A Sporting Chance for Regulating Capital Markets

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How do you fix a broken game? Or more importantly, how do you regulate a game over the long-term to keep it from breaking? These questions should have been on the minds of our financial regulators as they reacted to the 2008 stock market crash. Instead, they focused on how to manage the risk associated with mortgage derivatives and missed the much bigger problem: How do we keep players from gaming our capital markets and causing devastating meltdowns?

Regulators have tried to fix the markets before. In 2002, after the spectacular dot-com bubble burst, the solution was a comprehensive overhaul of regulation, with Sarbanes-Oxley as the centerpiece. Yet, as 2008 proved, Sarbanes-Oxley didn't fix even a fraction of the market's ills. Now regulators are again attempting to fix our markets—once and for all—this time with Dodd-Frank.

Washington's approach to regulating our financial markets follows the most common theory of regulation: Create the perfect set of rules that, once codified, are studiously maintained and protected from challenge or modification.

This approach is pervasive in business (and sports), yet we know that any time there is money to be made and power to be won, clever players will game games to their own benefit. Rather than attempt to outthink future market players, why not accept that perfect, omniscient regulation is impossible? Instead, accept the nature of players and games and continuously tweak the rules to neutralize the innovations by clever market players that threaten the game itself.

TWO APPROACHES

The world of sports offers two useful lessons for regulators. Major League Baseball (MLB) is the poster child for the "perfect regulatory paradigm" approach. Despite changes in the

marketplace, in team strategy, and in player physiology, MLB has allowed only two consequential rule changes in 90 years—lowering the pitcher's mound in 1968 and introducing the designated hitter in 1973 (in the American League only).

The National Football League stands in stark contrast to MLB. The NFL embraces the "continuous tweaking" approach. At the end of the 1970s, San Francisco 49ers coach Bill Walsh pioneered the West Coast Offense, a short-passing strategy that created a significant offensive advantage. The result was an amazing four Super Bowl wins in nine years. In the mid-1980s, New York Giants coach Bill Parcells pioneered a blitzing defense that rendered opposing offenses utterly ineffective. That led to two Super Bowls as well.

Each innovation created tremendous advantage on one side of the ball, and in so doing, threatened the parity between offense and defense. In response, the NFL tweaked the rules of the game—allowing defensive backs more latitude in the face of Walsh's innovation and then giving more latitude to offensive lineman in reaction to Parcells. The changes were aimed at restoring balance to the game and taking away new-found advantages.

After every season, the NFL Competition Committee meets to adjust the rules of its game to make sure the fan experience is the best it can be. One result is that the NFL has dramatically eclipsed in fan support, television ratings, and revenues what used to be America's game—baseball.

The capital markets have their Walshs and Parcells: incredibly clever hedge fund managers, CEOs, and investment bankers dedicated to gaining advantage in playing the game. There are plenty of examples: John Paulson and Goldman Sachs (GS:US)getting together to create synthetic mortgage products for the purpose of shorting the mortgage market; AIG (AIG:US) setting up its Financial Products Group in London under the supervision of the U.S. Office for Thrift Supervision instead of the SEC; and hedge funds launching short attacks on Lehman Brothers to ensure that it went down. And that's just a few.

SOME FIRST STEPS

America doesn't need its regulators to protect the current regulatory regime, acting like the

owners of MLB. It needs its regulators to keep tweaking the capital markets to offset the gaming, just like the NFL. Since on-going tweaks will always be necessary, it is impossible to enumerate all the changes that would fix the capital markets. But some first steps are clear:

• The Safe Harbor Provision in the Securities Act of 1995 should be repealed. This provision enabled CEOs to safely dispense "earnings guidance," which has no value for society and focuses executives on playing useless games with stock analysts rather than on pleasing their customers and their long-term shareholders.