're going to be talking about today, and that means you have agency problems out the whazoo. If you can't specify the rules with any great deal of specificity, as it were, the power to decide the level and direction of enforcement is to run the system, which is precisely what Elliot Spitzer does, and that means the pro-regulatory bias is still with you.

Third model, let's have preemption. I wish I could explain to corporate counsel here in Washington that you can't have preemption; that is a mirage. If preemption were successful, truly successful, you would have a big problem on the other side: you'd have a monopoly problem. How would you know that the federal government hasn't gotten it exactly right, that the SEC disclosure mandates are exactly the right rules? Well, I don't know that and nobody else knows either.

But the larger problem, it seems to me, is that preemption won't be successful. First, you have to accede to more regulation in exchange for the preempted provision, and then you don't get any exclusivity either. The central Madisonian insight is that preemption doesn't work on states; it operates on states that have absolutely every incentive to evade the new rules.

So, the corporations run to Congress and say, "The states are doing a, b, and c; preempt that." Well, if you get that, while you're still celebrating at the Palm, the state AGs and state trial lawyers have already thought of b, c, and d, or d, e, and f, and you'll never catch up with them. What's the conclusion? It seems to me so long this is concurrent jurisdiction of the full range and no opt out, there shouldn't be any room for federalism. But if you're willing to move to disentanglement, if you're willing to have exclusive federal and exclusive state regimes, and opt outs, then there's all the room in the world for federalism.

Do we have examples of this? Yes, we do. We have corporate law, which basically works on federalist principles. We have the dual banking system and conjunction with the Marquette regime, which is also plenty federalist because the OCC and the OTC just operate as the 51st and the 52nd state. We even have academics who have thought through extending these kinds of models through securities regulations and insurance regulations. So the models exist and people have thought through the details.

I think if we move in that direction there is room for federalism. If you're not willing to do that, I say abolish the states.

JUDGE EASTERBROOK: A modest proposal for you.
Our next speaker was supposed to be Carolyn Buck, the Chief Counsel of the Office of Thrift Supervision, but as you can see, she's not here. This shows that even the Federalist Society has very limited power in D.C. A vast, right wing conspiracy my foot.

Given a conflict between the Federalist Society and her official duty, Ms. Buck decided to do her official duty. Well, such is life, I suppose. But she has sent her deputy, Deborah Dakin, who is the Deputy Chief Counsel for Regulation and Litigation in the Office of Thrift Supervision, so Ms. Dakin.

MS. DAKIN: Good afternoon. I have to tell you that Carolyn was really looking forward to being here and would much rather have been here than where she is right now, but unfortunately official duties do call.

This afternoon I'd like to talk very briefly from the perspective of the Office of Thrift Supervision, and the idea of being the 52nd state sounds very interesting. I'm not sure that being a mere executive agency is good enough anymore.

One of the perspectives that I'd like to bring is the federal part of the dual banking system. You'll be hearing from the state part later. The dual banking systems existed in financial services since the mid-1800s when the Office of the Comptroller of the Currency was created. The agency I'm with, the Office of Thrift Supervision, is the successor to an agency that was created as part of the New Deal, the Federal Home Loan Bank Board. That agency was created and federal savings associations were first charted because there was a perception at the time by Congress and others that the state system for providing mortgage credit wasn't providing comprehensive housing credit in a way that was working. It wasn't something that people said, "Get rid of state savings associations," but they wanted to create an alternative federal savings association to help ensure the availability of mortgage credit. There was a view that that was an important federal need. At the time, Congress, in writing the Home Owners Loan Act, said that the Federal Home Loan Bank Board was to consider the best practices of thrift institutions, and those institutions would have been the state chartered institutions. So, Congress at the time contemplated that the decision what would be the best practice for federal savings associations and their regulation would be made not by the various states in determining how to enforce state laws, but would be made by an agency of the federal government that would look at the panoply of state laws and all the various choices that people were making and determine what worked best to help make mortgage and housing credit available. Again, it did not supersede state supervision. What it did at the time was create an alternative.

Congress also created federal deposit insurance for savings associations at the same time. And those of you who may remember the thrift crisis saw that there ended up being, I don't want to say a conflict, but some problems with how state savings associations worked with federal deposit insurance in the 1980s, because you had a situation where you had some states that were choosing to experiment, and that worked well in areas such as adjustable rate mortgages and negotiable orders of withdrawal accounts. It provided innovation. But some were choosing to allow investments and things that were highly risky for an insurance depository institution.

Now, some of you may recall there had been various state insurance systems that didn't prove viable, Maryland and Ohio being two prime examples of the forerunners of the thrift crisis. So, you ended up in a situation where you had federal deposit insurance by the FSLIC, but you didn't have the ability of the federal regulator to totally control what kinds of investments were being made. That ended up being a competition between some states and Congress in some statues, not quite a race to the bottom, but a race to expand powers in various ways that proved less than healthy for the overall system.

Congress made different choices in FIREA, recognizing that you still needed state savings associations, but choosing to give the FDIC greater powers than FSLIC had to look at certain ways in which those powers would be exercised.

As far as federal preemption of state laws goes, for federal savings associations—again, this is a charter that was created by the federal government. We believe that in order to effectively regulate those institutions it's important to have a uniform system of regulation. We believe that charted choices are very important, and federal savings associations make business reasons for why, given the type of lending they want to do, operating under uniform national standards is important.

Not everybody chooses to be a federal savings association. You have a wide variety of state lenders, ranging from state banks, to state mortgage companies that are not federally insured. Different companies have business reasons for choosing different charters, and federal preemption isn't that important to everybody. To some people it is very important, and we believe it is an important part of the charter as an alternative.

There may be reasons why somebody says, "I am not operating on a national level. I don't really care about the laws of 49 other states, because I'm only operating under one state. I know my state regulator. I'm comfortable with the regulatory scheme." Someone else may choose a different path and we believe it is important that they have those alternatives.

One of those reasons is because we believe it helps make housing credit more available. In the most recent refinancing boom, I'm sure a number of you chose to refinance your mortgages. I'm sure most didn't do that simply by walking to the depository institution or mortgage lender down the street from you. The Internet, telephones, national advertising, has made a national mortgage market, and you've had greater choices in the housing mortgages you've had available because there have been some nationwide lenders who provide competition.

Does that work perfectly all the time? No. We believe it's an important thing to have, and the courts have recognized that for a federal charter, federal preemption is important. Thank you.

JUDGE EASTERBROOK: Thanks so much for pinch hitting, but your job isn't done yet. There will be questions later.

Our next speaker is John Ryan, the Executive Vice President of the Conference of State Banks Supervisors. John?

MR. RYAN: Thank you very much. I appreciate the opportunity to be here today. First, on the topic, I hope that there's room for federalism in financial services and in our banking system. I certainly believe that there is a need.

Our banking system is actually not so much our dual banking system of state and federal chartering of parallel systems, but generally parallel and occasionally intertwining systems. There are a few things I'd like to talk about. First is, what is good about the American banking system? One of the things that I would assert is the dual banking system, which I think works very well in practice, if not in theory.

The second is, what is happening here in Washington? Why is this becoming such a hot topic? What is the push for preemption?

The third issue that I'd like to talk about, and this may be heretical in this group, but preemption and states rights are not mutually exclusive. That's one of those things where I think it works in practice, if not in theory.

The first is, what's good about our system? Well, I would assert, and others much wiser than I have already, is that the diversification and decentralization, which are the hallmarks of our dual banking system, are really its strength. For the majority of the industry that means local chartering, local regulation, local decision making, and local accountability with a federal twist. There is federal supervision for all insured depositories operating in the United States.

For federal institutions there has been a murky, sometimes more or less, intertwining of both state and local law, as well as state and federal law enforcement. The result of this system has been 9,000 or so insured depositories, of which 75 percent are state chartered. Small business ownership, which is fueled principally by consumer banks, is higher in the U.S. than in any other developed country. There is a strong co-existence of big money center banks, multi-national banks, and community banks all operating generally at peace with one another in our system.

If Alan Greenspan can be trusted, the result is also muted economic cycles and quick recovery, that is a result of both a decentralized regulatory and a decentralized banking system.

Europeans have often been befuddled by our success, but never have seemed to learn the lessons. They keep centralizing more and more. Canadian small businesses at this time, I saw a recent report on this, are presently complaining about their own system and capital distribution and are envious of ours, yet at the moment we seem to be attacking ours and moving more and more towards a centralized and more uniform system.

So, what's happening here in Washington? Well, a lot of it has to do with the pressures in the market place. Securitization, interstate operations, technology, are all driving factors, very legitimately so, for federal standards. The states have recognized this to a considerable degree and tried to facilitate it, so has the Congress, and so have federal regulators.

We, in the state system—this is where it does get complex and murky—recently supported extended preemptions in the Fair Credit Reporting Act that would preempt state law.

The largest financial institutions, however, aren't happy with the current status quo and are pushing more and more for uniform standards. They are achieving this in a most un-uniform way, and that is through interpretations of federal law conducted by federal regulators and law suits in the courts that give deference to federal regulators.

I think it took until 1996 to codify under HOLA the preemption that was established in the Depression, the preemption provided for federal thrifts. And the Comptroller, after 140 years, has recently discovered, or is suggesting, that he preempts the field, and also now has jurisdiction over state-chartered operating subsidiaries such as finance companies and mortgage companies that previously have been state regulated.

The problem is, as I said, that this uniformity is not uniform. Congress, when it has preempted, has preempted or applied consumer protection laws for all insured depositories. The FDIC regulates that for many state banks, the federal reserve for many state banks, the OCC for national banks, the OTS for federal thrifts. When it comes to state law, it's a very uneven proposition, particularly these days with preemption.

What else is going on in Washington is partially driven by some of the issues in the mortgage industry and predatory lending. The states have been very activist. The industry is finding this is getting in the way of business. The OTS and the OCC have been preempting state laws.

Recently, Congresswoman Kelly, from New York, had suggested that it's time to step back and look at how interpretations of federal laws are working and the unevenness of this "uniformity" being provided for federal institutions.

My last point is that preemption and states rights are not mutually exclusive. It's not an up or down issue on preemption. It's not yes or no. The success of preemption within a federalist context has been its measured and thoughtful application.

What we are facing today is much more of a wholesale preemption that isn't at all measured. It's coming from regulatory agencies, not elected officials. We believe that's a mistake.

What the Conference of State Bank Supervisors is asking for now is for Congress to examine the consequences on the historic success and the future success of our state banking system and our dual banking system. However, at the moment, huge lobbying resources are beginning to flow to shut down this debate. We think that's bad for the banking system and that's bad for the economy.

Thank you very much.

JUDGE EASTERBROOK: Thank you. Our next speaker this afternoon is Michael Roster, who is the General Counsel of Golden West Financial Corporation, and a director of the California Bankers Association. Before doing these things he served as partner of Morrison and Forester, and just to tar him with a remote academic relation, was General Counsel of Stanford University.

MR. ROSTER: And but for Wayne, I now have the dubious task of being clean-up speaker. All of my key points have been made in different ways. But let me reinforce how it is working in practice.

Much of the innovation still does come out of the state system in financial services. I think John had it absolutely right about the state system. Visa, MasterCard, Discover Card, the non-bank bank credit card banks, the automated clearing house system, the mutual funds, are all creatures of the state system, and still largely operate under the state system. They are the bulwark or a large part of financial services in the United States today.

On the other hand, the states created a lot of damage. Deborah has already alluded to some of it. In my 25 years of private practice I had fun creating a lot of innovative things, and cleaning up a lot of messes. Among the messes that Deborah already alluded to were the charters. In the late 1970s, California saw a lot of money, particularly for the state banking department, to charter thrifts in particular, and some banks. We chartered something like 120 new companies within five years. My firm refused to do it. We knew what was ahead.

But for one or two exceptions, every one of them failed. It created a very serious pressure on the FSLIC. It created a lot of serious pressure on the traditional responsible entities, who knew what was ahead. Notwithstanding how many times we did talk to the state officials, it wasn't under budget. It didn't matter.

That is one of the problems of the federal deposit insurance. One of the problems of the dual banking system is, if we believe in federal deposit insurance, then you can't have the states making large experiments and still leave the burden on the federal insurance.

Now, there are ways to bring that down. We've long advocated bringing that back down to $25,000, but it was a political deal to bring it to $100,000. And you may know Congress is ready to capitulate any day now to, "Let's index it and keep going," something I would hope does not happen.

Consumer laws. It is very easy, unfortunately, in the state system, to get a lot of votes by saying you're being tough on big business. So what we see are absolutely stupid laws being enacted that have unbelievable impact on the long-term viability of financial institutions. For example, when I first came into practice in the early '70s in California, we had high rates coming in mortgages so the legislature could curry a lot of favor by restricting the pre-payment penalty, the late charge, and the due on sale clause. The net result of that, plus a lot of other economic factors going around in the United States, is we had a trillion dollars of mortgage portfolios under water in America. And when you particularly understand how Senator Prockmeyer prohibited adjusted-rate mortgages on the federal side, and California put stringent restrictions on the state side, we really were about to suffer some serious problems.

My mentor, Bill McKenna, largely invented this federal preemption in banking. If you want, some day, or we can do it later today, I can explain to you what People v. Coast Federal Savings really was about. It was a lot of mischief. It was in the early 1950s, but in the 1970s we had to pay all the trillion dollars, I remember Bill saying, “Lets go with preemption.”

With all due respect to Deborah’s agency, they didn’t believe in him. We dragged them along kicking and screaming, by the way, in the early 1970s, asserting that there was federal preemption and the then Bank Board really did have it. They didn’t believe it. Now I watch in wonderment as the OCC totally reinvents the National Bank Act in 1972, another issue we might be able to take on later on.

Of course Deborah already really took on the state deposit insurance funds. It was then Utah, Ohio, Maryland, and Rhode Island, that created another wonderful business for me. Most of our non-bank banks in existence today are the legacy of the state insurance funds, every one of which went under. Every one of which was bailed out by powerful Senators, including Senator Garne out of Utah. That is why most of our credit card non-bank banks now sit in Utah. The state system did give us some benefits, but the net result was on federal.

Why do we need preemption? Credit cards. In the old days, I used to write these wonderful agreements that we tried to do a choice of law in the credit card agreement. My application is coming to Chicago and will be acted on Chicago and everything will be processed in Chicago. The problem is most of the banks wanted to go to Arizona. It was hard to make choice of law language.

We struggled. Preemption became a very important concept, to have some uniform rules. And the entire credit card system, the ability to export rates and to have uniformity turns on that. Mortgages, which is what my company does. We watch the laws being enacted by different states, and now every city. It would be virtually impossible to program a computer to keep track of the various laws that people are now enacting, partly again because it plays well with the local population.

What’s even more pernicious, now, is they know it’s not going to be enforced. So, of all the God awful things, they grandstand by passing the laws knowing it’s never going to happen because the federal system is going to bail it out and say, “No preemption.” They are counting, in many ways, on preemption.

Commercial lending. We used to do some huge refinances, like Federated Department Stores, 7-11’s, et cetera. You can not believe what it was like to figure out if New York does the seal, does the Board really have to fly to New York? Do we really have to do all this? And yes, we went through these exercises to assure New York law really would be binding. Largely because of the preemption and the depository issues we were able, in the larger financings through banks to be able to say, “Nope.” It’s New York Law. We are done with moving people around. Nevertheless it has been highly abused and I’ve taken on both the OCC and the OTS.

You cannot preempt without a standard as well. And Deborah was right. The original Homeowners Loan Act was taking the best practices of other local mutual thrift and home financing institutions. I will go to my grave with that old statute in my head. It was a very interesting system. Look at the best practices of the states and then bring them in and adopt them.

It is a workable system. It may be tough to explain in theory, but we are the most prosperous nation with the safest banking system because the dual system and federalism is working, and working very well. Thank you.

JUDGE EASTERBROOK: Thank you very much. And illustrating the proposition that the first shall be last, we now have Wayne Abernathy, who is the Assistant Secretary of the Treasury for Financial Institutions. Before coming to that job he was the Staff Director of the Senate Banking Committee, and an economist for its Subcommittee on International Finance. Wayne?

ASSISTANT SECRETARY ABERNATHY: Thank you. I apologize for being late. I guess the benefit of being last and not having heard all the other presentations is I'm in blissful ignorance. I don't know what's been said. So I may say things that people have already said. I'm not bound by the constraint of saying, "Why'd you say that all over again for?"

I also need to make a disclosure, I believe, speaking to this group. I am not a lawyer. I have never even played a lawyer on T.V. But I am a strong and firm believer in our federalist system. It means a couple of important things. One is, an apparently frustrating thing, and one we can take great comfort in.

The frustrating thing, which frustrates many people when they first come to Washington to do good is, you soon discover that because of our federalist system, no one person can do very much or get very much done. We should take great comfort in that because that means no one person can mess things up very much either.

I think that is something that we should rely upon to guide us as we look at the federalist system and wonder whether it is durable, and whether it has a place in our modern world.

I want to draw upon three models of the federalist system that we have in the area of financial services regulation. One works very well, one works poorly, and one is really not existent. The first is the dual banking system. That's the one that works very well. I'm a great fan of dual banking system. If John weren't here I'd say I'm the biggest fan of the dual banking system, but he gets paid to be a big fan of it and I get paid whether I'm a fan of it or not.

But I'm a great believer in the dual banking system, because I believe it has provided a better banking system that better meets the needs of banking costumers than you can find in any other country in the world, because of the competition and regulations it sets up. I have seen, numerous times, better regulation at the state level and better regulation at the federal level, because they're all looking at each other.

You've got important banks saying, "You know, we really could switch our charter." I don't know how many years J.P. Morgan kept on throwing out the idea that, "You know, we really could become a state charter bank." They never did that, but they just kind of had that out there.

There were a number of banks that did switch their charter when the OCC was not getting the balance right between being an adequate, sufficient, reliable regulator, and an overbearing regulator. We've seen state institutions that have fled their state charter either when the regulatory burden was too heavy at the state level or it wasn't adequate enough and people did not have confidence that the state regulator could do the job.

People realized, “If we’re going to retain our business, we’re going to have to change our charter.” The ability to do that has made sure that we’ve had good regulation, better regulation, more efficient and effective regulation in meeting the needs of the customers, which is the bottom line. Because of that, we’ve had a regulatory system that fosters and encourages innovation and development of new products. That is perhaps most significantly where our banks lead the world. We lead the world in this country in developing and bringing on line in a quick fashion new financial products.

Where did the swaps industry develop? It developed in American banks, and American banks still lead that. It wasn’t developed anywhere else. It was developed here.

Now, a place where it doesn’t work very well, securities regulation. We don’t have any significant competition, with regard to securities regulation. We basically have a federal system, meaning a Washington-based system, for most of the securities activity that takes place. For a certain amount of small-time activities, small in terms of size and in terms of the reach of their business, that’s left to the states.

The line is drawn pretty clearly, and the two don’t conflict, except at the margin every now and then. There is some nasty little rubbing that occurs and it results in little nasty arguments that really don’t mean a whole lot. But by and large they’ve divided up the turf, and most of it is regulated by the federal government.

The result is, we don’t have a lot of innovation in the area of securities markets. If you look at the financial innovations that have occurred over the last 15 to 20 years, they’ve occurred outside of the area of securities.

Financial futures, could those have been developed in a securities context? Perhaps. Perhaps you could have developed those types of derivatives and synthetics dealing with the financial markets, particularly the equity markets, but instead they are developed under a different regulatory system.

Insurance, now you turn to insurance. Here, we don’t have a system at all. It’s all done at the state level, so we can’t say there is much of a federal system other than that each of the states regulate insurance, and we have national insurance companies that try to cope with that problem.

The result is you get a lot of bad insurance regulation at the state level. You have a lot of insurance products where the companies cannot collect the premiums that match the risk that they have to carry. So they have to shift those costs elsewhere, and so there is a transfer of wealth from one set of insurers to cover another set of insurers because of the regulation that occurs at the state level. There is no real relief.

The final point that I’d make in connection with these three examples is, by and large, they’re experiments on how to deal with different financial services, and fortunately they compete with one another. And so we have the opportunity for innovation to take place in one system that works better than another. Our federal system of financial regulation is extremely inefficient and was intended to be that way, because of the fundamental belief that an inefficient system of financial regulation gives room for efficient markets. Thank you.

JUDGE EASTERBROOK: This sounds like there is room here for a new motto. Perhaps we could adopt it for the Seventh Circuit, put it up over the door, that said, “United States Court of Appeals for the Seventh Circuit, helping to keep the inefficient federal system inefficient.” But I’m afraid most people wouldn’t get it.

I was brutal on keeping everybody's time down, and I told them, actually, that I would bring a mace-like device that one of my clerks gave me that could be used. I didn't have to bring it out from under the table. So we have enough time for an exchange among the panel. I'll start with Mr. Borg for a minute or two if there are responses, and then in about ten minutes we should be able to go to the audience for questions.

MR. BORG: Let me pick up on some of Wayne's comments. He is right about the division of turf, which makes the entire discussion of financial services as one entity difficult. Again John, I think it's not quite parallel tracks. But I think the banking system is more of a parallel track, and you are right with regard to securities.

Corporate financial filings, SEC. Mutual fund registration, SEC exclusive. Accounting standards, SEC. Reg. D 506 filings, SEC. States sales practices, states. Point of sale enforcement, states. Suitability on Main Street for investors, states. Licensing of individuals, states. So they have divided up the turf every now and then.

We think of that as more of a complimentary system. Does it stifle some innovation? I don't think so. Not on Wall Street. There are more products coming out on Wall Street everyday and more sales issues, which have given trigger to some of this stuff.

Now, historically, prior to NSMIA, we did look at mutual fund registrations and merit review. Congress decided, in its infinite wisdom, we shouldn't look at that. I'm not making any relationship to whether we were looking at, we wouldn't have the mutual fund, but I will say this: on those Reg. D's, the Enron SPEs, or Special Purpose Entities, 506s, I'm going to tell you right now, they never would have gotten through my office. They never would have made it.

I do think that we have a complimentary system, and I do think that we are trying to work some things out.

The rhetoric that's going on between Elliot Spitzer and a few members of Congress, remember that's a very narrow area. Let's face it, Congress has to take the fault for it. They didn't listen to Arthur Levitt when he said there were accounting and consulting problems. The states backed him up on that. We supported that. No response.

Congress said, "SEC, we're not going to fund you." They had under funded, under employed. They created the preemptions, the gaps happened. What happened when you have gaps? People take advantage of it. You have to put some of the problems where it lies.

MR. GREVE: I just want to make one brief remark about my general sense of this. It deals with the question of why do these preemption fights become harsher and harsher? One way of explaining it, I think, is that most of the judicial preemption doctrines that we now have, in fact most of the statutes that give rise to those modern preemption cases, were written before 1980. This was before the advent of something known as the trial bar. It was also before something called the National Association of Attorneys General rose to power and figured out a way to loot American business. Of course businesses fight back against that stuff.

If you want to look at it from the state angle, of course there wasn't much harrumphing about federal preemption, and there wasn't even much capacity building at the state level so long as the federal government was in a pro-interventionist mood, as indeed it was throughout the 1970s. This new wave of state energy and activism only arose with the first deregulatory waves under the Reagan Administration.

That basically is the situation we face today. There is a real dispute about how much regulation you want that underlies the entire preemption question. I submit to you, I don't think that's comprehensive preemption. You're not going to get it, because the forces at the state level who benefit from the regulatory regimes that we have are too entrenched. You're never going to dislodge them. You have to have a Plan B with respect to that.

At the same time, for the state officials, you're dreaming if you think that you will always escape more and more ham-fisted federal interventions in your affairs. One way or the other we will have to find some way to move towards some equilibrium between state or local affairs, on the one hand, and national affairs on the other. We need some way of rearranging the deck chairs in that particular way. That means that you assign exclusive rights and authorities and functions to one or the other. That's the secret of the dual banking system. That is why I think it is a model that works tolerably well. Fighting over the last inch of preemption territory isn't going to help anybody in the long run.

JUDGE EASTERBROOK: Thank you. Deborah Dakin?

MS. DAKIN: Very briefly, as a representative of a federal executive agency, I just briefly want to mention how we've tried to put preemption out there. It's not been simply by interpretative regulatory fiat. We've actually put regulations out for public notice and comment, first in 1983, and no states bothered commenting on what we were doing. Then, in 1996, again no states commented when we were doing lending preemption.

I believe very strongly in the importance of public notice and comment in making our regulations better and helping us to better understand the positions of state and local governments when we are crafting our preemption regulations. We've noticed a much better increase in participation by state and local agencies in commenting on our regulations, and I think that helps make them better. Thank you.

JUDGE EASTERBROOK: Thank you. John Ryan?

MR. RYAN: Thank you very much. They were exactly right. We didn't comment at that time. I think we were fighting interstate battles. Our comments haven't seemed to make much difference since that time, so I don't know how much the comment process --

MS. DAKIN: But we appreciate them.

MR. RYAN: -- is really working. They're very nice about receiving them, I have to say. Sometimes we get a letter back.

JUDGE EASTERBROOK: And they all come back tied up in nice red tape.

MR. RYAN: The states have principally been laboratories for innovation in powers and structures for state charter banks. That's been very important in the industry. It was mentioned that the states had been a problem with the failure of federal proofs in the

1980s. I'd like to counter that because I don't know if that's the conclusion that you can naturally draw from that example. At the same time that the banking industry was having problems, state charter banks were not failing as a percentage of the industry at the same rates as national banks. These things were rather close, but there was nothing in the expanded powers which were limited in 1991. Prior to 1991 it resulted in no greater failures in state charter banks.

Also, the states have provided, and it was restated in the Regal-Neal Act, that they should act as laboratories for innovation and consumer protection laws. Obviously that was recognized in HOLA. If you preempt the field, if there are no applicable state consumer protection laws, what best practices do you draw from that?

What's been suggested is that you just make up regs in the process to fill the gaps. I find that a frighteningly undemocratic process. I think that state legislators and federal legislators should be making decisions, and not regulatory agencies.

That gets me to my final point. I don't want to sound like we're apoplectic over this, as was quoted in the paper recently, but I am really concerned that the federal regulation of financial institutions is becoming, to use Wayne's words, too efficient. You are having a cradle-to-grave regulator that enforces all laws, decides all applicable laws, and writes regs when laws don't exist.

I think that's a dangerous system. I don't think that's what's best for our economy or our financial institutions.

JUDGE EASTERBROOK: Thank you. Michael Roster?

MR. ROSTER: Just two quick points. I want to follow up with Michael's point about the plaintiff bar. It really has been a serious problem. It really has pushed the envelope in too many directions, and there's not been a power that has brought it back to some middle ground.

Yes, preemption was pressed largely to respond to courts and some lawsuits that were resulting in some serious, serious damage to the safety and soundness of our banks, and not any recoveries to the individual consumer. If you see through the class actions and the unholy alliances, both the plaintiff bar and the defense bar, including most large law firms, it's very profitable for both sides to continue this.

No one has spoken up very effectively to say, "You're both pocketing a lot money, but the individual you're claiming to protect is getting nothing at the end of it all." The collateral damage is that there are some pretty goofy provisions in both state and federal law.

The other key point I want to make, we haven't even talked about worldwide competition as we talk about federalism. I would find it disappointing if some other banking can jump through France and Germany and other nations that have been at war with each other and don't speak the same language, and yet they can more effectively accommodate transactions across national borders than we could over state borders. I think right now we have a system that is in there working very, very effectively.

We also didn't get into who is going to be the worldwide regulator of some of these entities, and in there we may have a whole new discussion of federalism as we find that the regulator is actually sitting in Belgium.

JUDGE EASTERBROOK: Wayne Abernathy, any quick comment?

ASSISTANT SECRETARY ABERNATHY: Yes, I want to pick up on that international issue. It's one of my notes here before I got the two minute warning to not move forward.

One of the key benefits that we have from the growing international commerce is that we're developing competition in international regulatory systems. One of the strongest arguments that was used to help bring about the codification of practice that the Graham-Leach-Bliley Act was, pointed out that all these things that in this country we think will be bad for banks and insurance and securities firms to do, they're already doing safely and successfully in other countries. The experiment has been a good one and an effective one there. We can safely let those different entities affiliate with one another here.

You see, that's similarly happening with regard to securities regulation. A lot of the improvements in our securities regulation that have taken place have been looking and seeing that there are some things going on internationally that show us that we need to adjust our regulations or this business can travel overseas. I like to encourage, wherever we can, the development and the comparison with what's going on abroad to help create some competition regulation that we might not have.

JUDGE EASTERBROOK: Thank you very much. It's time now for questions. There are just two rules for questions. One is, you should begin with your name and affiliation. You should go to the microphone so you can be recorded for posterity. State your name and affiliation and then state your question. Sharp and pointed questions are preferred. Softball questions are okay, I suppose, but no manifestos.

MR. GOETTLE: Shane Goettle. I'm with the Federal Housing Finance Board. I know, Mr. Ryan, you mentioned this in passing, and I know this is a favorite subject of yours, Assistant Secretary Abernathy. Predatory lending, if you could expand on that a little bit and the role of consumer protection in general in federalism.

Also, let me suggest touching upon financial privacy in another aspect of consumer protection.

ASSISTANT SECRETARY ABERNATHY: We can call on you first, John?

MR. RYAN: Well, on predatory lending I think that actually is as frustrating as this experience has been. I would say that this should really be a dual system of state legislatures and federal legislatures. I think that localities legislating banking practices is inappropriate.

But I think as frustrating as this experience has been for many institutions, it has shown where you can go too far with laws. Georgia rolled back their law, and the irony of it is, is that the comptroller, when he preempted, he preempted a law that didn't exist anymore. He preempted a law that they'd already rolled back. But the threat of federal preemption does play a check here.

But I think we should go back to the Constitution; that only the Congress can actually preempt. We're all talking about regulators preempting. I think there is an appropriate role for Congress to play here, and maybe that is looking at what the states have done. You've had a lot of states act, maybe creating some problems, and looking at needs for where there's uniformity. I think that's been appropriate with the Fair Credit Reporting Act. Maybe that's appropriate here with predatory lending, maybe not. Maybe that's appropriate in areas of privacy where you have information that knows no boundaries.

There are lots of areas where it's also appropriate to have applicable state laws. I don't think you should just be sweeping the field of them, but that you should look at them on a case-by-case basis and that Congress really should be playing that role in preempting.

ASSISTANT SECRETARY ABERNATHY: I'm a little shy of talking about predatory lending and privacy because I'm not sure what you mean by them. Maybe you know what you mean by them, and I have my own definition, but those terms are so broad it's hard to have a meaningful conversation in connection with them. Having said that, I recently read a marvelous paper that deals with the issue of predatory lending and the dual banking system and how the current regulatory system gets it just about right. That's Mr. Greve's paper. A wonderful paper. I think the argument is a strong one, which is, if states want to enact legislation that will have the effect of cutting off a lot of people from access to credit, which a lot of these predatory lending statutes do because they focus on products rather than on practices, States should have the authority to do that for the institutions that they have responsibility for.

If the national bank regulator wants to deal with predatory lending with regard to supervision of national banks by saying we're going to focus not on products, but rather on practices and go after the bad actors, then they ought to be able to do that. We'll see which one works to meet the interests of consumers best. Because in the end, that's what our regulation should be doing. They should be finding the best way to allow financial institutions to deliver products to consumers that consumers want. And when regulation gets between the institution and the consumer, and the institution can't meet the needs of the consumer, that's bad regulation.

MR. SIMON: My name is Tomas Simon. I work for Legg Mason. It's kind of off the beaten track, but we've got a good panel up here. California. What is it going to take to get us out of that situation and when do we get the --

JUDGE EASTERBROOK: Further movement of the San Andreas Fault.

MR. SIMON: Yes. Well, yes, my parents are still out there, so let me know when that happens so I can warn them.

But with the bond ratings, what's it going to take to get those better and how long of a turn-around is that normally?

MR. ROSTER: I think the Treasury should speak on that. I'm the Californian.

ASSISTANT SECRETARY ABERNATHY: Well, I can't talk about what their particular financial problems are. That really is something they need to deal with themselves. I would just say, we fought a war to get California and got a lot of other good states along with that process as well.

MR. ROSTER: I'll simply add, I think the governor who's sworn in on Monday is going to move very quickly with a number of proposals. It depends on whether he can strike a deal quickly with the legislature.

MR. BAKER: John Baker. LSU Law School. This a fall out to Michael Greve's point about the impact of the trial bar. For the panel on the use of mandatory arbitration clauses, which also exclude class actions. Have they been effective in cutting back the threat that Michael was opposing, and can they be extended more as a private remedy that might minimize the need for broad scale preemption?

MR. ROSTER: I'll start. I was appointed to a state supreme court panel on arbitration by the Chief Justice in California. I always believed arbitration made a lot of sense, and at Stanford we implemented a lot of programs where instead of litigating, people could get a quick determination in a matter of hours.

I was shocked at how opposed the judiciary is in California to arbitration. On this panel were mostly judges and retired judges, and they hated it and were out to undo it any way possible. Then I was further shocked to see that members of the legislative staff unilaterally put themselves on the Blue Ribbon Commission, even though they weren't appointed, to make sure we did not permit arbitration to go forward very effectively. Then we came up with a whole list of very cockamamie disclosures, and if any of you looked at it, it is almost impossible to comply with it.

Now, mandatory arbitration is an issue. It's one of these things, as with preemption, it has been abused. Some banks, in particular, put mandatory arbitration in, and I'm not making this up, and required a California resident to arbitrate in Minnesota, or in South Dakota, and pay the full fees of the first day. That was insane.

So then you also get to the class action issue. It's one of those examples of a very good thing pushed way too far, and at least in California we're losing it. I would hope we will come up with a scheme that really does permit effective arbitration again. It may be that we have to give up on the mandatory aspect to make it work.

JUDGE EASTERBROOK: Michael, did you want to say more?

MR. GREVE: I know little about it, but I'll say this much. It is of course a form of contractual choice of law. Once you take that step saying people can, by contract, at least choose arbitration, put aside the mandatory aspects. Can't they agree on resolving their legal disputes under some other state law system?

MR. ROSTER: I was just hoping Judge Easterbrook would comment, because he's had several opinions on this issue.

JUDGE EASTERBROOK: That's precisely why you haven't heard me comment. Not only have I had several opinions on this, there are some cases under advisement in the Seventh Circuit on questions like this.

MR. ROSTER: No, but on the ones you've already written.

JUDGE EASTERBROOK: Mr. Borg, did you want to say something about this?

MR. BORG: I'm not an expert on arbitration. Of course you know the security's rules are a little bit different than some of the other arbitration. Everything's done through the NASD. We are aware of some issues with regard to the arbitration. The only thing I can tell you is that the North American Securities Administrators Association has authorized for some time in the spring a forum on arbitration issues in the securities industry. I think it will be either in New York or Washington as a several day program, after which there will be a white paper that will be released to all the state regulators for sign-off to see if there are some issues there.

I know we're in the process of getting those issues collected both from the plaintiff side, the defense side, and the regulatory side. NASAA has decided it will not be on any of the panels, because it wants to hold a very neutral, upfront forum. So we're inviting everybody else that has an interest in that area to discuss what those problems are.

We're going to look forward to seeing what that is, because quite honestly state regulators from our point of view need to be a little more educated. My big problem with arbitration right now is I didn't ask NASD for a location in my state. My folks have to go to Atlanta or to Memphis, so it's a little different issue.

MR. RYAN: Something I'd like to add. It's a little bit of an offshoot of this. I think that state regulation has actually provided a very good model for how to protect consumers and deal with those who are directly injured. The Household settlement would be a good example of that. That is money that is going back to consumers.

All fifty state banking departments are looking through records very carefully and trying to get money back to those consumers that were harmed. Something that I think is at risk here in this sort of power play over institutions is that role that the states play. With the preemption and uniform enforcement of law, excluding state AGs, state regulators, and only having one federal regulator enforce laws, I think puts that system at danger. I think that, Donaldson at the SEC recognizes, and I would hope that our federal banking counterparts could, that you can't be everywhere at once and that it's important to have those state resources responding to consumer complaints. That's probably a better way to address those issues.

JUDGE EASTERBROOK: Thank you.

MR. REDLEAF: Andy Redleaf. I run a group of hedge funds in Minneapolis. I think if the panel could address their irrelevancy a little more in that most banking transactions that we do are with international subsidiaries of recognizable American institutions, all of which have the tacit guarantee of the Fed in terms of clearing system collapse and that those kinds of transactions now dwarf all of the regulated banking system. Whatever the numbers are, if anyone has an idea how much is completely outside of the regulatory framework. All of this, if not irrelevant now, will be shortly.

JUDGE EASTERBROOK: Who wants to handle that? Mr. Abernathy, you want to be irrelevant as well as inefficient?

ASSISTANT SECRETARY ABERNATHY: Yes. Remember I worked in Congress for twenty years. Many a day I'd come home and say, what did I do today?. Lot of activity, but did it have any relevance?

Well let me say this with regard to the question. It might not be directly at your point but it's the thought that came to my mind as you were speaking. That's the role of hedge funds. That is, if you really think about it, we've been doing a lot of thinking about hedge funds lately, that is the state counterpart to the federal securities institutions.

Hedge funds are state-chartered, state-regulated, financial institutions. Because of that regulatory system that they have at the state level, they're able to experiment. They're able to probe for where there might be financial opportunities. They're able to go into waters where the big boats can't go, and able to meet a lot of needs that would otherwise be unmet.

I think we would be in very serious difficulty if we decided we were going to impose some onerous federal regulatory system upon hedge funds and not allow them to do the kinds of things that they do.

MR. RYAN: Let me add to the hedge fund matter, only because Wayne brought up the states. The hedge funds are lightly regulated, and they're really not regulated on a state level. Most of their dealings are with institutions or credited investors that are outside our jurisdictions. The states very rarely see anything regarding hedge funds.

My concern about hedge funds is where the hedge funds are going to be targeted next. First of all the FCC is already looking at the entire hedge fund industry. But from the state perspective, I'm focusing on hedge funds that are drilling down and going outside the sophisticated investor and starting to offer interest in the five, ten, and fifteen thousand dollar range, where now they're becoming retail. If hedge funds become retail, you're going to see a lot of state action. At the present time, the only thing that's required of hedge fund managers is that they be licensed as an IA, investment advisor, in most states, and that's really more for notification purposes. But you haven't seen a whole lot of state action on hedge funds.

However, if the hedge funds start going retail, I think you will see a lot, because there's really no regulation out there, unless the SEC comes out with something comprehensive.

JUDGE EASTERBROOK: Ms. Dakin?

MR. ROSTER: As a way of keeping the hot debate going here, if I can make a little comment on that. They are regulated at the state level. Hedge funds are subject to state contract law. They are subject to partnership law. That is where their regulation comes from, in addition to the regulation that the market imposes on them.

But I would agree with you one hundred percent that if hedge funds get out of the small group of people, if they are able to change their nature, be in these partnerships that are offered to either small groups of people who all know one another, or to relatively wealthy individuals, we ought to close that avenue off.

MR. REDLEAF: The regulation I was talking about was strictly on the security side. Even a big corporation is going to be subject to some corporate state laws somewhere, but as far as direct regulation by the regulator for securities, it's very almost non-existent at the present time.

MS. DAKIN: Not speaking at all about hedge funds, my sense is as long as Congress and the American people believe that federal deposit insurance is relevant, you're going to need some sense of regulation of depository institutions. Where the federal deposit insurance has been superseded by too big to fail for a number of institutions regardless of what the statutes say, I can't speak to. But it seems to me as long as you have federal deposit insurance, you're going to need some federal regulation in order to try to avoid the cost to the taxpayers like the thrift crisis in the 1980s.

JUDGE EASTERBROOK: If I can just say a word, I am always enthusiastic about international competition because it means that no matter what the efficient or inefficient system at the state or federal level is, the cost can't exceed a fairly small level in financial transactions, because it's so easy for money to move elsewhere. That was the lesson in the regulation of derivatives by the CFTC. It used to be that the world's major derivative exchange was the Chicago Board of Trade. Business simply moved to Frankfurt and other places until the laws were thoroughly revamped.

As soon as the costs rise too much anywhere in the world, it's very easy for transactions to flee in search of a place where contracts are actually enforced.

MR. OLSEN: Yes, my name is Carl Olsen from Los Angeles. I want to put in a word for federalism in financial institutions because it gives the public the hope that there is a race to the top. Without federalism there's no good comparison.

My question has to do with financial crimes. It seems like Washington has put this in a very low priority. Take as an example New York State prosecutors that are getting a lot of heat from Washington about prosecuting so enthusiastically. The FCC hasn't even filled about 25 percent of the auditors and the enforcement staff that they've been budgeted for. The FBI will role on any bank robbery of one thousand dollars, but won't role on financial crimes of one million.

I guess the most appalling thing is that on the FBI's ten most wanted list, I don't think there are any financial crimes. What do you think the motivation is here in Washington to not protect the public?

MR. RYAN: Coming from the state perspective, I really don't think there is a motivation not to protect the public, but it is so easy to get consumed within Washington on all these Washington-centric issues. I think that there is a strong value to having folks out in the field, the cops on the beat monitoring our financial system in addition to federal regulators.

Within the banking system the primary focus of our federal regulators appropriately is safety and soundness. That's what tends to dominate their time.

MR. BORG: From the state perspective, as probably one of the stronger enforcement states, I think we try at least two criminal cases a month in my office with regard to white collar crime. However, when you get to the big national scandals, if you will, the research analysts conflicts, you're trying to work with a number of groups. That investigation was not just the fifty states, it was the SEC and their various regional offices and the NASD, and the NYSE.

My feeling on that was, we settled that case way too soon. I was about 25 percent through my part of the investigation when that settlement came apart. This is my personal opinion. I'm not speaking for the state securities regulators as a whole. But I differed with some of my colleagues on that. But to say that there was a very big push from all sorts of directions to get this behind us on the theory that as long as this continues, you're still going to have turmoil in the markets.

So at what point is this comparable to the too big to fail type thing, except that my feeling was it went too quickly. I didn't have enough, in my investigation, at the point I was when the settlement occurred, to have brought criminal charges.

That being said, in a more local environment, you'll find that where the SEC may bring 300 or 350 total actions a year, and they don't do criminal, that goes to the Justice Department. The states probably bring 4,000. If I bring 35 or 40 criminal convictions a year in a small state such as Alabama you have to multiply that by 50 to figure out what's going on. The difference is we don't get the publicity, so you never hear about it. I think I've convicted three CEOs or COs or presidents and whatnot in the last year on corporate fraud matters. But they're smaller companies. They're not going to make the national news, and you probably haven't heard of them.

I think the states are very, very big on white collar crime enforcement. It's our primary mission. And even though we've split with the SEC, we have never given up fraud authority or criminal authority with respect to the other areas that even the SEC regulates. Which brings us into conflict with the SEC on a lot of matters.

On national market rules, they do it. If it has an implication on that, a lot of times we will defer to the federal regulators. I think historically white collar crime has not been treated the same as street crime, and I disagree with those who think white collar crime is a victimless crime.

There should be more enforcement. I think the American people are going to demand it before they bring confidence back to the markets.

MR. GREVE: Can I?

MR. BORG: And I know Michael Greve is going to disagree with me.

MR. GREVE: I just want to introduce one contrarian thought. There is, of course, a tendency to say, "Whoa. We now found out there is gambling in the casino. And whoever it is found out to go after more gamblers." Ipso facto looks like a better guy, ex-post.

But I think one has to entertain at least the possibility that the regulatory regime we have is not just wrong in some details, that it's fundamentally misguided. There's a wonderful Supreme Court case about SEC disclosure rules from the 1940s, when people still had a lot of confidence in government. It says the philosophy of the SEC regime is to substitute a regime of full disclosure for caveat emptor. That is to say, take caveat emptor

—you know, buyer beware—out of it. Have full disclosure, and yes if only Justice Douglas or Chairman Douglas can write the right disclosure rules, hallelujah, it'll be a totally great market. You no longer have to take care of yourself in this market.

And mind you, it is not crazy to say that what went on in 1999 and what went on in 2000 was the result, among other things, of that moral hazard. That is to say, everything's disclosed. For God's sake, there were newspaper stories about Aunt Millie day trading. Trying to beat the street.

Where was the NASAA then? Why weren't these guys all of a sudden out there screaming, saying, "Time out, you investors should not be in this market. It's a random walk. You can't beat these guys. Get out before you get really burned, because we can't really protect you." Everything we do afterwards is just placebo.

Where was Elliot Spitzer then? He came two years too late. Sorry. And then afterwards to stand up and scream, "I'm the white knight, I'm the investors' protector." I think that's a cheap shot.

You really have to entertain the possibility that it's much better for a regulator to say something like the following: "Look guys, investors, dear consumers, the whole place is a whore house. There are conflicts of interest everywhere. What we, the regulators, can do is we'll slap some Victorian façade on it, and we'll make sure that everybody inside gets a health test. But that doesn't mean that it's a good idea to go there." Which come to think of it is what my mother, when I was young, told me. For them afterwards to say, "We're shocked, shocked that all of this happened here." It looks too much to me like publicity hounding.

Just one more thing—it has all the wrong incentives, because then you're dealing with a crisis environment where people just want to be bailed out and want to be made "whole." It's not a good environment in which to make public policy. I submit that we might want to find better institutional arrangements at the front end rather than patting people on the shoulder afterwards.

JUDGE EASTERBROOK: I think we have to go to our last question of the day, but before we do that I'll exercise the chair's prerogative and say that it again might be interesting to compare the structure of regulation in securities markets, or for that matter banking markets, with the structure of regulation in derivative markets, especially in the wake of the 2000 legislation that reorganized.

There is one set of rules for professionals, who fundamentally can trade any kind of derivative they can invent—and derivatives can be pretty complex contracts—and a different set of rules for amateurs. Amateurs are not given access to those markets. There are all sorts of means of trying to keep amateurs out, of requiring the sale level to be very high.

Michael Greve's suggestion really sounds like more separating professionals and amateurs in securities markets and allowing the professionals to do what they please while fencing out the people who have no conceivable informational advantage.

Our last question.

MR. SMITH: Yes. For the honorable gentleman from Alabama.

JUDGE EASTERBROOK: State your name and affiliation, please.

MR. SMITH: John Smith. Morgan Stanley. When you woke up this morning and read about the Putnum settlement, I think the ink was dried before the blood was dry on that. When you read about that, and you realized that there was probably some of your states pension money in there and tens of thousands of your fellow Alabamans had probably invested in these funds and in some way been aggrieved investors, how do you make a decision with your state's attorney general to go forward or not?

What's your thought process on something where the SEC is in and out in four days? How do you decide whether to go forward? And what is the process?

MR. BORG: First of all, my state's a little different than most. The Attorney General doesn't usually get involved with securities matters. Let me get something straight with these AGs, because everybody talks about the 50 AGs. There are only five states that where securities regulations is under the AGs. There are only five. The only one you've heard about basically is Elliot Spitzer. He's the only one that's been pretty active. Most of the others have delegated it back to the securities regulators.

Anytime I see that there is a market, a fraud that involves my investors, I have to take into consideration what issues have been resolved by New York and the SEC in that matter. Does that mean that that's fait accompli, that we're not going to take any action? No, I need to see what those final results will be.

On the research analyst cases, I was not happy. I was not happy. But we decided in the interest of moving this thing along and getting in with the states and making it a unanimous decision that we went along with it.

It's too early for me to tell you what we're going to do on Putnum. Quite honestly my state pension fund doesn't have anything in Putnum, so they're not interested. But I did have cases involving WorldCom and Enron, because they're heavily involved in that, and that would be a factor.

At the present time I have no complaints on Putnum from people in my state. That doesn't mean there aren't any losses. That also doesn't mean that there are huge losses, and until we take a look at that whole thing, quite honestly I saw that newspaper, but I don't know what the terms of that settlement are.

That will come back to my office. We will review it. We will try to make a determination as to what extent of that activity is in our state, if it's even worth pursuing. At some point you have to balance your resources and costs with the potential action. And unfortunately I don't have unlimited resources.

I don't have a specific answer, because I don't know the details yet, but we do look at them on a one by one basis. Some cases we bring, some cases we'll prosecute, some cases we'll sit down with. WorldCom being one, Enron defendants being another.

JUDGE EASTERBROOK: Any further thoughts? In that event, please join me in thanking the panel for an excellent presentation.