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June 9, 2004

Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0310  
Email: [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Reference: Release No. 34-49695, File No. S7-22-04

Dear Mr. Katz:

I appreciate the opportunity to respond to the Securities and Exchange Commission's (SEC) request for comment on a proposed interagency statement concerning complex structured finance activities of financial institutions.

The bull market during the latter part of the Twentieth Century witnessed tremendous growth of financial products as capital markets transitioned from niche to mass markets.<sup>1</sup> As markets became more robust, segmentation took place<sup>2</sup>. Products became more complex to meet the heretofore-unforeseen demands of consumers. Illustrative to the changes that are occurring with complex structured financial products in the securities markets were the changes that occurred with the 30-year fixed mortgage. Unforeseen inflation of the 1970s created uncertainty that rendered the mortgage market ineffective. The market adapted to high rates by offering innovative products in the form of variable rate, negative amortization, balloon, and other types of mortgages that tailored products to customer specification. Efficiency was brought to effectiveness when mortgages were standardized and securitized. As best practices evolved, they were later codified in the mid-1980s in banking regulatory reforms.

Although regulatory red flags were raised as complex structured financial products were made available to green issuers, intermediaries, and investors, the SEC believes practitioners can keep pace with financial innovations by developing robust governance policies. For this to happen effectively and efficiently, I argue that the Commission must evolve its regulatory scope beyond "risk" issues (i.e., probabilistic top-tier NASDAQ and NYSE securities) to address "uncertain" issues that are indeterminate (unseasoned enterprises or projects with negative cash flow and their attendant derivative products<sup>3</sup>).

Notwithstanding the broad spectrum of investments available in the capital market, the policy statement focuses exclusively on the concept of risky assets and related risk-management techniques. The dictionary defines "risk" as the chance of loss. Risk is probabilistic and thus presents foreseeable consequences, whereas "uncertainty" is indeterminate and characterized by unforeseeable consequences. Since "uncertainty"

is a component of the concept of “complexity”, these terms should be carefully defined to better coordinate regulatory procedures with an understanding of business drivers. Current complex structured financial products evolved from earlier, simpler versions that required innovative and adaptive mutations to address uncertain and unforeseeable circumstances.<sup>4</sup> Innovation and adaptability in an uncertain environment are the very hallmarks of a free market. For markets to be robust and innovative, the investment environment must provide opportunities that arise from “uncertainty”. If all segments of the capital markets were as probabilistic (deterministic) as the policy statement suggests, problems with *deus ex machina* enterprises such as Long Term Capital Management (LTCM) would be unlikely.<sup>5</sup>

Conflating “risk” with “uncertainty” produces the unintended consequences of contingent and unforeseeable liabilities for market practitioners. This jeopardizes market effectiveness. Holding market participants who deal in uncertain investments to the condition of predictability conveys regulatory rights without attendant regulatory responsibilities. Imposing commands to attain predictive capability on capital markets characterized by “uncertainty” undermines market resiliency and increases the probability of systemic failure. Regulating a market characterized by “uncertainty” as though it were deterministic imposes sanctions on unforeseeable events that stifle free market innovation and adaptability.

Market efficiency, by comparison, is a measure of cost, time, and level of effort (number of steps/individuals involved in completing a transaction). While the SEC would quickly censure any broker/dealer involved in overcharging investors through an interpositioning scheme, the policy statement advocates interposing compliance attorneys at every juncture of a transaction involving a complex structured financial product. What is the “net benefit” to justify these added costs?

Adding regulatory costs without corresponding benefits creates a governance trap for the SEC. This is the regulatory equivalent of Heisenburg’s Uncertainty Principle. Heisenburg posited that the simultaneous measurement of two conjugate variables— such as regulatory commands and the level of commercial activity— entails limitations on the precision of the management for each variable. The more demanding regulatory commands for a given level of commerce, the more imprecise the management of commercial activity due to transactional transferences to market externalities. This, in turn, causes the capital market to be less transparent and less efficient<sup>6</sup>.

Regulators set governance policy<sup>7</sup> by choosing commands appropriate for the incentive set available in the economy. Incentives are the potential for net benefit in terms of economic profit. Commands are the package of standards and rules that regulators enforce to reflexively alter behavior in pursuit of profit. Standards and rules are divergent concepts. Standards are prospective societal policies that enable the realization of norms relative to cultural values. Rules are the retrospective codification of best-practice procedures that should, in theory, optimize market efficiency. Rules and standards can be perceived as alternative mechanisms through which the objectives and principles of regulators are satisfied. Financial product

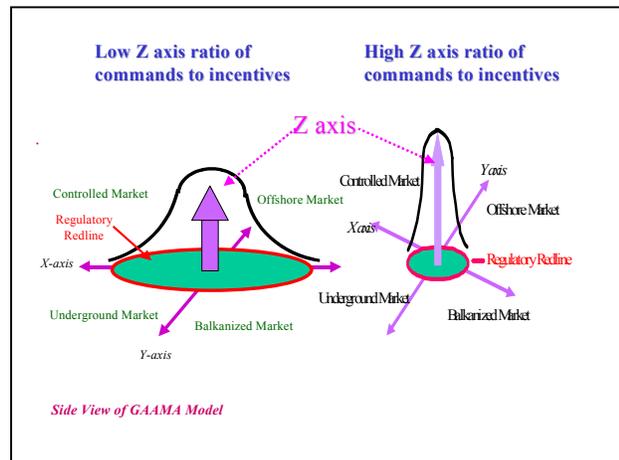
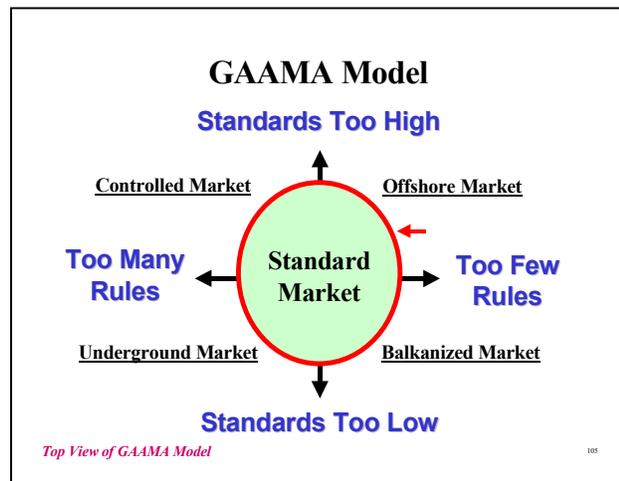
innovation now requires that “risk” be differentiated from “uncertainty.” Historical information derived from financial statements that is used for risk-related predictions is separate and distinct from forward-looking information that projects future operating results of uncertain enterprises. Conflating “risk” with “uncertainty” results in a misspecification of data causing asymmetrical and/or asynchronous information flows. Governance misapplication due to an inability to disclose the unforeseeable brings into being incentives to conduct business either offshore or underground.<sup>8</sup>

To monitor the effectiveness and efficiency of capital market governance, the GAAMA model<sup>9</sup> is put forth to analyze the amount of commerce conducted in standard markets as compared to the amount of commerce conducted in non-standard market externalities of controlled, balkanized, underground, and offshore markets. GAAMA is an acronym for:

- **Global**—widespread in terms of mass and materiality;
- **Asynchronous**—not timely information,
- **Asymmetrical**—unequal access to or incorrect information;
- **Market**—financial system; and
- **Activity**—researching, pricing, transacting, clearing, settling, and inventorying.

The GAAMA Model is a three-dimensional, non-linear, dynamic paradigm. The x-axis delineates commercial activity resulting from too many rules that cause confusion (i.e., the tax code) and/or too few rules or best practices that cause uncertainty (i.e. a computer problem without the help desk). The x-axis resolves bad trade practices.

The y-axis determines the pricing function. Standards that are too high are exclusionary operational supports that direct order flow, while standards that are too low are indiscriminate price controls that act as a disincentive to commercial activity. By way of illustration, the tax code has specific rules applicable to the depreciation expense deductible for personal computers. Each rule in the tax code is held to the societal standard that it be assessed “fairly” and held to the cultural standard of “progressivity”.



The GAAMA Model's z-axis represents a ratio of commands-to-incentives for a given level of commerce. The z-axis posits that the smaller the ratio of commands-to-incentives, the larger the areas of normative market activity to provide a societal net benefit. The model analyzes incentives and commands to ensure proportionality with the current level of commercial activity.

What is ironic is that having demonstrated the virtues of the capitalistic system, American policy makers are now trying to recreate the governance regime of our European ancestry. Napoleonic Code governs Europe, where an activity is prohibited unless expressly permitted. English Common Law reverses the process; unless an activity is expressly prohibited, it is permitted. America took English "openness" and added the concept of "sweat equity" during the Jacksonian Era as an incentive to the settlers of the frontier. The current regulatory trend seems to be reverting to the Napoleonic Code that our ancestors rejected.<sup>10</sup> In response to increasing market activity, capital market governance has become a labyrinth of confusing proscriptions. Regulation is a negative definition business—thou shall not ... except for—that mitigates first-move advantage. To provide equity from disproportionate statutes, governing agencies have granted relief through exceptions. However, when exceptions to the rule become the rule, a new rule is needed.

Accordingly, I argue for systemic change of capital market governance. Given greater demand required by global mass markets and greater complexity required by innovative enterprises, the SEC can no longer effectively govern with a one-size-fits-all regulatory regime that conflates risk with uncertainty. Furthermore, efficient utilization of regulatory resources suggests a modification of the Commission's centralized command and control organizational structure with its focus on financial products. Robust markets create an exponential demand for products in comparison to the Commission's linear ability to supply regulatory resources.<sup>11</sup> This creates a Hobson's choice for the SEC either to constrain market dynamics (errors of omission) or fall behind the compliance curve (errors of commission).

To reconcile this dilemma, I suggest that capital market governance be organized into three separate regulatory regimes along functional lines based on the predictability of cash flow and related variability from price equilibrium. Government and municipal securities whose securities are valued as a function of their tax authority trade in virtual-equilibrium conditions and are regulated under separate regulatory regimes. Mature NYSE and NASDAQ with probabilistic cash flows are "risky" issues that trade in near-equilibrium conditions. These securities should be afforded separate regulatory treatment from "uncertain" issues that trade in far-from-equilibrium conditions. This segments the capital market in a manner that is similar to ways that investors organize their funds in savings, investment, and speculative accounts.

Presently, the SEC accomplishes its regulatory objectives through the registration and direct regulatory control of issuers, intermediaries, and self-regulatory organizations (SROs) in the securities markets.<sup>12</sup> This regulatory approach works well for

predictable investments that are governed through risk management, but is somewhat less than desirable for those investments involving uncertainty. Given different pricing metrics and sales practices, it is difficult to govern uncertain investments and risky investments under the same regulatory regime.

The SEC's one-size-fits-all regulatory rationale rests upon the Efficient Market Hypothesis (EMH). EMH is an investment theory that states that it is impossible to beat the market because prices already incorporate and reflect all relevant information. At the heart of the EMH is the "rational investor," a prototypical investor who uniformly processes homogeneous information by giving all data equal value.<sup>13</sup> The underlying assumptions of EMH as the sole construct for governance have become as passé as the 30-year fixed mortgage. Contrary to the assumption of homogeneous information, experience shows that investors prioritize their investment objectives in terms of savings, investment, hedging, and speculation.

To this end I propose a governance regime for uncertain investments that emphasizes regulating investor capabilities. For investors who demonstrate their understanding of uncertain investments, no mandatory regulation is necessary other than anti-fraud provisions covering an affirmative representation of the investment offering.<sup>14</sup> This market-driven approach to governance would not only be more effective but also increase efficiencies enabling practitioners (issuers, investors, intermediaries, and regulators) to focus on the value-added proposition of their investment decisions. Issuers would be able to provide better disclosure at a lower cost. Data from predictable business activities that is extrapolated from historical financial statements (as separate and distinct from prospective forward-looking information relative to new ventures) can be presented with a higher degree of logical consistency. Consumer education and market infrastructure enhancements qualify investors to create a "preferred shoppers" network for uncertain investments. Since sophisticated investors search for precise disclosure to allocate funds in accordance with their investment objectives intermediaries are better able to manage complex structured financial activities on both a per transaction and relationship basis. The process of self-selection encourages intermediaries to "understand" rather than "work" the financial ramifications of such transactions.<sup>15</sup> Lastly regulators are better able to match resources with priorities more effectively and more efficiently as a higher percentage of complex structured financial activities are conducted in normative rather than GAAMA markets.

I trust these comments have been responsive to your request. Should you have any questions, I can be reached at 301-215-6441 and would welcome the opportunity to discuss them with you in greater detail.

Respectfully submitted,

Stephen A. Boyko, President  
Global Market Thoughtware, Inc.

## Endnotes

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### <sup>1</sup> Transitioning from Niche Domestic Market to Global Mass Markets

Category	1974	1999	% Change
Societal ownership	18%	74%	310%
NYSE listings	1,935	3,025	150%
NYSE capitalization	\$511 billion	\$12 trillion	2,400%
NYSE daily volume	12 million	700 million	5,700%
Mutual funds	305 funds	6,778 funds	2,100%
Capitalization	\$56 billion	\$4.5 trillion	7,900%

<sup>2</sup> All financial decisions are made in the margin based on consumer input. FedEx's marginal pricing system provides valuable market information. This is a great competitive advantage versus the post office's average pricing model.

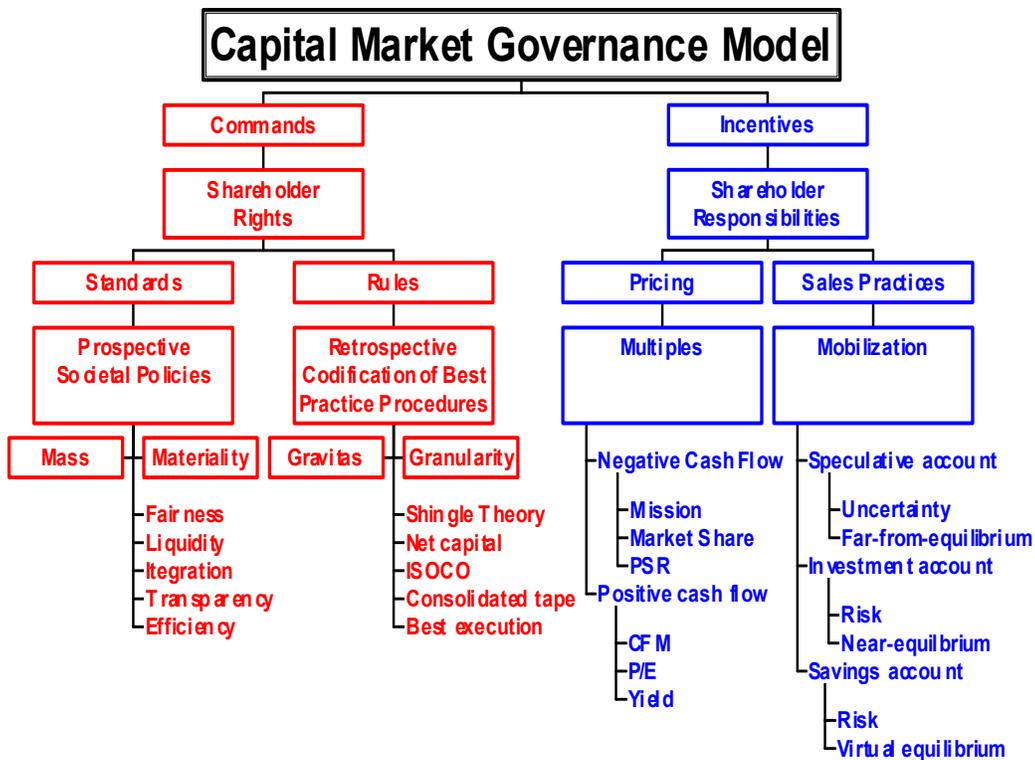
<sup>3</sup> Disruptive-product put strategies as described by visiting Wharton scholars Bill Hilliard and Charles Baden-Fuller in their article entitled "A New Strategy for Venture Investors: Hedge" (<http://knowledge.wharton.upenn.edu/article/995.cfm>) expands the purview of complex structured financial transactions to entrepreneurial enterprises and related innovative products.

<sup>4</sup> Peters, Edgar. *Complexity, Risk, and Financial Markets* (Wiley: N.Y., 1999) p. 19.

<sup>5</sup> Dowd, Kevin. "Too Big to Fail: Long Term Capital Management and the Federal Reserve." In September 1998, the Federal Reserve (Fed) organized a rescue of Long Term Capital Management (LTCM), a very large and prominent hedge fund. The Fed intervened because it was concerned about possible dire consequences for world financial markets if it allowed the hedge fund to fail. Dowd argues that the Fed's intervention was misguided and unnecessary. LTCM would not have failed and the Fed's concerns about the effects of LTCM's failure on financial markets were exaggerated. In the short run, the Fed's intervention helped the shareholders and managers of LTCM get a better deal for themselves than they would otherwise have obtained. <http://www.cato.org/pubs/briefs/bp-052es.html>

<sup>6</sup> Boyko, Stephen. "An Entrepreneur Exchange to Reduce the Regulatory Divide", *American Society for Competitiveness Conference*, October, 2003.

<sup>7</sup> The following is a detailed description of a proportionate governance model that balances command costs attendant to shareholder rights with incentive benefits derived from shareholder responsibilities. Shareholder rights are a composite of rules and standards. Standards are prospective societal policies that define industry effectiveness. They are defined in terms of “mass” indicating the number of people effected by the command and “materiality” indicating the relative importance of the command (for a detailed explanation of standards, reference Global Parallels: Proportionate Governance for Increased Commerce, <http://inthenationalinterest.com/Articles/Vol3Issue19/Vol3Issue19Boyko.html> ). Rules, on the other hand, are the retrospective codification of best-practice procedures that define operational efficiency. They are industry proscriptions that explicitly delineate organizational limits in terms of *gravitas* and granularity. *Gravitas* is the seriousness of a violation as measured in terms of the amount of a fine and/or duration of a sentence. Granularity is the degree of precision required to ensure compliance as measured in terms of practices and pricing. For example, the standard of fairness is supported by NASD Rule 2120 (Sales Practices).



<sup>8</sup> Once society validates a good or service with a critical level of demand, regulatory proscriptions determine the location and price of the transaction not whether it will take place.

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<sup>9</sup> This is a modified version of the GAAMA Model presented at the 1997 Ukrainian Capital Market Conference and later published as “The Governance of Outsourcing” <http://inthenationalinterest.com/Articles/Vol3Issue11/Vol3Issue11Boyko.html>

<sup>10</sup> Boyko, Stephen and Gottesman, Aron. “Understanding Entrepreneurs” (March 31, 2004) <http://inthenationalinterest.com/Articles/Vol3Issue13/Vol3Issue13Boyko.html>

<sup>11</sup> By way of illustration, the Former Soviet Union lacked the information system to restructure and therefore was unable to address effectively the hierarchical complexity required for a global society. In the early years of the Soviet Union, the total number of goods controlled by Gosplan’s centralized planning was approximately 500,000 to 750,000 items. By 1972, the total number of goods produced in the economy was 12 million and a decade later the number had doubled to 24 million. This meant that planning only used a 2-to-3 percent sample size of total products to forecast aggregate demand. It was simply impossible to calculate real demand for all items in the economy. This flaw became exponential as the economy became more dynamic (Ellman, M. and Kontorovich, V. 1998. *The Destruction of the Soviet Economic System: An Insiders’ History*. New York, NY: M.E. Sharpe.).

<sup>12</sup> See Choi, S.J., (<http://www.law.berkeley.edu/journals/clr/library/choi01.html>).

<sup>13</sup> Peters, Edgar. *Complexity, Risk, and Financial Markets* (Wiley: N.Y., 1999) p. 79.

<sup>14</sup> Reference: “Entrepreneurial Exchange: inclusive market solutions,” *Buyside Magazine*, <http://buyside.com/archives/2003/0310/html/0310gst.asp>, and “Capital and the Small Businessman: A Proposal for an International Entrepreneurial Exchange” *In the National Interest*, <http://www.inthenationalinterest.com/Articles/vol2issue20/vol2issue20boyko.html>

<sup>15</sup> “Smartest Guys in the Room: The Amazing Rise & Scandalous Fall of Enron”, penned by *Fortune* scribes Bethany McLean and Peter Elkind, a chronicle of the scandal that digs deep inside the numbers while, wisely, maintaining focus on the "smart guys" deep-frying the books.