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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

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The Revolving Door

Sometimes (oftentimes?) banks do bad things,[1] such as:

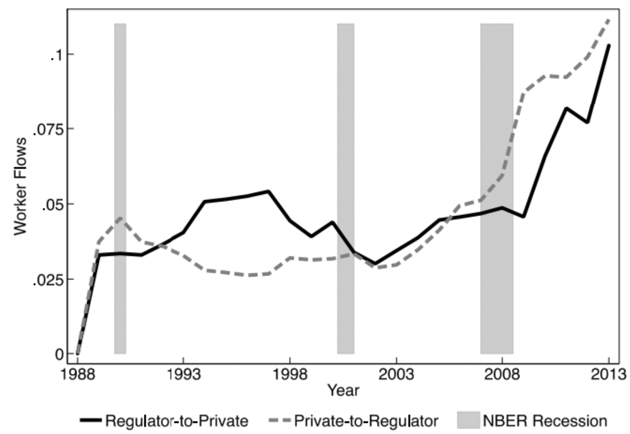
- Misleading investors about CDOs,[2]
- Misleading investors about RMBS securities,[3]
- Misleading investors about toxic mortgages,[4]
- Misleading investors about auction rate securities,[5]
- Rigging bids for municipal bonds,[6]
- Committing foreclosure abuses,[7]
- Ignoring Chinese walls and publishing misleading investment research,[8]
- Engaging in deceptive robosigning practices,[9]
- Energy market manipulation,[10]
- Using illegal credit card practices,[11]
- Fraudulent coverups of massive trading losses,[12]
- Violating federal and state securities laws,[13]
- Colluding to fix LIBOR interest rates,[14]
- Promoting tax shelter fraud,[15]
- Enabling money-laundering,[16] and
- Engaging in currency manipulation.[17]

Regulators and Prosecutors try to prevent and punish these acts of malfeasance. But after the financial crisis of 2008, prosecutors were concerned that charging a big bank with a crime would destroy the bank and perhaps cause another financial crisis.[18] And so, until about half a decade later, there were no prosecutions to speak of. The concerns were that, if a bank were officially labeled a criminal enterprise through the justice system, the bank would lose clients and counterparties, potentially leading to failure, as had happened with Bank of Credit and Commerce International and Drexel Burnham Lambert.[19] Trading partners and institutional investors such as pension funds, endowments and other fiduciaries would take their banking business elsewhere ("where to?" is a good question, as the abuses seem rampant in cross section of the industry). No one wanted to cause another bailout. But, over time as the recovery progressed, public outcry over the "too big to fail" climate increased, especially (and somewhat ironically) in the political realm.[20] By 2014, regulators developed workable methods that would allow banks to plead guilty to crimes without imploding.

One example of how regulators have lowered the disincentives for criminal banking activities is through waivers. Large, well established banks (and other public companies) can be classified as "well-known seasoned issuers" ("WKSI") in order to issue securities on an expedited basis without extensive SEC review. A company that is convicted of a felony loses its WKSI status, unless the SEC grants a waiver. In 2015, the SEC granted such a waiver to Deutsche Bank, the third such waiver allowing felonious financial institutions to keep WKSI status despite criminal conviction.[21]

Another disincentive to justice may be the so-called "revolving door." The revolving door usually refers to the frequent instances when prosecutors and regulators leave the government's employ to work for the companies they previously prosecuted and regulated. It can also refer to the times when bankers become regulators. The Federal Reserve Bank of New York has studied the revolving door, and they find that regulators do indeed leave for banks (usually during stricter enforcement environments).[22] They also find that bankers leave to become regulators. This two-way flow of talent supports a "Regulatory Schooling Hypothesis", in which the complexity of bank regulation leads banks to hire former regulators while bankers become regulators in order to understand, and potentially influence, the regulations. John Cochrane also discussed this study.[23]

Figure 4 from the Fed study is shown. In this chart, gross worker flows are illustrated over time as line series. Additionally, macroeconomic conditions as measured by NBER recessions are shown as shaded vertical areas. The dashed line shows gross private-to-regulator worker flows, defined as the share in each year of all workers in the sample that transition from the private sector to the regulatory sector. The solid line shows gross regulator-to-private worker flows, defined as the share in each year of all workers in the sample that transition from the regulatory sector into the private sector.



Prior to 1988 there were no flows documented. In 1988-90 there is a sharp two-way increase in worker flows; this period follows implementation of the Tax Reform Act of 1987 in the wake of the S&L crisis. Then following the financial crisis of 2008, worker flows spike again, approximately twice the magnitude of the earlier increase. The second spike coincides with the drafting and implementation of the Dodd–Frank Wall Street Reform and Consumer Protection Act of July 2010. By 2013, more than 10% of people in this sample of more than 35,000 regulators move from regulator to industry or back again each year.

A variety of hypotheses for the revolving door have been proposed, including:[24]

1. Regulators want to get higher-paying jobs at banks, so they go easy on banks to make the banks like them and hire them (the Quid Pro Quo Hypothesis)
2. Regulators want to get higher-paying jobs at banks, so they try to be diligent, fair, competent and zealous, so that the banks are impressed by them and hire them.
3. Regulators want to get higher-paying jobs at banks, so they are hard on banks in ways that force the banks to hire lots of ex-regulators—to understand complicated rules, say, or, like Neil Barofsky, to work as monitors

for regulatory settlements (the Regulatory Schooling Hypothesis).

4. Regulators want to get higher-paying jobs at banks, so they are hard on banks in general, hoping that the banks will hire them to just shut them up.
5. Regulators want to get higher-paying jobs outside of banks, so they ban banks from engaging in certain activities and then quit to do those activities themselves.
6. Regulators actually get paid more than bankers, so they have no desire to leave and all of this is irrelevant.
7. Bankers have earned enough wealth that they can personally afford to accept pay cuts in order to infiltrate the regulators in order to reduce the effects of future enforcement on banks (the Trojan Horse Hypothesis)

Wait, What? Hypothesis #6 is absurd, *prima face*, you say? According to Paul Kupiec, of the American Enterprise Institute—who has held senior positions at the FDIC, IMF and Federal Reserve Board, and served as chairman of the research task force of the Basel Committee on Banking Supervision—regulators make more on average ($190,000) than bankers ($49,540).[25] Bloomberg Columnist Matt Levine disputes Kupiec's figures, finding that the average regulator's pay is about $122,000, exactly in line with the pay of an average J.P. Morgan employee.[26] OK, #6 may be absurd after all.

The Fed Study concludes in support of hypothesis #3, and against hypothesis #1.

Questions

1) Is malfeasance in the banking sector the norm or the exception?
2) What incentives might exist that contribute to banking malfeasance?
3) What disincentives are in place to prevent or mitigate banking malfeasance?
4) During the mid 1990s, more workers flowed from regulators to banks than the other way around; why?
5) Do regulators actually get paid more than bankers on average? What about in the tails? What if we exclude commercial retail bank employees and focus on Investment banks only?
6) The Federal Reserve's Study results indicate that during periods of strict enforcement, movement from banks to regulators increases more strongly than movement from regulators to banks. The study interprets this effect as "regulatory schooling," in which bankers go to learn the new rules. Do you think the Fed's *Regulatory Schooling Hypothesis* is more likely to be empirically true than the *Trojan Horse Hypothesis*, in which banks infiltrate the regulators with their own people seeking enforcement leniency over time? How about versus the *Quid Pro Quo Hypothesis*?
7) How much of the spread between private-to-regulator and regulator-to-private worker flows since 2008 might be due to bank layoffs?
8) What would Milton Friedman think of the revolving door?
9) Considering the following examples of Goldman Sachs alumni, would you consider that firm to be an illustrative example of the Trojan Horse Hypothesis?
   - Henry Paulson – United States Secretary of the Treasury
   - Jon Corzine – U.S. Senator and Governor of NJ
   - William C. Dudley – President of the Federal Reserve Bank of New York
   - Robert Rubin – Secretary of the Treasury of the United States
   - Gene Sperling – Director of the National Economic Council
   - Lawrence Summers – Secretary of the Treasury of the United States, President, Harvard
   - Rahm Emanuel – Mayor of Chicago

- John Thain – Chairman of the NYSE
- Arthur Levitt – Chairman of the Securities and Exchange Commission
- Gary Gensler – Chairman of the U.S. Commodity Futures Trading Commission
- Henry H. Fowler – United States Secretary of the Treasury
- Neel Kashkari – President of the Federal Reserve Bank of Minneapolis
- Mark Patterson – Chief of Staff to the Secretary of the Treasury of the United States
- Judd Gregg – Governor of NH and United States Senator from NH
- Bradley Abelow – Chief of Staff and Treasurer of NJ under Jon Corzine
- Joshua Bolten – Former White House Chief of Staff under George Bush
- Jim Himes – Member of the House of Representatives representing CT
- Reuben Jeffery III – Undersecretary of State for Economic, Business, and Agriculture
- R. Scott Morris – CEO of Boston Options Exchange
- Robert Zoellick – US Trade Rep., Dep. Secretary of State, World Bank President
- Mario Draghi – President of the European Central Bank
- Mark Carney – Governor of the Banks of England and Canada
- Gianni Letta – Secretary to the Council of Ministers of Italy
- Ziad Bahaa-Eldin – Deputy Prime Minister of Egypt
- Olusegun Olutoyin Aganga – Nigerian Finance Minister, Trade and Investments
- Efthymios Christodoulou – Governor of the Bank of Greece
- Petros Christodoulou – GM of the Public Debt Management Agency of Greece
- Michael Cohrs – Member of Court and the Bank of England
- Guillermo de la Dehesa – Secretary of State of Economy and Finance of Spain
- Vladimír Dlouhý – Minister of Industry and Trade of the Czech Republic
- Ian Macfarlane – Governor of the Reserve Bank of Australia
- Tito Mboweni – Governor of the Reserve Bank of South Africa
- Karel Van Miert – EU Commissioner for Transport, Consumer Protection & Competition
- Carlos Moedas – European Commissioner for Research, Science and Innovation
- Romano Prodi – Prime Minister of Italy and President of the European Commission
- Peter Sutherland – UN representative; EU commissioner; attorney general of Ireland
- Massimo Tononi – Undersecretary of the Ministry of Economy and Finance of Italy
- Malcolm Turnbull – Prime Minister of Australia
- Erik Åsbrink – Minister for Finance of Sweden

Notes

1 Some examples include: HSBC; ICBC; Standard Chartered; Credit Suisse; RBS, BNP Paribas; Bank of America; Deutsche Bank; Rabobank; UBS; RBC, Goldman Sachs; Morgan Stanley; Wells Fargo; Citigroup; J.P. Morgan; J.P. Morgan; J.P. Morgan; and many more.

2 https://www.sec.gov/news/press/2011/2011-131.htm.

3 http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171486012#.UuF2gLRMGCh.

4 https://www.justice.gov/opa/pr/justice-department-federal-and-state-partners-secure-record-13-billion-global-settlement.

5 https://www.sec.gov/litigation/litreleases/2009/lr21066.htm.

6 https://www.justice.gov/opa/pr/jpmorgan-chase-admits-anticompetitive-conduct-former-employees-municipal-bond-investments.

7 https://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading.

8 https://www.sec.gov/litigation/litreleases/lr18854.htm.

9 https://www.justice.gov/opa/pr/federal-government-and-state-attorneys-general-reach-25-billion-agreement-five-largest.

[10] https://www.ferc.gov/media/news-releases/2013/2013-3/07-30-13.asp.
[11] http://files.consumerfinance.gov/f/201309_cfpb_jpmc_consent-order.pdf.
[12] http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965#.UuGTVLRMGCh.
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[14] http://dealbook.nytimes.com/2013/12/04/e-u-imposes-1-7-billion-euros-in-fines-over-rate-rigging-scandal/.
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[18] http://www.wsj.com/articles/justice-department-overruled-recommendation-to-pursue-charges-against-hsbc-report-says-1468229401.
[19] http://www.bloomberg.com/news/articles/2014-05-01/criminal-charges-against-banks-risk-sparking-crisis.
[20] https://twitter.com/hillaryclinton/status/688917116314120192.
[21] https://www.sec.gov/rules/other/2015/33-9764.pdf.
[22] https://www.newyorkfed.org/medialibrary/media/research/staff_ reports/sr678.pdf.
[23] http://johnhcochrane.blogspot.com/2014/06/revolving-door.html.
[24] http://www.bloomberg.com/view/articles/2014-06-26/strict-regulation-makes-the-revolving-door-spin-faster.
[25] http://www.wsj.com/news/articles/SB10001424052702304311204579507512375765276.
[26] http://www.bloomberg.com/view/articles/2014-04-22/are-bank-regulators-overpaid.