On paper, Wall Street gets its way

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More than a year ago, when the markets were flying high, a chorus of alarm went up on Wall Street. Talk spread that the United States risked losing its edge in the financial world.

But the threat that many executives saw was not the credit crisis then looming — it was the threat of excessive litigation and overregulation. Wall Street urged Washington to lighten up.

The financial industry could not get what it wanted then, but it may get what it wants now.

If adopted, the sweeping overhaul of the system overseeing the American financial system proposed by Treasury Secretary Henry M. Paulson Jr. on Monday could hand Wall Street investment banks a major victory in their years of effort to streamline regulation.

While the plan is unlikely to gain Congressional approval soon, and may go nowhere in a partisan election year, it echoes many of the seemingly subtle and yet profound changes that Wall Street has been lobbying for all along.

One change Wall Street wants is for regulators to shift from policing the industry with hard and fast rules — do this, don't do that — to using looser "principles" that might be open to interpretation. Another is to modernize the hodgepodge of state and federal regulators that sometimes overlap and compete with one another.

Mr. Paulson's plan would take a step toward both of these changes by consolidating banking and insurance regulators and potentially merging the Securities and Exchange Commission with the Commodity Futures Trading Commission, then stripping the combined entity of much of its regulatory authority. Many on Wall Street applaud those proposals.

"I thought it was a major step forward," Thomas A. Russo, chief legal officer of Lehman Brothers, said of the proposal. "The world became homogenized, but the regulatory structure stayed within the same straitjacket."

Proponents of the principles approach say it is more efficient. They point to the meteoric rise of London as a global financial center, which has fueled worries that New York might one day lose its title as the world capital of capital. The Financial Services Authority, Britain's main financial regulator, relies on principles rather than rules.

Some former American regulators, however, wonder whether Wall Street deserves a longer leash, especially at such a chaotic time in the markets and the broader economy. After all, the financial industry has had plenty of scrapes with regulators in recent years, over issues ranging from conflicted stock research to questionable mortgage investments.

“Some advocates want broad principles that will not be enforced,” said Harvey J. Goldschmid, a former Democratic commissioner at the S.E.C. who now teaches at Columbia Law School. “You take that approach and the problems of subprime and securitization will look like minor bumps compared to the mess we will have in the future.”

Richard C. Breeden, former chairman of the Securities and Exchange Commission and chairman of Breeden Capital Management, questions whether the Treasury’s proposals will end up hurting rather than helping the investing public.

“I don’t see what’s in it for the public in this plan,” Mr. Breeden said. “What’s in it for the taxpayers and the customers of these firms?”

But Wall Street, among the most deep-pocketed and politically savvy industries in America, senses opportunity.

In November 2006, the Committee on Capital Markets Regulation released a report concluding, “It is the committee’s view that in the shift of regulatory intensity balance has been lost to the competitive disadvantage of U.S. financial markets.”

A separate report, released two months later by Mayor Michael R. Bloomberg and Senator Charles E. Schumer, stated in stark terms that the United States was falling behind.

“The last thing that New York and the country, for that matter, need is to wake up one morning and find we are no longer the financial capital of the world,” Senator Schumer, Democrat of New York, said at the time.

Hal S. Scott, the Harvard Law School professor who directed the Committee on Capital Markets Regulation, said on Monday that he agreed with many of the Treasury’s short-term recommendations. But he argued that the government should not waste its time with the medium-term proposals and instead move directly toward more radical reform with a principles-based system.

“Too often we have a problem and we say ‘here’s a rule’ and then people figure out a way to get around the rule,” Mr. Scott said. “We’d be better off with a principle.”

Still, Wall Street has until recently flourished despite — and sometimes because of — the current regulatory system. Markets for some complex investments, like collateralized debt obligations, do not appear to have been policed by anyone. And no agency has effectively addressed the huge leverage in the system, a problem that seriously compounded the recent crisis.

Indeed, as the industry has increased its profits geometrically in recent years, the size of agencies like the S.E.C. has not kept pace. As a result, regulators have struggled to react to seismic changes in the industry, like the rise of hedge funds and the proliferation of financial products that are traded in the shadows among firms, rather than openly on exchanges. That has former S.E.C. commissioners wondering why turning the commission into a different agency would improve things.

“It’s the height of disregard to America’s investors to abolish the one agency that has done something to protect the public from the baser urges of Wall Street,” Mr. Breeden said.

But he admitted change was hard. “It’s not so clear that just because you draw simpler charts and simpler boxes, the system works better,” he said.