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Is Democratic Regulation of High Finance Possible?

By
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Cristie Ford's paper is about the strengths and limitations of applying sophisticated regulatory design—flexible regulation as opposed to hard and fast traditional forms—to increasingly complex financial systems. The argument itself is complex. Ford is neither an apologist for flexible regulation nor a generalist for or against some grand program. Rather, she increases the magnification: “The main regulatory failures implicated in the crisis,” she writes, “were a function of gaps in regulation, extraordinarily inadequate resources and execution, and an ill-informed and insufficiently skeptical regulatory mindset.” A trio of missteps, then: gaps in regulation, that is, practice or application of law; inadequate resources, that is, vulnerabilities in our regulatory infrastructure; and an insufficiently skeptical mindset, that is, institutional culture. Hers is a multidimensional and robust explanation.

Ford is also not a naïve traditionalist who thinks we can pour new wine into old wineskins. We “regulate a fluid object such as financial engineering with a fluid form of regulation. I do not suggest that we really can do otherwise,” she writes. A new regulatory approach is needed for a world itself quite new. What can we do then? “What we can do,” Ford says, “is [to] understand the consequences of our regulatory choices and make better-informed and more conscious decisions about what we want the financial sector to achieve.” So what Ford is, is a pragmatist. And like all good pragmatists, a democratic impulse courses through her article.

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When Ford writes “what we want the financial sector to achieve,” who is this “we”? Is it a small “we,” a tight circle: the technocrats, the intellectuals, the hedge-fund managers, the Senate Banking Committee? Or is it a more generous “we,” the unfixed arm of the compass stretching wider to include our neighbors, our mothers, longshoreman, artists, plumbers, nurses, teachers, rabbis—the body politic, the commonwealth? Ford leaves open both possibilities. But I think she, pragmatist though she is, would incline toward the bigger “we.” “Part of the way forward,” she offers, “may be to fight the big normative fight in the open, to battle over principles in a public forum and to let one side win.”

But is democratic regulation of highly complex systems possible—or even desirable? If we aspire to be a government for the people, by the people, could we, should we, also have markets governed for the people, by the people? The thing is, “we” are limited and ill-informed. The midcentury writings of Joseph Schumpeter and others drew on turn-of-the-century elite theory, which in turn drew on Max Weber’s writings on plebiscitary democracy and Alexis de Tocqueville’s forced elegies for aristocracy, themselves going back to an idea found in Plato: that the private citizen, in Schumpeter’s (1942/1976, 261) words, is ignorant, “a member of an unworkable committee, the committee of the whole nation.” And that is just regular politics.

F. A. Hayek believed that the public simply could not engage in piecemeal economic regulation—and he believed this decades before financial engineering gave us things such as “subprime trenches,” “credit default swamps,” and “synthetic CDOs.” For Hayek, it was not just that economic theory was complicated, it was that economics as a discipline is in the business of turning common sense, the stuff of public deliberation, on its head. “Economics,” he wrote in 1933, “consists essentially in the *demonstration of inconsistencies in a kind of ordinary reasoning* which everybody employs and the validity of which no one would ever doubt were it applied to simple cases where it can be easily understood” (1933/1991, 20, emphasis added).

But complexity certainly is a barrier, one that Ford returns to over and over in her article. She observes that “it was virtually a given that the state was utterly incapable of grasping or keeping up with, let alone managing or directing, valuable financial innovation.” Laypeople proved even more incapable. Ford cites a fascinating example of citizen letters generated in response to debates around the notice-and-comment procedure of the Volcker Rule. Letters from private citizens were short and unsubstantive. Letters from the financial industry were not short, and they were well argued. “Derivatives,” she writes, “have engendered a level of technical complexity that may be beyond our capacity to regulate (indeed, often literally beyond our capacity to comprehend).”

Here, then, is the central tension of the article and the central problem it confronts. It has to do with new things—newfangled financial inventions—but is a very old problem about governing complex systems in a democratic way, about the relationship between expertise and public rule. Let me make a few observations about this.

First, if the technical complexity of high finance is beyond our capacity to comprehend and thus to regulate, it is a structural problem, not a knowledge

problem. What I mean is that there are people who understand these systems quite well, people who invented these systems, but they tend not to be employed by the people. In fact, as your understanding of high finance increases, the incentives for your working in a regulatory capacity plummet. We learn in Michael Lewis's *The Big Short* (2011) that at financial conferences you can easily spot the guys from Moody's: they are the ones in the cheap suits. Steve Eisman, Lewis's money managing protagonist, describes the people who work at rating agencies like this: "They're underpaid. The smartest ones leave for Wall Street firms so they can help manipulate the companies they used to work for. There should be no greater thing you can do as an analyst than to be the Moody's analysts. . . . Instead, it's the bottom! Why does the guy at Moody's want to work at Goldman Sachs? The guy who is the bank analyst at Goldman Sachs should want to go to Moody's" (Lewis 2011, 156). We could try to make that happen. If it is a matter of analyst caliber, we could try to incentivize talent to stay on the side of regulation.

That might help to balance the scales a bit, but it does not help us to overcome the technocracy/democracy problem, which is about public influence and oversight of extremely complex systems. The curious thing about finance is that it presents itself as inevitable and irreversible—Ford writes that there is no appetite for going back to simpler and perhaps less prosperous times—which forces normative regulation to play catch up. Finance says, "You guys go ahead and have the conversation. I have work to do." But there are several examples of normative regulation limiting, even shutting down, complex systems that the public did not fully understand. In fact, our lack of understanding sometimes helps to justify regulation. Think of stem-cell research. Think of cloning. Science approaches a huge moral question mark, and policymakers—with wide public support—say "whoa there." You may not agree with this heavy-handed limiting of scientific progress, but the point is that it was the heavy hand of elected officials mobilized by vocal publics. The inability of current moral frameworks to make sense of the complexity puts on the brakes. Why does finance avoid such regulation? Because the stakes are too high? Higher than the stakes of curing disease and raising the quality of life, the stakes of stem-cell research? My point here is that complexity does not have to impinge or mute normative conversations or effective regulation. Complexity can sometimes facilitate these very things.

And if our regulatory apparatus was simply outfoxed by high finance, if one reason flexible regulation did not work as well as it should have in the years leading up to the crash was because we simply did not have the capacity to understand what was happening at Goldman and Lehman, a fair question is: Are we stupider than Canada? In the years leading up to the crisis, Canada was seen as out of step. When the rest of the world was lowering capital requirements, Canada was raising them. Canada was so cautious about getting into the deregulation game that the IMF wagged its finger at Canada for not doing enough to promote securitization. Even China thought Canada was being too sheepish.

Look who's smiling now. Canada is the only G7 country to weather the financial crisis without a state bailout of its financial sector. *Financial Times* journalist Chrystia Freeland has for a couple years now been trying to figure out what

Toronto can teach New York. She sees Canada as a real-world example of a banking system in an advanced capitalist economy that survived the storm. How Canada pulled it off is beyond the scope of these brief comments. Some people chalk it up to culture, but Freeland sees, rightly I think, the real reason in rules and institutions. Canada's regulatory system has three restrictions in particular—capital requirements, quality of capital, and leverage ratio—along with an infrastructure and regulatory culture that requires bank bosses to take personal responsibility for their risks. In an article from 2010, Freeland quotes a chief economist who used to work as a senior official at the Canadian finance ministry: “The perspective of government on the financial sector is: ‘We are the regulator—our job is to tell you what to do, not to help it grow. The government has always felt its job was to say no.’” Canadian finance ministers did say no; and they said no to financial manipulations just as complex and obfuscated as the ones we in the United States said yes to.

So maybe complexity is not the problem from a regulatory perspective. But complexity is a problem for democratic regulation. If we are going to have a big normative fight out in the open, what is required? The easy answer is transparency, openness, and clarity to give “us” a chance to weigh in. So, pursuant to Dodd-Frank protections, agencies have published lists of lobbyists and outside experts they consult and have created online spaces for public discussion. This is fine, but it expands the “we” outward only slightly more—to people who can join a public forum about, say, emerging markets. Could we go further? Would it be possible to regulate the communication of complexity? To regulate the simplicity of the message? Why is not understanding involved and difficult financial maneuverings our problem—and not theirs? We have regulated against complex messages before. Food and warning labels. Pronouncements of medical side effects. Why do we feel an unnecessarily complex ballot interferes with voters' ability to participate fully in the democratic process but seem to treat unnecessarily—and perhaps intentionally—complex language from the financial sector as “just the way it is”?

Dodd-Frank is animated not by a concern for democratic regulation but one for “technocratic regulation.” Here I have in mind provisions aimed at improving agency expertise and promoting neutrality, moves to expand agency competence and limit political influence. A recent note in the *Harvard Law School Journal on Legislation* (Rahman 2011, 567) argues that “this expanded authority is legitimated and constrained, not by statutory directive or other forms of political constraint, but rather through a variety of mechanisms aimed at ensuring that agency actions are expert-driven and rational.” The problem with this approach, the author argues, is that it “obscures the reality of the normative disputes underlying seemingly technical policy questions” (p. 571). There is reason to worry about ideological capture here, situations in which regulators and the regulated share an unspoken worldview that is based on normative principles.

We are back at our old problem. Plato's problem. Schumpeter's. Can we regulate democratically systems of enormous complexity—or must we settle for regulating through technocratic means? Maybe we have gone about approaching this question all wrong. Maybe we have assumed that what must precede useful and

vocal democratic participation is a basic understanding of the system. But ignorance—as stem-cell researchers know—can regulate, too. But can it regulate intelligently? Can ignorance promote democracy? That was the title of a comment published in *Science* two years ago (West and Bergstrom 2011). The comment previewed a report (Couzin et al. 2011) that showed that uninformed people (and animals) can promote democratic group consensus. The idea is that in situations involving collective decisions, a small but driven and intransigent minority—say, the top 1 percent—can sway the collective. But the presence of uninformed group members can inhibit the minority's influence and return control to the majority. How? The uninformed citizen will tend to adopt the views of those around him, automatically amplifying majority opinion and, in doing so, weakening the powerful minority and promoting democracy. Is this how it works in real life—as opposed to a computation model? The jury is still out. But I find the idea a potentially new solution to our old problem of democratic regulation.

Or have we got it all twisted around? For better or worse, we democratically regulate all kinds of complicated things. The environment. Death. Infrastructure. We vote on all kinds of things we never fully grasp. In the last election, I voted on a question about the right for patients to end their own lives. I did not come close to fully grasping the practical, psychological, and philosophical depths of the issue. I still checked a box.

After all the damage done by Wall Street, after all the abuse, the wreckage caused by fast money, the fraud that was not technically fraud, the crippling of the global market, the decimation of communities broken by the foreclosure crisis—after all that, it is we who often feel like the stupid ones. It is we, the bail-outers, who feel we do not know enough to have a say. Wall Street falls on its face; Main Street blushes. Perhaps the biggest problem when it comes to democratic regulation of high finance is how we have been made to think it is a problem.

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