A Gift Not To Be Overlooked

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February 15, 2010

The financial market earthquake and resulting economic devastation experienced worldwide in the last two years is nothing short of extraordinary. Many question today whether it has run its full course, or whether additional aftershocks remain in store. We shall see. In the mean-time there is much that can be done. The crisis has presented securities and financial markets regulators and other policy makers with a rare gift. Permit me to explain.

The recent financial market turmoil occurred as many securities markets regulators in this region actively worked to upgrade their markets through the study of international best practices and subsequent implementation of new or amended rules and regulations, all in pursuit of developing robust securities markets. Indeed the progress that has been made over the last decade here in the United Arab Emirates and elsewhere in the region is worthy of high praise. I know that here in the UAE work in support of additional market development and regulation is ongoing through dedicated leadership and a strong technical staff. In the midst of all of this effort comes the gift.

Our financial institutions and markets – local and global – have experienced an unintended "stress test" of phenomenal magnitude – and I would argue, of great value. It has been observed that actual events far exceeded even the worst risk scenarios incorporated in many market models used by financial institutions and rating agencies, in itself a disturbing occurrence.

Stress tests are intended to reveal weaknesses in structures – whether a bridge, an airplane wing, or a securities market. To paraphrase the comments of the highly respected investor Warren Buffet, when the tide goes out, hidden dangers are revealed. So, our recent experience, shared in one variation or another by every financial market around the globe, may reveal hidden dangers to us, and in addition to the opportunity to address the dangers, offer much to learn.

This is the rare gift to regulators and policymakers that I mentioned earlier – hard data – on what elements of our securities markets worked, what elements failed and what elements, with some adjustment, could work better. This hard data is there now to be gathered and evaluated on the performance of the regulatory structure both in your own markets and in other markets as well.

This data offers an immediate and solid foundation for regulators and policymakers on which to base adjustments and improvements to the regulatory structure, if revealed as necessary by

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the stress test. The results may show that some aspects of existing regulation performed well. This may be a source of assurance to investors and increase confidence in markets.

The results may also show some aspects of existing regulation did not perform well. Investors and other market participants will see analysis and remediation by regulators of troubling results as a sign of even greater assurance of the strength and integrity of the market.

Of course to some degree a review of the data is already underway by financial journalists. The volume of much of their output however, has been broad but not very deep. We should recognize that no one is better positioned, more highly motivated, and likely more capable of studying and understanding the data than the regulatory authority. Certainly they are in a position to take action in response and make the needed fix, or to point out the need for additional authority if its absence stands in the way of better promoting sound markets and the interests of investors and companies alike.

A comprehensive review by regulators of how well securities markets performed in the stress test may produce benefits that extend well into the future. What to look at? While each market may present its own unique circumstances that deserve attention, here are a few areas that may be common to all:

With Regard to Exchanges:

- Did markets operate smoothly?
- Did systems function well?
- If disruptions occurred, what was the cause and how may they be avoided in the future?
- Did signs of unusual or manipulative trading occur?
- If so, has it been looked into and, if justified, what actions have been taken?

With Regard to Broker-Dealers:

- Were customer orders timely executed?
- Were customer funds protected?
- Were sound capital levels maintained?
- Did inappropriate use of information occur?
- Were internal risk controls and procedures followed?

- If not, did supervisory procedures identify failures?
- Where problems occurred, what remedial measures have occurred?

With Regard to Companies:

- Were disclosure requirements followed?
- Were significant events timely disclosed?
- Have new sources or aspects of risks been identified that merit disclosure in the future?
- Were internal financial controls and procedures in place and did they operate appropriately?
- Did management meet its responsibilities in responding to the situations presented?
- Did the board meet its responsibilities?
- If the answer to one or more of the above is "no," what remedial steps are underway?

That's obviously a lot of ground to cover, but again, the results to these inquiries will be "hard data," a valuable tool in any effort to improve markets.

There is more, by the way. I would argue that the "stress tests" are not over, we have just entered a second phase. The first phase tested the operation of our markets and their mechanisms – the exchanges, broker-dealers most directly – as well as the issuing companies and investors participating in the market. In this second phase we are in now, several broader systems are being tested. Three are worth noting: the quality of financial reporting and auditing; the effectiveness of the dispute resolution and regulatory enforcement system, and the continuing efforts of regulators in the post crisis environment.

First, financial reporting and audit;

As we move forward past the events of the crisis we have an opportunity to assess the quality of financial reporting for the periods leading up to and encompassing the crisis. Likewise, we have the opportunity to evaluate the quality of audit performance. In each area we may spot strong points as well as weak points. The opportunity is offered to analyze what adjustments to practices or new training form an appropriate response.

Second, dispute resolution, adjudication, and enforcement; and

As investor complaints are heard and financial difficulties at companies and broker-dealer firms are revealed, the dispute resolution, regulatory enforcement, and judicial systems will also undergo stress tests. What institutional re-enforcements or adjustments, new training and procedures, or new arrangements in dispute resolution, enforcement, or capacities to deal effectively with financial institution and market disputes may enhance confidence in regional financial markets?

Third, the functioning of the regulators in moving forward.

Today a great deal of attention is given to regulatory reform at the global level. The response to the crisis and its aftermath by regulators and policymakers at regional levels is significant as well, and perhaps a bit more challenging. With one eye toward developments in the global financial architecture, regional regulators must continue with the tasks at hand while operating in a post-crisis world. While moving with determination toward the incorporation of global standards and practices, concentration must be maintained on the reason for the existence and promotion of regional markets— providing an attractive, reliable, efficient, and inexpensive means of raising capital for business founders and entrepreneurs of the region. This “tension” if that’s what it is, demands more than a transplant of methods from elsewhere. Additional effort is well spent in fine tuning rules and regulations so they are responsive to local factors and interests while simultaneously achieving best practice levels. Training sessions with entities affected by new regulations and educational seminars with investors and the public – as occur in the UAE and elsewhere — may be quite useful in promoting understanding and gaining market support.

Our recent global financial crisis has come with the gift of hard data on institutional and market performance, there to be gathered and put to best use. Ongoing work should continue, not come to a stop. Ongoing work may benefit greatly if combined with the hard data provided by the gift. Of course the very fact that we are all here today is a strong indication of the positive response and intentions of regional regulators in the post-crisis world.

For more information, please contact Vinson & Elkins lawyer Paul A. Maco. Visit our website to learn more about V&E's Securities Litigation and Enforcement practice.