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# Global Financial Reform—the Silver Lining in the Goldman Sachs Cloud? [1]

One thing we know: the financial, and potentially political, turmoil stemming from the United States Securities and Exchange Commission’s recent civil fraud action against Goldman Sachs will be sizeable, not just for its implications on the world’s most influential financial institution – but for the political grease it supplies to the wheels of global financial reform. This reform will likely include both punitive and structural measures, and while the public may find satisfaction in the former, the latter is where real international progress can be made through the creation of global financial standards.

While the Goldman Sachs case appears complex and will undoubtedly grow more so, one shouldn’t be intimidated by financial jargon. At issue is whether it’s legally material that Goldman Sachs failed to explicitly tell investors that the choice of assets backing a deal was influenced by the same person betting those assets would fail. Intuitively, this seems like a material fact. On the other hand, if everyone has the same information, we expect sophisticated investors to do their own research and determine what side of the bet they want to take. When you strip out all the jargon, what we are talking about here is transparency. Goldman is accused of providing too little, and their defense will be that a literal interpretation of fraud says they provided enough. Here’s the rub – assuming no new evidence comes out – they are probably right. Even the deposed Wall Street Crusader himself, Eliot Spitzer, is on record stating that the SEC has a tough road ahead.

The only certain outcome is more aggressive global financial regulatory reform. This reform will not come from taxing bonuses, trader perp-walks or forcing banks to shed certain businesses; it will come from changing the rules that govern how investors trade with one another.

One of the primary changes you’ll hear mentioned will be a push for trading to occur “on exchange”. This is distinguished from the OTC (over the counter) markets. The OTC markets occur directly between counterparties (or through brokers) often over the telephone, while exchanges stand in the middle to coordinate, provide insurance against defaults, gather data and other functions. The financial products that trade OTC are, generally, customized as opposed to the standardization required to be listed on an exchange. Both types of markets create interconnectedness and dependency between counterparties. Exchanges, however, promote transparency around this interconnectedness, while OTC markets (while more customizable and generally faster growing) do not.

This is relevant from an international relations perspective as exchanges are a safer alternative for emerging nations seeking to access the global financial marketplace than the OTC market. Exchanges, themselves founded as gathering points where buyers and seller forgo the advantage of customized products for (relative) safety and oversight, have expanded trans-nationally through consolidation – however cultural and regulatory barriers still prevent real global integration. This push to move trading onto national exchanges should further the creation of global financial standards that, hopefully, will allow people to invest across the world with full disclosure. Call me idealistic, but I still believe that transparent financial interdependency can be a cornerstone of international understanding and cooperation and that 100 billion dollars worth of privately negotiated transactions does not have the same positive geopolitical effect as 50 million of known transactions.

I was initially surprised at the success of Ben Mezrich's *Rigged*, a novelization of the story behind the creation of the Dubai Mercantile Exchange, largely because I never envisioned my work in Dubai as being interesting to a wide audience. As complex financial issues become front-page news, however, I'm reminded of how simple and elegant a solution exchanges provide when faced with the choice between growth that leads to productive financial innovation versus reckless financial destruction. Dubai's decision to enter the global crude oil market via an alliance with a U.S. based exchange, and all the regulatory oversight that comes with it, was an extraordinary decision and one that should be emulated by other emerging markets.

Markets evolve over time, but there are always paradigm shifts that occur during severe disruptions. It is at these points we learn real lessons about how markets function. The charges against Goldman Sachs represent one of those critical points, precisely because they are so legally tenuous. Where one falls on this issue is largely a matter of whether one believes financial dealings should ascribe to basic ideals of fairness, or if all is fair in love, war and finance. Before this is over, far more infuriating facts will be revealed (recently it was announced that Goldman's general counsel is the romantic partner of ACA's president – the very firm that supposedly independently picked the assets), and if anyone cares to delve into the details of these deals, it will be obvious that some were very, very bad for certain Goldman Sachs investors. All of this news will be salacious, all of it will feel instinctively wrong – yet little of it will be illegal. As Jack Nicholson remarked in *A Few Good Men*, we'll see if we are ready to 'handle the truth.'

This case is not about fraud. Instead, it concerns a fundamental questioning of how markets should function. Depending on the outcome, global integration of financial markets will either take a massive step back or a giant one forward. The impending circus that will be the Goldman Sachs civil fraud trial may just be the catalyst that allows the latter to happen.