



PRESIDIO SCHOOL OF MANAGEMENT

21 November 2007

To: Taiya Smith - Executive Secretary of the Treasury

From: Students of Presidio School of Management's Economics, Capital Markets and Law class, John Katovich J.D., Professor

Re: TREAS-DO-2007-0018, Public Comment on Regulatory Structure Associated with Financial Institutions.

Dear Executive Secretary Smith:

On behalf of the students of Presidio School of Management's Economics, Capital Markets and Law class, (John Katovich J.D., Professor)¹, please accept these comments in response to the Department of Treasury's request for comments on what improvements are needed in relation to the regulatory structures associated with financial institutions.

Introduction

With the subprime crisis continuing to wreak havoc in U.S. and world capital markets, and the U.S. dollar falling to a record low against the Euro, the U.S. Treasury Department (and other U.S. governmental entities) faces an unprecedented challenge in designing regulatory measures that speak to responsible business measures while maintaining U.S. competitiveness in the increasingly global capital markets. The generally accepted theory of regulation is that it should be designed for the protection and benefit of the public or a particular subgroup. But even if we think only of regulation as applied to the economic markets, the protections and benefits must be considered for the

¹ Presidio School of Management, located in San Francisco, CA, offers an MBA program in Sustainable Management integrating social and environmental values within every course. Since 2003, the program has succeeded as a collaborative learning community committed to human, natural and financial sustainability. Our professor in Capital Markets, John Katovich, has been in-house and external counsel to companies in the capital markets, served as General Counsel for the Pacific Stock Exchange, addressed the U.S. House of Representatives, Committee on Banking and Financial Services – including the Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises, and has participated as an exchange team member in front of the U.S. Supreme Court regarding arbitration. Professor Katovich is also currently the Executive Vice President and Chief Legal Officer of the Boston Stock Exchange, soon to be a part of the Nasdaq Group of exchanges.

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long-term health of the impacted stakeholders. We urge the U.S. regulatory authorities to resist the enactment and support of regulatory schemes that take only a myopic view of short term profits, and to instead foster smart, innovative and creative measures that can be understood and embraced by anyone that understands why a long term view is essential.

We would like to propose a new vision for a sustainable future in which the U.S. harnesses the power of innovation to lead the way in a globalized, post-industrial, clean energy economy. The benefits of a responsible and sustainable clean energy economy to the U.S. would include energy independence, equal support of local economies, and the creation of new jobs that actually support a responsible and sustainable economy rather than simply adding to the problems we are faced with today. Realizing our vision will require significant investment in clean technology research and development, job training, governmental responsibility in policy undertakings, and new infrastructure. However these measures will also lead toward new responsible and sustainable industries, and should not be thought of as only a cost, but rather an investment in our future.

Our capacity to invest in education and infrastructure is increasingly threatened by our growing debt burden, which is significantly outstripping growth in the GDP. In the U.S., between 1950 and 2005, for example, the total debt (household, business, government, and foreign) increased 86 times compared with a 40 times increase in GDP. In 2005, total outstanding debt (excluding the unfunded liabilities) as a percentage of GDP was 326% and growing².

We are concerned that the growing debt burden creates an environment in which businesses and households must focus on short-term gains at the expense of long-term investments. With the growing threat posed by climate change and the rapid depletion of the natural capital needed to sustain economic growth, we will need to reinvent the way we do business if we are to grow our economy, maintain our quality of life, and leave a healthy planet to the next generations.

To obtain our vision of a robust U.S. economy in balance with a sustainable future focus we believe there are three primary issues that need to be addressed. We will speak to these three issues as they relate to supporting, or hindering, the capital markets, and by extension, the development of a more sustainable society and the vision we described above. Those three issues are: Transparency, Accountability, and Accessible Debt.

We address these topics individually below under General Issues that require specific attention and focus on them in responding to certain questions relating to Key Regulatory Objectives and Consumer and Investor Protection. While some of our proposals may seem far-reaching, even radical, we believe they have merit and support and should be part of any discussion of the questions that the Treasury Department has posed. As Milton Friedman counseled,

² Anielski, Mark. 2007 *The Economics of Happiness*. New Society Publishers, p. 185.

...it is worth discussing radical changes, not in the expectation that they will be adopted promptly but for two other reasons. One is to construct an ideal goal, so that incremental changes can be judged by whether they move the institutional structure toward or away from that ideal. The other reason is very different. It is so that if a crisis requiring or facilitating radical change does arise, alternatives will be available that have been carefully developed and fully explored.³

We believe that the U.S. government now has an opportunity to use its great knowledge, resources and history of innovation to become a leader in the creation of a regulatory framework that considers much more than the protection and benefit of the wealthiest individuals. We can be a nation that is looked back on as once again stepping up to take decidedly strong and lasting measures that preserves this nation, and the planet for thousands of years to come.

1. General Issues

1.1 Transparency

There is a need to address the lack of documentation for the business costs of externalities, such as CO₂ emissions.

In order for investors to understand the true risks of their investments, there must be a regulated, standard way to assess, and compare at the very least, one company's potential liabilities versus another's. Many businesses today, for example, are calling for federal action on carbon regulation because they want to be able to act on a level playing field with their competitors and without fear of being penalized for early action.

There is demand for this kind of information as described in the September 18, 2007 filing of the Petition for Interpretive Guidance on Climate Risk Disclosure filed by a coalition of businesses, government representatives and NGOs with the SEC. The Petition argues that increased federal, state and regional regulation is likely, and that the effects of GHG emission regulation and climate change are a material risk to the performance and operation of many businesses and important to investors. CALPERS, the largest US pension fund with over US\$250B in assets, is calling for companies to disclose their climate risks and benefits claiming the information that they get from sustainability and CSR reports is not adequate for investors to know a company's true risks. At a recent Senate banking subcommittee hearing,⁴ CALPERS and other groups,

³ http://quotes.zaadz.com/Milton_Friedman accessed Nov. 19, 2007.

⁴ Statement by Mindy S. Lubber, President, Ceres, & Director, Investor Network on Climate Risk, Measuring Financial Risks and Opportunities. Hearing before the Subcommittee on Securities, Insurance, and Investment of the United States Senate Committee on Banking, Housing, and Urban Affairs Regarding Climate Disclosure, Measuring Financial Risks and Opportunities - October 31, 2007.

including the NY Attorney General, called for companies to disclose their risks in four areas related to climate change.⁵ Most European governments already require such disclosure and similar regulation would align US policy more closely with emerging global reporting standards.

Additionally, there is rapidly increasing participation in the Carbon Disclosure Project, a nonprofit group that monitors corporate disclosure related to climate change. Clearly, recent actions as documented here present sufficient evidence that there is demand by companies and investors for a regulated and standardized way to assess and compare their potential liabilities in the area of externalities such as climate change.

Finally, as measurement is the first step toward management, it is hoped that carbon disclosure requirements will facilitate transition to a mandatory CO₂ cap and trade scheme and consequently lower overall CO₂ emissions. The sooner the US institutes such a scheme, along the lines of the European Union Emissions Trading Scheme (EU ETS), the sooner US companies can participate in and profit from the lucrative and growing global market in CO₂ credits. The carbon market grew in value to an estimated US\$30 billion in 2006, three times greater than the previous year, and many experts predict that it could exceed \$140 billion by 2020.⁶ Rather than avoiding such regulation, the US should embrace it and strive to dominate the new and rapidly growing market for this increasingly sought after commodity.

1.2 Accountability

Banks need to be held accountable for poor lending practices.

With the effects of the U.S. subprime credit debacle of 2007 being felt around the world, many foreign governments, including Australia and Germany, are calling for an international regulatory body to be created to monitor lending practices. European Commissioner of Economic and Monetary Affairs, Joaquin Almunia stated “[t]he present turbulence has spread a lack of confidence in the financial markets and beyond, in a manner and intensity that was not foreseeable.”⁷ To preempt future scandals and to ensure transparency, an international body should be created to develop a set of checks and balances that will monitor the policies of lenders who would be selling their securities on the international market.

⁵ *Measuring Financial Risks and Opportunities*, 2007. Prepared comments from the hearing before the Subcommittee on Securities, Insurance, and Investment of the United States Senate Committee on Banking, Housing, and Urban Affairs Regarding Climate Disclosure. October 31, 2007.

⁶ 2006 figure is from *State and Trends of the Carbon Market, 2007*, The World Bank, Washington, D.C., May 2007. Projection for 2020 is from a report by Celent quoted by [Carbon Finance](#), accessed Nov. 20, 2007.

⁷ Landers, Mark. 2007 *Credit Crisis Spreading New Jitters in Europe*. NY Times, Oct. 25, 2007.

While participating in the development of said international regulations the Treasury must also ensure accountability of domestic lending practices. Domestic banks must not expect the federal government to bail them out of financial crisis they have created with financial tools whose impacts or risks are not truly transparent. Allowing banks to create such tools with little oversight leads to our third issue of disproportionate debt to our GDP.

1.3 Accessible Debt

A system based on borrowing and short term gains is in direct conflict with sustainable business practices.

As long as our financial system continues to reward short term gains and make those easiest to acquire, capital will not move to the types of investments society needs (such as renewable energy and long term technologies) in order to prepare itself to survive and flourish when raw resources become limited.

The Department of the Treasury should seriously consider returning the power of money creation back to the US Congress by moving progressively towards a full reserve banking requirement for banks and other financial institutions and away from fractionalized reserve banking. Currently 98% of the money supply in the U.S. is created by private banks through the issuance of interest-bearing loans. The current fractional reserve system is leading to a mountain of debt, which currently totals more than three times the GDP⁸. The need to repay interest on this ever-increasing debt creates a bias toward unsustainable growth. The benefits of this system are accruing to a handful of private banks at the expense of the general public.

A society living on debt, as we are now, must think in the short term because there is always capitalizing interest to be paid. There are then no incentives for businesses, nor individuals, to invest in longer-term activities that would benefit society as a whole but not pay back immediate returns. The returns of any investment must always be compared to the costs of debt, from which the majority of the funding comes from. This does not provide society with sufficient flexibility to preserve human and natural capital and increase long-term investments in natural and human resources.

In addition, a society that has become fixated on short-term holdings and speculation of financial instruments has lost touch with the underlying reasons behind investing and production. The book Ecological Economics states,

“[G]rowth in money is meaningless unless there is a corresponding increase in real wealth, so now we must ask: Does financial speculation lead to growth in real wealth? Some paper-paper purchases are purchases of new stock offerings that do provide financial capital, which can mobilize physical factors of production, but this is only an estimated 4% of stock purchases. Speculation in

⁸ Anielski, Mark. 2007 *The Economics of Happiness*. New Society Publishers, p. 185.

currency, in which millions of dollars are traded back and forth for very small margins over short time scales, clearly produce nothing. Indeed, such transactions almost certainly contributed to the crises in several South East Asian economies in 1997-1998 as speculators sold off regional currencies, and these crises meant dramatic decreases in production from those economies. If those who produce nothing are earning, through speculation, more money that entitles them to more real wealth, then those who actually do produce something must be becoming entitled to increasingly less wealth.”⁹

2. Key Regulatory Objectives

2.1 Objectives

The key objectives of financial institution regulation should be to ensure transparency and inclusiveness.

Transparency is required to support equity and fairness for all the stakeholders of financial institutions, from owners, employees, investors, governments, to civil society. Information provided by institutions must be accurate, honest, prompt and equitably distributed. The objective of inclusiveness is required to broaden the scope of information being regulated, which will lead to the positive impact of the organization on its financial, human and natural surroundings.

In addition, the design of the regulation needs to be fluid and fast in order to be able to respond to a rapidly changing environment and increased globalization of markets, organizations and citizens. At the same time, regulation must be well conceived, carefully crafted and effectively implemented to improve efficiency, transparency and trust while avoiding the negative impacts of over regulation. The Sarbanes-Oxley Act presents one potential model/approach for achieving this and moving forward. It did not so much add regulatory layers as make existing regulation more effective by making management responsible for accurate reporting. While it has been widely criticized, there is growing evidence that, rather than cause the loss of listed companies in the U.S., it has improved market transparency and efficiency, and correspondingly increased investor confidence.

⁹ Daly, Herman and Joshua Farley. 2003. *Ecological Economics*. Island Press, p. 257.

2.2 Alignment of Framework and Objectives

A combination of Principles-Based and Prescriptive Measures needs to be continually reassessed over the long term.

Principles-based regulations allow for the continued nurturing of innovation and improvement that make our country competitive. Principles-based regulations are ideal for situations where many potential solutions exist but none are preferred, such as reporting on carbon footprint/dollar earned. However, there are certain areas where principles-based regulations are not sufficient, as for example, dealing with the amount of money held in reserve accounts. This regulation must be prescriptive. If a rapid change is required, prescriptive solutions may be the more effective solution.

The optimal combination of rules-based and principles-based approaches will require the collaboration and input from a multi-disciplinary stakeholder group. In addition, the framework must be able to respond promptly and effectively to high-priority issues, such as the enormous financial, human and environmental risk attributable to global climate change.

Finally, transparency and reporting should be designed to encourage voluntary efforts by financial institutions, and to place greater emphasis on incentives for them. For example the UN Global Compact highlights the companies that are performing beyond their principles and also those that are no longer meeting their commitments.

2.3 Improvements

Move from fair and orderly goals to transparent and inclusive goals.

Greater transparency and more equitable sharing of information will inherently lead to greater market discipline. Including information beyond the current financial myopia to social and environmental impacts will reduce financial system risk. The key word is “system.” The financial system is at greater risk when viewed in isolation.

If the objectives of the regulatory system are transparent, fast and inclusive, then the framework itself has to support it. This means infrastructure improvement (movement to computerized systems), access granted to investors for information and regulatory decision making, and incorporating masses of data pertaining to environmental and social impacts of the actual financial activity (of companies, or of markets as a whole). For example, individuals and companies that knowingly contributed to the current subprime crisis should be identified and forced to take responsibility for their harmful actions.

3. Consumer and Investor Protection

3.1 Transparency

The current regulatory structure should adequately address consumer or investor protection issues.

The objectives of the financial markets include: transparency; trust that investors will be protected from predators and their own ignorance; and strong enforcement of the regulations. The recent growth in corporate accountability regarding social and environmental impacts and their valuation of the economic performance is an indicator of the need for regulated reporting standards. Improving the regulatory structure to increase investor trust through accountable reporting of both tangible and intangible value drivers will better protect both the investor and the financial markets.

There is today an urgent need to determine whether we have enough transparency in the financial markets to accurately and efficiently evaluate a firm's performance. Under the current regulatory structure, investors have access to minimal and sometimes conflicting information regarding the performance and long-term goals (other than financial) of a firm. This creates asymmetric information in the financial markets to the valuation of a company and its associated risk.

3.2 Enforcement

Strong enforcement to ensure financial institutions are conducting their fiduciary duty in a fair and ethical manner that allows free market forces to operate without manipulation.

Fraud and misinformation upset the balance between investor trust and economic forces, thus impacting the overall efficiency of the markets. While there are many techniques for regulation with volumes of rules like anti-manipulation, insider trading and capital rules, it is unclear how successful the SEC has been with respect to enforcement. With the exception of the periodic public display of a celebrity being charged with insider trading, more exposure for unethical practices and rule breaking could be a powerful motivator. Poor peer perception can devastate a company's reputation and thereby create another platform for effective enforcement.

3.3 Oversight of Sustainability

Stricter transparency standards that include social and environmental performance under a third party certified organization such as the Global Reporting Initiative (GRI).

This will more accurately allow investors and consumers to value firms and make

more informed, safer choices. Additionally, it will define a company's license to operate and have a greater impact on the world at large. While the GRI is a volunteer-based system without laws of accountability for entities that stray from their sustainability commitments, peer perception can step in as an indirect enforcement measure. More public exposure for companies who stay true to their GRI-like commitments will reinforce consumer and investor trust while damaging the reputation of others who only greenwash their activities but fail to meet their GRI-like promises.

Conclusion

When examining current regulations and possible improvements, we should remember the Navajo proverb, “you can't wake a person who is pretending to be asleep.” We must first acknowledge that there is a problem before we can find a solution.

We greatly appreciate the opportunity to comment on the Department of the Treasury’s questions regarding the regulatory process. We commend the Treasury for accepting public comment on its endeavors to maintain the competitiveness of United States capital markets. We believe that a concerted effort to increase transparency, improve accountability, and reclaim authority over monetary supply will significantly improve the regulatory structures associated with financial institutions, and we look forward to being a part of helping with these solutions as we move from our work as students of the markets to becoming catalysts for this change.

We welcome further discussion on these specific issues, or others, and extend an invitation to anyone in the department who would like to contact or visit Presidio School of Management and speak with the students and professors.

Sincerely,

The students of Presidio School of Management’s Economics, Capital Markets and Law class, (John Katovich J.D., Professor)

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