

**FINANCIAL CRISIS AND REFORM**

Remarks of Marshall Sonenshine

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We convene in the eye of a storm that has been described as a tsunami and more recently as “the perfect storm.” In this context, financial reform is akin to rebuilding the levees while the flood is still occurring. That is our subject today and the challenge for the new Administration in January.

Many of us work in the storm. I have worked in banking for over twenty years, first at Salomon Brothers, later as Partner at Wolfensohn and Co, and today as Managing Partner of Sonenshine Partners, the New York based Merger and Acquisitions and Restructuring investment banking firm. We used to say that we finance professionals work in a regulated industry; I am not sure that has adequately been the case for significant portions of the financial services industry, and there lies the problem and the solution, so I will say a few words about each.

#### THE PROBLEM

The storm reflects inadequate and sometimes outright avoidance of supervision or regulation, in several areas of financial markets that specifically needed it. These areas include but are not limited to (a) loan origination, particularly residential mortgage; (b) securitization of credit instruments; (c) the credit default market, which has essentially constituted an unregulated \$50 trillion shadow market that often dwarfs the regulated credit markets to which it refers; and (d) the safety, soundness and transparency of conventional financial institutions and systemically significant alternative asset managers. We also made mistakes in monetary policy in the years leading up to the crisis and in our more recent emergency bailout policies, some of which reflect gaps in our financial oversight structure.

Our avoidance of adequate oversight reflected until very recently an increasingly deeply held belief in financial de-regulation, which arose in the context of a generally expanding economy over the past two decades. During this period, our financial system weathered shocks, which occurred roughly every five years – the stock market crash of 1987 following the first wave of leveraged finance and the

brewing S&L crisis, the Gulf War recession, the Asia crisis, the Long Term Credit Management collapse, the tech bubble collapse, 9/11, the accounting scandals that precipitated Sarbanes Oxley, and so on.

This resilience to shocks during the long cyclical expansion period encouraged a culture that placed too much faith in the ability of markets to self correct, and permitted a balkanized regulatory structure to remain inadequately mandated for new dynamic global financial markets. *Those regulatory flaws were exposed in the recent fallout from the proliferation of new financial products that were often unhinged from underlying economic markets and inadequately regulated.* The damage was magnified by unprecedented leverage at virtually all levels of the financial system. This crisis is worse because it reflected not just markets behaving badly, but also our regulatory system behaving inadequately.

Thus did the US become in 2008 a leader in financial destruction, having been for the previous 75 years a global leader in financial market innovation and regulation, the latter reflecting two paramount principle that we, perhaps more than any other nation, represented -- transparency to investors and safety and soundness of financial institutions. We applied those principles successfully in the main US securities markets, but we applied them reluctantly and poorly in mortgage origination, credit, securitization and derivative markets. We failed adequately to supervise and in many cases exempted from supervision many systemically significant actors in these markets. We allowed firms that lacked the proper disciplines or incentives to be mortgage originators. We allowed rating agencies effectively to exempt SIVs from the 1940 Act. In the credit default market, we abdicated entirely, creating a shadow \$50 trillion credit market to operate often as Off Track Betting, sometimes tenfold the value of the underlying credit instruments to which it refers. In all of these markets, we declined to supervise institutional originators, intermediaries and investors until we were left with no choice but to do that and much more. So what is the solution?

## THE SOLUTION

The solution to these problems is two-fold. First, we should apply our time honored principles of transparency and safety and soundness to the areas of financial life where we have fallen short. We should not bow to political slogans that misapprehend the nature of free markets. *Financial markets are free when they are organized by rules that are rational, clear and protective of systemic risk; they are not free when they facilitate free-for-all environments in which poorly conceived and highly leveraged bets are placed to the peril of not only the house or investor, but a broad array of market participants whose confidence is sacrificed in the gamble.* We should restore the legacy of Ayn Rand to Philosopher and Novelist rather than Financial Czar.

Second, the current patchwork of regulatory agencies should be rationalized to accommodate applying our transparency and soundness principles to twenty-first century financial markets. We can anticipate a broad re-writing of the financial playbook on a scale not seen since the New Deal, potentially addressing the following types of changes:

1. We should rationalize agency functions and re-organize these around major categories of financial institutions: Insurance, Banking / Bank Holding Company and Other Financial Services (such as broker dealers, exchanges, and futures markets). Institutions in multiple segments, such as the large multi line bank holding companies and securities firms that just converted to that structure, will have a primary regulator that would also agree to collaborate with or accept jurisdiction from other agencies. The Treasury Department Blueprint similarly broadens the individual categories of institutions. It also acknowledges the need for both regulatory rationalization, as in merging OCC and OTS, and the expansion of certain powers, as in expanding the SEC's purview to include futures and creating a

- federal regulatory structure for insurance, an industry still operating under a 19<sup>th</sup> century state regulatory structure. But Treasury's Blueprint seems cumbersome organizationally and perhaps tepid in new interventionism, as if the problems we face warrant regulatory structure rationalization principally because institutions have broken free of old industry categories, but not because far broader regulation is needed as a policy matter.
2. We should create a Super Agency to oversee the principal financial regulatory agencies from the perspective of systemic safety for US financial markets in international context. The Treasury Blueprint would name the Federal Reserve Board the market stability regulator, continuing its current functions with some added coordinating functions. Others of us would create a new oversight authority, allowing the Fed to do what it was intended to do, as opposed to taking on new challenges. One can and should debate the merits of these alternatives. Whoever plays the super-agency role should have real systemic perspective that goes beyond economic and credit market data, the traditional focus of the Fed, and includes a much broader financial market data set covering all major financial products, markets and institutions in the US and global financial markets, always from a systemic risk perspective. We Americans are unlikely to embrace the British FSA unified regulator model, but we might do well to go beyond a mere coordinator among still-balkanized financial agencies, and we might need to create a new organization to survey systemic market risk beyond credit and beyond our borders. Super agency powers might include power to comment on and in some cases potentially modify regulations or decisions of other financial agencies from a systemic risk perspective. Any super agency presumably would have long term senior appointments approved by the Senate and not coterminous with Presidential terms, and would have its own staff, and a Board comprised of representatives of the

several agencies whose activities it coordinates. *It would also need an advisory board from Business, Finance, Research and International Financial Communities to avoid the pitfalls of supervising only what it customarily measures, as opposed to what is actually occurring.*

3. The CDS market must be regulated to be sound and transparent. Efforts are already well underway to establish a clearing function. That will help, but ultimately the market must have integrity as to safety and soundness of participants and disclosure, even if not real time, as to market activity. We may find some very troubling information once we peer under the hood of this \$50 trillion jalopy, so we need to proceed carefully. But if there is a risk greater than knowledge it is ignorance. And if we are unwilling to have a transparent and sound CDS market, then we ought have none at all.
  
4. Participants that have the scale or other attributes to impair the system by their activity – the ones that when in trouble will be called “Too Big To Fail”– ought not escape some level of regulation and in some cases heightened supervision. “Some level” need not mean scrutiny as though the institution is a bank in receivership, but it ought not mean no scrutiny or scrutiny lite, as though the role of regulator will once again be played by Ms. Rand. Large bank holding companies have such complex financial positions that securities analysts and even credit agencies are unlikely fully to understand them as well we regulators can. Large insurers such as AIG present a similar problem. If these organizations are too big to fail, then certainly they – including their off balance sheet investments -- are too big not to examine carefully and maybe even explain publicly. Henry Kaufman would have regulators publish their credit analyses of large firms to alleviate market opacity. Hedge funds, a special situation, are typically unregulated even though they often use leverage and financial derivatives in ways that their investors, creditors and trading partners may not

have contemplated and that may have unanticipated systemic consequences. Funds are often invest for pensions, endowments and other publicly or systemically significant investors, and they often operate in secrecy even from their own investors. The phrase *caveat emptor* may satisfy those craving moral absolutes or *Schadenfreude* for LP's in funds gone bad, but *caveat emptor* misses the point, because it was not merely the GPs and LPs who suffer but a far broader network of constituents whose confidence in markets is fundamental to the functioning of the financial system.

5. The globalization and continued integration of financial markets means that regulatory coordination on the international scene is a key element of modern financial regulation. That needs to be an ordinary course part of the financial agencies and the super agency. We cannot rely on emergency G-20 meetings to handle real-time and often inter-related complex global financial issues.

Finally, as we re-engineer financial regulation for the twenty first century, we should remember that finance is the lifeblood but not the entire anatomy of an economy. We cannot expect finance to prop up companies that would continue to specialize in inadequate risk controls or inadequate automobiles. We cannot bail out companies that would perpetuate poor governance choices, like choosing directors of financial institutions who have little understanding of financial markets or vesting CEOs with de facto control of the Board and the compensation structure throughout the organization. Nor can the Federal Government reasonably be lender of last resort to companies whose compensation structures reward risk choices that are at best misleading indicators of profit or value and at worst ticking time bombs for the institution or the market. We cannot rescue the perpetually challenged. In short, as we obsess about new regulation, we should remember that it is *a competitive business economy* that finance is supposed to power.

# Marshall Sonenshine

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Marshall Sonenshine is Chairman and Managing Partner of New York investment banking firm Sonenshine Partners. Sonenshine was previously Partner in Wolfensohn & Company, the M&A boutique headed by former Salomon Brothers' head of banking Jim Wolfensohn and US Federal Reserve Chairman Paul Volcker. Sonenshine was part of the leadership team that merged Wolfensohn first into Bankers Trust, where he headed Media M & A and Aerospace/Transportation M & A, and later into Deutsche Bank, where Sonenshine was asked to serve as Co-Head of M&A. Prior to joining Wolfensohn, Sonenshine was a banker with Salomon Brothers in New York.

Sonenshine holds a BA, *magna cum laude*, from Brown University and a JD from Harvard Law School, where he served as an Editor of the *Harvard Law Review*. He studied at L'Institut d'Etudes Politiques in Paris and, while at law school, he served as a Teaching Fellow in International Relations at Harvard University's Government Department and an Instructor in Legal Methods and in the International Program at the Law School. Following Harvard he became law clerk to Hon. Lawrence Pierce of the United States Court of Appeals for the Second Circuit, in New York.

Sonenshine counsels numerous leading companies and has advised on numerous leading transactions worldwide, including the Disney/ABC merger, the merger of International Lease Finance Corporation into America International Group, the global restructuring of GPA Group plc with General Electric, the restructuring of AEG, the global industrial group within Daimler Benz, the Sony/Columbia Pictures/Guber Peters Entertainment merger, the sale of the Structural Dynamics to EDS, the hostile defense of The United States Shoe Corporation, the merger of Chancellor Media and Capstar (and later Clear Channel), the sale of Abaqus to Dassault Systèmes SA, the recapitalization of KKR-and-Wachovia backed New South Communications (later Nuvox), the sale of Riverstone Networks to Alcatel, and many others.

Sonenshine's civic and charitable affiliations include serving as a member of the Council on Foreign Relations, a Trustee of The International Center of Photography and Jazz at Lincoln Center, a past member of the Brown Annual Fund Executive Committee and Vice Chairman of the board of New York-based ArtsConnection. He has served on the Obama New York Tri-State Regional Finance Committee and has led political fundraising events including in 2008 for the Obama Victory Fund and Democratic National Committee Chairman Howard Dean, and for Delaware Democratic Governor Elect Jack Markell. Sonenshine is a frequent speaker and author on business matters. He and his wife, Dr. Therese Rosenblatt, live in New York and have three sons.