2011 *Chapman Law Review* Symposium:

From Wall Street to Main Street: The Future of Financial Regulation

Friday, January 28, 2011

Chapman University School of Law

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MCLE Course Material

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From Wall Street to Main Street: The Future of Financial Regulation

Friday, January 28, 2011

MCLE Course Material

10:45 am– 12:30pm **Panel 2**	***Congress Punts; Administrative Agencies Receive; Welcome to a Decade of Rulemaking***	108
	Rosalind Tyson, Regional Director, Los Angeles Regional Office, U.S. Securities and Exchange Commission ▪ *Dodd-Frank's Impact on SEC Regulation & Enforcement*	109
	Reza Dibadj, Professor, The University of San Francisco School of Law ▪ *Toward First Principles*	110
	Donna M. Nagy, C. Ben Dutton Professor of Law, Indiana University Mauer School of Law – Bloomington ▪ *Dodd-Frank's Impact on Securities Enforcement & Litigation*	112
	W.H. (Joe) Knight, Jr., Professor of Law, Seattle University School of Law ▪ *Fear of Flying – The Behavioral Psychology of Dodd-Frank*	117
	Mark A. Moore, Principal, Aldrich, Bonnefin & Moore, PLC ▪ *Dodd-Frank and the New Consumer Protection Bureau*	118
	Moderator: Professor Kurt Eggert, Chapman University School of Law	
2:00pm – 3:15pm **Panel 3**	***The Return of the Rating Agencies: Rerun or Redemption?***	125
	Claire Hill, Professor, Solly Robins Distinguished Research Fellow and Director, Institute for Law & Rationality, University of Minnesota Law School ▪ *The Limits of Dodd-Frank's Rating Agency Reform*	126
	Kurt Eggert, Professor of Law, Chapman University School of Law ▪ *Cleaning Up After the Rating Agencies Failed*	133
	Cassandra Jones Havard, Professor of Law, University of Baltimore School of Law ▪ *Got Transparency?*	164
	Moderator: Professor Timothy A. Canova, Betty Hutton Williams Professor of International Economic Law, Chapman University School of Law	
3:30pm – 5:00pm **Panel 4**	***Who's the Boss? Re-writing the Rules of Corporate Governance***	166
	Iman Anabtawi, Professor of Law, UCLA School of Law ▪ *Dodd-Frank, Corporate Governance and Systemic Risk*	168
	Z. Jill Barclift, Associate Professor of Law, Hamline University School of Law ▪ *Governance in the Public Corporation of the Future: The Battle for Control of Corporate Governance*	169
	Stefan J. Padfield, Associate Professor of Law, The University of Akron School of Law ▪ *The Dodd-Frank Corporation: More Than a Nexus of Contracts*	172
	Gary Aguirre, The Aguirre Law Firm ▪ *The Dodd-Frank Bounty for Whistleblowers: A New Arrow in the SEC's Quiver or Career Suicide for the Whistleblower?*	180
	Moderator: Mr. Keith P. Bishop, Partner, Allen Matkins, Adjunct Professor, Chapman University School of Law, Former California Commissioner of Corporations	

The Changing Regulatory Landscape

Summary of the Dodd-Frank Act

Prepared by:

Deutsche Bank

(July 2010)

Landmark Moments in US Financial History

Year	Event
1785	— The US adopts decimal coinage system and the Dollar is chosen as the money unit for the United States
1791	— The First Bank of the United States is created, providing national currency and acting as the government's fiscal agent
1863	— National Bank Act establishes a system of national charters for banks
1913	— Imposition of the federal income tax on individuals and corporations — Federal Reserve Act divides country into 12 districts, each with a federal reserve bank
1932-33	— Series of new bills to rescue the economy: Glass-Steagall Act, Emergency Bank Act (prevents Fed collapse), Gold Standard abolished; restructuring of the Federal Reserve — Regulatory measures: introduction of deposit insurance, the FDIC, and the SEC
1999	— Gramm-Leach-Bliley Act (also known as the Financial Services Modernization Act of 1999) repeals Glass-Steagall Act of 1933
2010	— **Dodd-Frank Wall Street Reform and Consumer Protection Act**

The passage of the Dodd-Frank Act represents the most comprehensive US financial reform since the 1930s

Dodd-Frank Wall Street Reform and Consumer Protection Act:
20 key areas of focus

Rules for Government / Regulators

1. Financial Stability Oversight Council
2. Ending Too-Big-To-Fail (Unwind Authority)
3. The Federal Reserve
4. Bank Supervision

Rules for Banks / Corporates

5. Enhanced Prudential Standards
6. Volcker Rule
7. Bank Capital
8. OTC Derivatives
9. Foreign Financials
10. Insurance

Rules for Investors

11. Securitization
12. Executive Compensation & Corporate Governance
13. SEC and Investor Protection
14. Credit Rating Agencies
15. Hedge Funds and Private Equity Funds
16. Municipal Securities

Rules for Consumers

17. Consumer Financial Protection Bureau
18. Other Consumer Protections
19. FDIC Deposit Insurance

20. Other Provisions of the Dodd-Frank Act

We have focused our efforts in this presentation on 20 key areas that span over 2,319 pages in the actual legislation

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Summary Conclusions

- ✓ The final bill is sweeping in its scope and impact, and is especially tough on the Big Banks (Wall Street)
- ✓ Most provisions result in significant downward pressure on profitability, upward pressure on capital, and increased system stability
- ✓ Although the legislation moves further down the path of ending Too-Big-to-Fail, it fails to eliminate this risk
- ✓ The Federal Reserve has emerged as a much more powerful regulator than had been contemplated just months ago
- ✓ GSE reform (Fannie, Freddie) is the most notably absent issue in the bill
- ✓ On a relative basis, hedge funds, insurance companies, and the credit rating agencies emerged largely unscathed from the legislation
- ✓ New regulations in the derivatives market are significant, and will likely make it more expensive for companies to hedge macro-economic uncertainty at a time when volatility in the market is very high (margin and capital demands on liquidity)
- ✓ Throughout the bill, a significant amount of discretion is given to a broad range of regulators to write the detailed rules in the years ahead (we are not done!)
- ✓ The complexity, ambiguity and timing of substantially higher capital requirements will have a negative impact on lending in the economy
- ✓ Opportunities for global regulatory arbitrage could be significant
- ✓ Many non-U.S. emerging market jurisdictions will likely be more attractive opportunities than the U.S. for financial sector growth and investment
- ✓ Once implementation is complete, credit markets should respond very positively to the reduction in leverage, increased stability, and higher capital levels

A close examination of the Dodd-Frank Act reveals that the often repeated notion that "banks dodged a bullet" is simply not true.
Rather, a few small victories merely softened the blow on the most draconian proposals.
To be sure, the final bill is sweeping in its scope and impact.

A Plethora of New Agencies

Eliminated Agencies

- **Office of Thrift Supervision** (standalone)

Selected New Agencies

- **Consumer Financial Protection Bureau** ("independent" with the Fed)
- **Financial Stability Oversight Council** (stand-alone)
- **Federal Insurance Office** (Treasury)
- **New Offices of Minority and Women Inclusion** (banking and securities regulators)
- **Investor Advisory Committee** (stand-alone; to advise SEC)
- **Office of Investor Advocate** (SEC)
- **Office of Credit Ratings** (SEC)
- **Credit Rating Agency Board** (SEC)
- **Office of Financial Literacy**
- **Office of Financial Research** (Treasury)
- **Office of Housing Counseling** (HUD)
- **Office of Fair Lending and Equal Opportunity** (Fed)
- **Office of Financial Protection for Older Americans** (Fed)

While the OTS is the only significant existing U.S. Government agency to be eliminated ...
...the legislation would create a massive increase in the number of new agencies within the U.S. financial regulatory oversight architecture.
In addition, thousands of new employees will be needed across a full range of existing U.S. regulatory agencies.

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Over 500 Rules and Studies Still to Come

Summary of Mandated Rulemaking and Studies by Agency

Agency	Rulemaking	Studies
Bureau of Consumer Financial Protection	24	4
Commodities Futures Trading Commission (CFTC)	61	6
Financial Stability Oversight Council	56	8
Federal Deposit Insurance Corporation (FDIC)	31	3
Federal Reserve	54	3
Federal Trade Commission (FTC)	2	0
Government Accountability Office (GAO)	0	23
Comptroller of the Currency (OCC)	17	2
Office of Financial Research	4	1
Securities and Exchange Commission (SEC)	95	17
Treasury	9	1
Total	**243**	**67**

US Chamber of Commerce Estimate

- 533 rulemakings
- 60 studies
- 70 reports

Over 240 rules are **required** to be written by 11 different regulators, mostly within the next 18 months. The U.S. Chamber of Commerce notes that the **potential** number of new rule makings and studies is actually well in excess of 500.

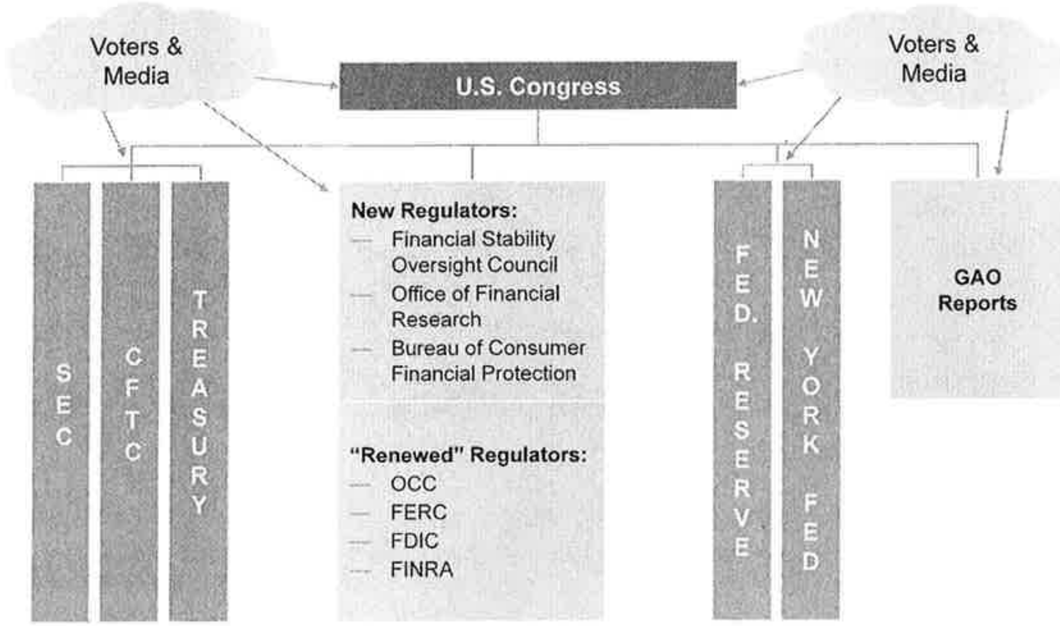
Timing and Implementation Schedule

Topic	Timing and Implementation Considerations
Consumer Financial Protection Bureau	– Within 18 months (possible extension to 24 months)
Volcker Rule	– Within 2 years
Capital Requirements	– **Risk-based capital and leverage**: Within 18 months – **Phase-out of Trust Preferred**: 5 years (2013 – 2016)
OTS elimination	– Within 15 months
Rating agencies	– Within 1 year
Hedge funds and PE funds	– Within 1 year
Securitization	– 1 year after publication of the final rules for RMBS – 2 years for most other securities
Derivatives	– **Generally:** In 360 days – **Swap push-out**: Generally, within 2 years (possible extensions)

Gradual phase-in periods should mitigate much of the initial shock to the U.S. economic and financial system

A

Why Rulemaking Won't Be Simple...



Agenda

1 Frank Kelly, Head of Government Affairs – Americas

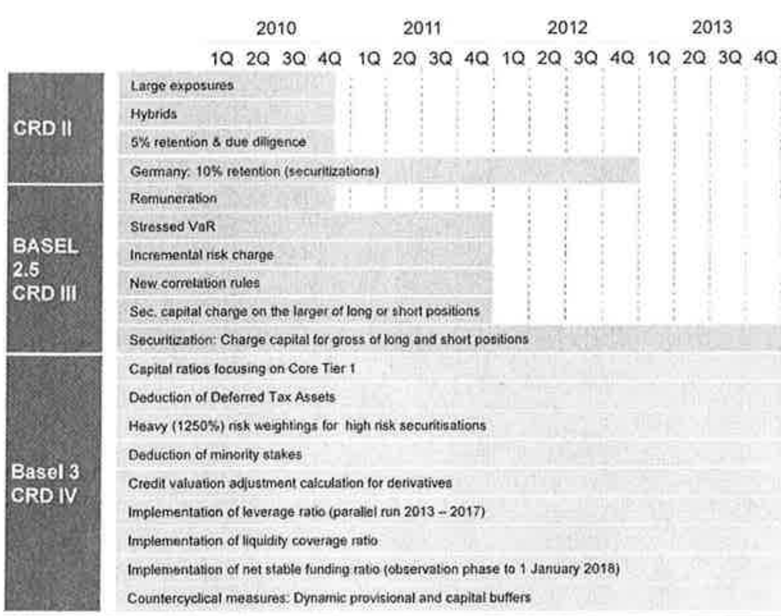
2 Andrew Procter, Global Head of Government & Regulatory Affairs

Higher quality capital standards

Significant uncertainty on the shape of future regulation along with any proposed implementation timetable

Basel 2.5	**New Trading Book rules** — Correlation trading — Trading book securitisation — Stressed Value at Risk — Incremental risk charge
Basel 3	**New Capital Rules** — Capital Deductions (DTA, Pension Plans, Minority Interests) — Treatment of equity positions — Tighter definition of capital — Holding of capital buffers **New Liquidity Rules** — Liquidity Coverage Ratio (LCR) — Net Stable Funding Ratio **Leverage Ratio**

Expected Basel implementation timeline



G-20 Communique

"We agreed that all members will adopt the new standards and these will be phased in over a timeframe that is consistent with sustained recovery and limits market disruption, with the aim of implementation by end-2012, and a transition horizon informed by the macroeconomic impact assessment of the Financial Stability Board (FSB) and BCBS.

Phase-in arrangements will reflect different national starting points and circumstances, with initial variance around the new standards narrowing over time as countries converge to the new global standard."

Timeline certain
Timeline uncertain

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Changing supervisory practices
Strengthening markets in the name of financial stability

The supervisory framework will change but more importantly so will many supervisory practices

Changes to the framework	**Micro-prudential supervision** — Strengthened micro-prudential supervision through enhancing the colleges model of supervision — More centralised rule-making in the European Union — Special rules for systemic relevant banks: living wills, TBTF **Macro-prudential supervision** — The introduction of macro-prudential supervision geared towards preventing the emergence of asset bubbles and financial instability

Many proposals are in the pipeline that will have fundamental impacts on trading activities

Short selling	— Proposal for a planned European regime in the Autumn — Enhanced transparency with powers for regulators to intervene
Volcker Rule	— The US will ban proprietary trading or investing in or sponsoring hedge funds or private equity funds — The EU not expected to follow. Unclear the precise extent of any extra-territorial implications of the US action

Improving over-the-counter derivatives markets

Industry led initiatives to enhance market infrastructure well underway. Differences between the EU and US likely in some instances

Clearing	— Central clearing for eligible trades — Joint responsibility across CCP's (central counterparty) / regulators / dealers to determine what is eligible — Focus on robustness of CCP's — More stringent rules on bilateral collateral arrangements
Transparency	— An acceptable level of pre-trade price discovery available to OTC market users — Greater post-trade transparency required to all derivative asset classes — No restrictions on execution channels for eligible execution venues in the EU — Greater drive for on-exchange trading in the US — All trades reported to global trade repositories for each asset class
Standard-ization	— Recognition that product standardisation in most cases is unnecessary — Drive to standardise the processes and legal frameworks around derivatives

UK Regulatory Architecture: Future Structure

Consumer Protection and Markets Authority
Responsible for investor protection and conduct of business.
(Listing and company reporting?)

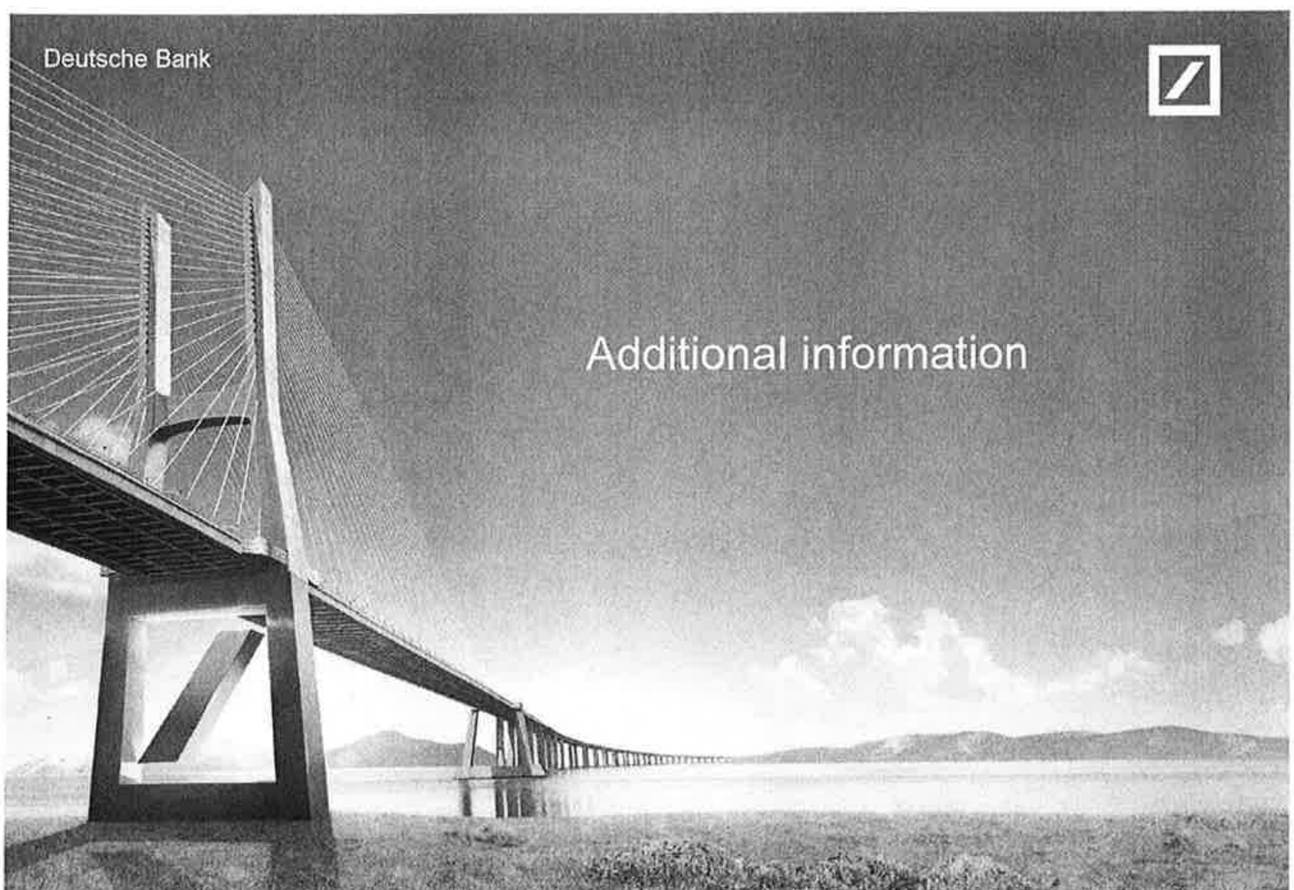
Bank of England
Responsibility for macro-prudential supervision and oversight of micro-prudential supervision

Economic Crime Agency
Responsible for serious crime/enforcement
(Details of proposal still to be published)

Prudential Regulation Authority
Subsidiary of Bank of England
Responsible for day to day supervision

Financial Policy Committee
Chaired by M. King
(Governor of BoE)
Responsible for macroeconomic and financial stability

Banking Commission
Headed by John Vickers
Aims to review banking system; focus on reducing systemic risk
To look into division of retail and investment banking
Finding by Sept. 2011



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#1 – Financial Stability Oversight Council

Overview

- **New agency to monitor systemic risk and make recommendations to regulators**

Details

- Council of 10 voting members, chaired by US Secretary of Treasury (outlined on following page)
- **Responsibilities**
  - Identify threats to financial stability and gaps in regulation
  - Facilitate coordination across Federal and State agencies

- Strong systemic oversight role
- Limited enforcement power
- Can only make recommendations

Financial Stability Oversight Council

Recommend to Fed for heightened standards as companies grow in size and complexity, with greater requirements for companies threatening stability	With a 2/3rds vote, can require non-bank financials to go under the authority of the Fed	With a 2/3rds vote, can approve Fed's decision to compel asset sales	With a 2/3rds vote (must incl. Treasury Sec, Chairman of Fed and FDIC Chairman), can prohibit federal assistance to swaps entities regardless of exemptions

- **"Office of Financial Research" created within Treasury**
  - Staffed with accountants, economists, lawyers, former supervisors and specialists providing technical expertise
  - Collects and analyzes critical data which will be made public in periodic reports to Congress

"Hotel California" provision

- **No evasion**
  - Large bank HoldCos that received TARP cannot drop bank charter to evade Fed supervision

#1 – Financial Stability Oversight Council (continued)

- Strong systemic oversight role
- Limited enforcement power
- Can only make recommendations

Financial Stability Oversight Council Members

10 Voting Members	5 Nonvoting Members
1. **Chair: US Treasury Secretary**	1. Office of Financial Research (OFR)
2. Federal Reserve Chairman	2. Federal Insurance Office (FIO)
3. Comptroller of the Currency (OCC)	3. State banking supervisor
4. Consumer Financial Protection Bureau (CFPB)	4. State insurance commissioner
5. Securities and Exchange Commission (SEC)	5. State securities commissioner
6. Federal Deposit Insurance Corporation (FDIC)	
7. Commodities Futures Trading Commission (CFTC)	
8. Federal Housing Finance Agency (FHFA)	
9. National Credit Union Administration (NCUA)	
10. Independent member named by the President	

#2 – Ending Too-Big-To-Fail (Unwind Authority)

Overview

- **FDIC gains additional new power to unwind large failing financial firms**
- **However, generally more alignment of unwinds with the bankruptcy code (than the more ad hoc powers permitted in the bank resolution statutes)**

Details

- **Orderly Unwind and Liquidation Mechanism**
  - Requires Treasury, FDIC and Federal Reserve to agree a company is in financial distress
  - Treasury must either obtain the consent of company's board of directors, or an order from the US District Court for the District of Columbia, authorizing the appointment of the FDIC as receiver
  - Shareholders and unsecured creditors will bear losses (more aligned with provision of bankruptcy code than had been the case previously), and management removed
  - FDIC may recover up to 2 years of compensation from senior executives substantially responsible for financial company failure
- **Taxpayer funds will not be used to rescue failing financial companies**
  - The costs of unwinding failing firms will be borne by the financial industry through fees imposed after a firm collapses via a fee assessed on financial firms with assets > $ 50 billion
  - During liquidation, the FDIC can borrow only the amount of funds that it expects to be repaid from the assets of the company being liquidated; government first in line for repayment
- **Funeral plans**
  - Large, complex institutions must periodically submit plans for own unwind
- **Bankruptcy**
  - Most large financials that fail are expected to be resolved through the bankruptcy process

- More powers for FDIC
- More transparency for creditors
- Weakens "Government uplift" support in bank credit ratings (critical issue with investors)

#3 – The Federal Reserve

Overview

- **The Federal Reserve becomes the preeminent financial regulator with a broadened supervisory scope and will be subject to the most transparency in its 96-year history**

Details

- **Consumer Protection**
  - Will house the new Consumer Financial Protection Bureau
- **Systemic Regulation**
  - Will work closely with new Financial Stability Oversight Council to set tougher standards for disclosure, capital and liquidity that will apply to banks as well as non-bank financial companies
- **Transparency**
  - Fed will have to disclose counterparties and information of 13(3) and discount window lending and open market transactions, with specified time delays
- **Limits on Fed's Section 13(3) Emergency Lending Authority**
  - Treasury must approve any lending program
  - Emergency lending to "individual" entities prohibited
  - Collateral must be sufficient to protect taxpayers from losses
- **Limits on debt guarantees**
  - To prevent bank runs, the FDIC can guarantee debt of solvent, insured banks after meeting onerous approval requirements from the Fed, FDIC, Treasury, the President and Congress

- Directly aimed at preventing future Fed activity analogous to its role in the Bear Stearns and AIG failures

#3 – The Federal Reserve (continued)

Overview

- **The Federal Reserve faces new rules on governance and will be subject to ongoing audits**

Details

- **Governance**
  - GAO to conduct study on current system for appointing directors and identify measures to improve reserve bank governance, within 12 months of the date of enactment
  - Eliminates the role of bankers in picking presidents at the Fed's 12 regional banks:

Class A Directors	Class B Directors	Class C Directors
— Elected by member banks to represent member banks — **Will no longer vote for presidents**	— Elected by district member banks to represent the public — **Will elect presidents**	— Appointed by the Board of Governors to represent the public — **Will elect presidents**

- **Accountability**
  - GAO will conduct a 1-time audit of all Fed 13(3) emergency lending during the financial crisis, with report submitted to Congress within 12 months of enactment
  - GAO will have authority to audit 13(3) and discount window lending, and open market transactions
- **Supervision**
  - The Fed will keep its existing bank supervisory powers of both large and small banks
  - Creates a **Vice Chairman for Supervision**, member of the Board of Governors of the Fed designated by the President, who will develop policy recommendations

#4 – Improving Bank Regulation

— Largely systemic focus

Financial Stability Oversight Council (FSOC)

- Newly created agency responsible for systemic risk
- Provide recommendations for capital and leverage requirements
- Prevent systemic risk from threatening the financial system
- **10 voting members**: Treasury Secretary, Fed Reserve Chairman, Comptroller of the Currency, CFPB, SEC, FDIC, CFTC, FHFA, NCUA, independent member named by the President
- **5 non-voting members**: OFR, FIO, state banking regulator, insurance regulator, securities regulator

— Largely institutional focus

Federal Reserve	Federal Deposit Insurance Corp (FDIC)	Office of Comptroller of the Currency (OCC)	Office of Thrift Supervision
— Bank holding companies and state banks that are members of the Federal Reserve system — Retains oversight role on over 5,800 small and midsize banks	— State banks and thrifts that are **not** members of the Federal Reserve System	— National banks and federal thrifts of all sizes	— ~~Supervisory oversight of thrifts~~ ELIMINATED

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#4 – Improving Bank Regulation (continued)

Overview

- **Eliminates:** OTS
- **Keeps**: Fed, FDIC, OCC
- **Creates**: FSOC

Details

- **Clear and streamlined supervision**
  - OTS abolished, with authority transferred to OCC; thrift charter preserved
  - Elimination of regulatory overlap (less arbitrage on regulatory supervision)
  - Clear lines of responsibility among regulators on supervision
- **Charter Conversions**: banks cannot convert charter to avoid an enforcement action (unless both the old regulator and new regulator do not object)
- **Volcker Rule**: prohibition on prop trading and restrictions on investments in hedge funds
- **Stronger lending limits**: credit exposure from derivatives transactions included in banks' lending limits
- **Supervision of holding company subsidiaries**: requires the Fed to examine non-bank subsidiaries that are engaged in activities that the subsidiary bank can do on the same schedule and in the same manner as bank exams
- **Intermediate holding companies**: allows use of intermediate holding companies by commercial firms that control grandfathered unitary thrift holding companies to better regulate the financial activities, but not the commercial activities
- **Interest on business checking**: authorizes banks to pay interest on corporate checking accounts, effective one-year from the date of enactment
- **Dual banking system**: preserved; state banking system that governs most community banks will continue to exist

#5 – Enhanced Prudential Standards

Overview

- **Enhanced prudential standards for systemically important non-bank financial companies and interconnected bank holding companies**

Details

- **Discourage excessive growth and complexity**
  - Financial Stability Oversight Council to make recommendations for increasingly strict rules for companies that grow in size and complexity
- **Volcker Rule**
  - Prohibits banks from prop trading and restricts fund sponsorship
- **Risk-based capital requirements**
  - Establishes a floor for capital that cannot be lower than the standards in effect today
- **Stricter leverage limits and liquidity requirements**
  - Financial Stability Oversight Council can impose 15:1 debt-to-equity ratio to mitigate threats to stability
- **Stress Tests**
  - Requires stress tests to be conducted by the Fed but does not specify frequency
- **Concentration limits**
  - Credit exposures to non-affiliates cannot exceed 25% of capital stock and surplus
- **Resolution plan and credit exposure reporting**
- **Risk committees**
  - Required for systemically important, publicly traded non-bank financial companies, as well as publicly traded bank holding companies, with total consolidated assets > $10 billion

New U.S. capital and leverage requirements will influence international discussions on capital adequacy guidelines (Basel III standards)

#6 – Volcker Rule: Overview

Overview

- **Intended to limit bank activity in higher risk businesses such as proprietary trading, hedge fund and private equity businesses**

Key Provisions

Proprietary trading prohibited	**Securitization activities limited (conflicts of interest)**
Investments in and sponsorship of hedge funds and private equity funds restricted (3% rule)	**M&A restrictions (10% rule)**

Applicability

- **Applies to banks, their affiliates and companies treated as a Bank Holding Company**
  - Will only apply to US subsidiaries of foreign companies that have systemically important operations in the United States or that receive Bank Holding Company treatment
  - Excludes foreign trading by foreign companies
- **Application to systemically important non-bank financials**
  - Above restrictions (proprietary trading, investment funds) do **not** apply; however, higher capital and other quantitative criteria applied

#6 – Volcker Rule (Continued): Propriety Trading Restrictions

- Banks are prohibited from engaging in proprietary trading
- Language stringently defined in the legislation rather than leaving flexibility with the regulators as earlier versions had contemplated
- GAO study on prop trading to be produced within 15 months of date of enactment

Exemptions From the Ban on Proprietary Trading

1. Investments in US government, agency, state or municipal debt(1)
2. Investments in small business investment companies
3. Market-making related activities
4. Risk-mitigating hedging activities
5. Activities on behalf of customers
6. Activities conducted by a banking entity solely outside the US, unless the banking entity is directly or indirectly controlled by a banking entity in the US
7. Activities by regulated insurance companies

The definition of proprietary trading in the final bill is critical to assessing its ultimate impact on trading revenue

Proprietary Trading (defined): *"The term 'proprietary trading', [...] means engaging as a principal for the trading account of the banking entity or non-bank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract..."*

- Dodd-Frank Act

(1) Includes Fannie Mae, Freddie Mac, Ginnie Mae, Federal Home Loan Banks, Farm Credit System securities

#6 – Volcker Rule (Continued): Other Key Provisions

Fund Investments and Sponsorship

- **Hedge fund and private equity fund investments and sponsorship (3% Rule)**
  - Banks can provide no more than 3% of the fund's capital
  - Banks cannot invest more than 3% of their Tier 1 capital
  - Banks can sponsor and act as a trustee/general partner/management member of funds as long as it is done for bona fide trust, fiduciary, or investment advisory services
  - Banks are prohibited from bailing out a fund in which they are invested

Securitization

- **Securitization**
  - Firms cannot underwrite an asset-backed security that will result in a conflict of interest
  - Exemptions for activities designed to reduce the risks of an underwriter, provide liquidity or related to market-making

Addresses recent fraudulent conduct **alleged** in SEC lawsuit against Goldman Sachs

Concentration Limits

- **Concentration limits – M&A restrictions (10% Rule)**
  - No mergers that would result in a company with liabilities greater than 10% of the total liabilities of all financial companies at the end of the prior calendar year

Notable Studies

- **Studies**
  - Study by the Council on how to effectively implement the Volcker Rule will conclude within 6 months of the date of enactment
  - Within 18 months of enactment, the appropriate Federal banking agencies must jointly review the activities that a banking entity may engage in under federal and state law and consider whether additional restrictions, including those to concentration limits, are necessary

#7 – Bank Capital

Overview

- **Federal Reserve establishing enhanced leverage and risk-based standards and capital requirements for systemically important firms**

Details

- **Trust preferred (TruPS) and hybrid securities excluded from Tier 1 capital**
  - For banks with assets < $ 15 billion, existing TruPS grandfathered
  - TARP preferred issuances grandfathered, regardless of the size of the institution
- **Minimum capital and leverage ratios**
  - Establishes a floor for capital that cannot be lower than the standards in effect today
  - Requirements will apply to:
    - US insured depository institutions
    - US bank holding companies
    - US intermediate holding companies of foreign banks
    - Thrift holding companies
    - Systemically important non-bank financials
  - Fed must include off-balance sheet activities in calculating new capital requirements
  - Must address risks relating to derivatives, securitized products, financial guarantees, securities borrowing and lending, repos, concentrations in assets where values are model-driven
  - New capital requirements must be countercyclical
- **Contingent Capital**
  - No specific contingent capital requirements
  - Within the next 2 years, Council must conduct study on the feasibility, benefits, costs and structure of a contingent capital requirement

Collins Amendment

Timing and applicability of capital requirements outlined on the following page

Dodd-Frank Floor for Capital and Leverage Requirements[1]

	Minimum risk-based capital ratios: Tier 1 capital	Minimum risk-based capital ratios: Total capital	Minimum leverage ratio
Well capitalized	6%	10%	5%
Adequately capitalized	4%	8%	4%

(1) Currently applicable capital and leverage ratios for insured depository institutions will set the floor for new requirements

#7 – Bank Capital (continued)

Timing and Applicability of "Collins Amendment" Capital Requirements		
	Regulatory capital deductions (e.g., hybrid exclusions from Tier 1)	**Leverage ratios and risk-based capital ratios**
Banks with assets > $15 billion	Phased in from Jan 1, 2013 to Jan 1, 2016; no impact for first 2 years and incremental phase-in 1/3rd per year starting Jan 1, 2013	Effective when new requirements are implemented, which will be within 18 months
Banks with assets < $15 billion	Grandfathered (effectively)	Effective when new requirements are implemented, which will be within 18 months
Thrift holding companies with assets > $15 billion	Phased in from Jan 1, 2013 to Jan 1, 2016	5 years after enactment
Thrift holding companies with assets < $15 billion	Grandfathered (effectively)	5 years after enactment
Intermediate US holding companies of foreign banks	Effective 5 years after enactment	5 years after enactment
Non-bank financials	Phased in from Jan 1, 2013 to Jan 1, 2016 (systemically important non-bank financials may be exempt by the Federal Reserve)	Effective when new requirements are implemented, which will be within 18 months
Mutual holding companies	Grandfathered (effectively)	Effective when new requirements are implemented, which will be within 18 months (unless thrift holding company)

- **Exemptions**
  - Foreign parents
  - Federal home loan banks
  - Banks with assets < $ 500 million
  - Holding companies of industrial banks, credit card banks and trust banks
  - Systemically important non-bank financials **may** be exempt by the Federal Reserve

In general, the elimination of trust preferred as Tier 1 capital will be phased in from Jan 1, 2013 ...
...while new leverage and capital requirements will be implemented within 18 months.
All entities listed in the table are subject to the leverage and risk-based capital ratios.

Source: Davis Polk & Wardell: Collins Amendment – Minimum Capital and Risk-Based Capital Requirements, June 28, 2010.

#8 – OTC Derivatives: Overview

Overview
- **Comprehensive set of new rules to reduce counterparty risk and increase transparency**
- **While the Dodd-Frank Act establishes the broad outline of regulation, most of the details will be determined by the regulators (CFTC and SEC) in the months ahead**

Key Issues

1. **Central clearing**
2. **Exchange trading**
3. **"Major swap participant"**
4. **Swaps push-out provision** ← Lincoln Amendment
5. **Capital requirements**
6. **Margin requirements**
7. **Post trade reporting**
8. **FX swaps**

Important Distinctions:
- **Capital and margin requirements:** Between dealers/ major swap participants, and end users
- **Central clearing by end-users:** Between financial and non-financial companies

#8 – OTC Derivatives (Continued): Key Provisions

Key issue	High-level Considerations
1. Central clearing	– **Financial companies:** Required to centrally clear (existing swaps grandfathered) – **Non-financial companies: Not** required to centrally clear (exempt) – **Captive finance subsidiary companies: Not** required to centrally clear (exempt), but only if business exists to predominantly serve an industrial parent (and not judged to be a major swap participant) – **Implications:** Liquidity demand of high initial margin; *daily* variance margin, cash "form" of margin
2. Exchange trading	– Generally speaking, the Dodd-Frank Act focuses more on the importance of central clearing than exchange trading – **Requirement:** If no exchange or swap execution facility (SEF) lists the swap for trading, then the swap may be transacted with central clearing only (non-financials exempt from clearing and exchange) – **Implications:** Inability to customize (important to hedge strategy and accounting treatment)

3. Major swap participant (MSP)
 	
Possible to be designated a MSP for certain classes of swaps, and not others
	– Designation for entities that:
	  – maintain a substantial net position in swaps (except to hedge risk or benefit plan);
	  – whose outstanding swaps create substantial counterparty exposure **that could have adverse effects on the financial stability of the U.S. banking system or financial markets; or**
	  – is a financial entity that is high leveraged, not subject to capital requirements
	– **Implications:** If applicable, will be subject to a high degree of regulatory oversight, including capital and margin requirements and business conduct standards

4. Swaps push-out	– Banks will have to move certain swaps trading operations into separately capitalized, non-bank affiliates – **Exemptions:** Hedging own risk, interest rate swaps, FX, and certain metals (gold, silver, etc) – **Implications:** For end-users, could mean less liquidity and higher counterparty risk in commodities, CDS and equity linked derivatives

#8 – OTC Derivatives (Continued): Key Provisions

Key issue	High-level Considerations

5. Capital requirements	– Conservative capital requirements for dealers and major swap participants
	– Higher capital requirements for dealers for counterparty credit risk on OTC positions
	– **Implications:**
	  – For banks/ dealers, less profitability, higher capital demands, and reduced credit appetite
	  – For end-users, higher capital costs likely to be "passed thru" to some degree

6. Margin requirements
 	
This possibility has become an issue of strong political debate
	– Regulators could set minimum margin requirements for non-cleared (OTC) swaps (although may allow more flexibility on "form" to permit non-cash collateral)
	– Regulators also likely to set stringent minimum margin requirements for clearinghouses
	– **Implications:**
	  – For financials, sharply higher liquidity demands on cleared swaps
	  – For non-financials, possibility of higher liquidity demands if regulators decide to regulate (and elevate) OTC margin standards

7. Post trade reporting	– Most swaps will be subject to "real-time" price and volume reporting requirements – No exemptions (will apply to both centrally cleared and OTC swaps) – **Implications:** more price transparency; possibly less liquidity on certain transactions

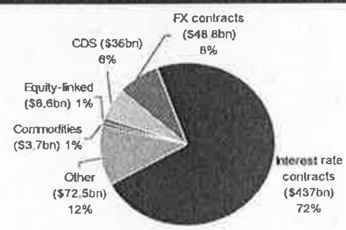
8. FX Swaps	– Prior drafts of legislation had given an exemption to clearing for FX swaps
	– The Dodd-Frank Act would not exempt FX swaps from central clearing, **unless the U.S. Secretary of the Treasury determines otherwise** (creates ambiguity on future treatment)
	– **Implications:**
	  – For financials, would incur the liquidity demands of central clearing on FX swaps
	  – For non-financials, less impact since exempt, but could negatively impact market liquidity

#8 – OTC Derivatives (Continued): Swaps Push-Out

- **Prohibits federal assistance to swaps entities (Section 716)**
- **"Swaps entities"** defined as Swap Dealer or Major Swap Participant
- **"Federal assistance"** defined to include FDIC insurance and Fed borrowing
  - Effectively prevents banks from acting as swaps entities
  - However, banks can have affiliates that are swaps entities
  - → **Will result in banks spinning-off trading of certain swaps into separately capitalized, non-bank entities**
- **Regulators to set prudential standards for swaps entities**
  - Must consider expertise and oversight systems, financial strength, and risk controls of entity
- **Includes language that taxpayers will not suffer any losses as a result of the derivatives provisions of the Dodd-Frank Act**

Importantly, the bill does not appear to either explicitly prohibit, or explicitly permit, guarantees of such affiliate by the Holding Company

Breakdown of Derivatives Market



Exemptions from Push-out Provision

- **Hedging own risk**
- **Interest rate swaps (72% of market)**
- **Foreign exchange swaps (8% of market)**
- **Coins, gold, silver and other metals**

Importantly, over 80% of the derivatives market will be exempt from the new swaps push-out provision. Will primarily impact CDS, commodities and equity-linked swaps.

Source: Bank of International Settlements (BIS) (December 2009), Wall Street research (December 2008).

#9 – Foreign Financials

Overview

- **Will impact foreign financials operating in the United States**
- **Most significant new development:** Collins Amendment impact on capitalization of U.S. subsidiaries of foreign financials

Key issue	Considerations
Capital Requirements (Collins Amendment)	– Exemptions from Federal Reserve's capital adequacy guidelines under SR-01-01 guidelines no longer valid, causing US bank subsidiaries of foreign financials to be subject to new risk-based capital and leverage requirements as well as regulatory capital deductions (5-year phase in)
Enhanced Prudential Standards	– Systemic risk provisions apply - US financial activities of foreign companies can be subjected to supervision and enhanced prudential standards – Funeral plans will apply to US bank subsidiaries; foreign parents likely required to complete unwind plans for other entities in other jurisdictions as well as for the parent given several regulators globally have adopted living will requirements
Securitization	– Securitization retention rule applies to US bank subsidiaries of foreign financials
Derivatives/ Swaps push-out	– Various anti-evasion provisions built into the derivatives title in particular – Swaps push-out provision will apply to US bank subsidiaries of foreign financials – The EU is not expected to implement similar restrictions
Volcker rule	– Will apply to US subsidiaries of foreign companies that have systemically important operations in the United States or that receive Bank Holding Company treatment – Limits on proprietary trading exclude foreign trading by foreign companies

#10 – Insurance

Overview

- **Creation of a Federal Insurance Office, but with little enforcement power**
- **Mandates study for potential future changes in insurance regulation (see below)**

Details

- No enforcement power
- Coordinating and information gathering body
- Will conduct a study on potential future changes in insurance regulation
- Could be a stepping stone toward the idea of a federal insurance charter

- **Federal Insurance Office**
  - Federal Insurance Office created within the Treasury

Federal Insurance Office

- Monitor the insurance industry and identify regulatory gaps
- Gather information about the insurance industry, including access to affordable insurance products
- Recommend to the Financial Stability Council insurers that should be treated as systemically important
- Serve as a uniform, national voice on insurance matters for the US on the international stage
- Streamline regulation of surplus lines insurance and reinsurance through state-based reforms

- **Study for further regulation**
  - Federal Insurance Office required to submit, within 18 months, a report to Congress on improving US insurance regulation
- **Volcker Rule**
  - Activities by regulated insurance companies are exempt from the ban on proprietary trading
- **Derivatives**
  - Excluded from swaps desk push-out as long as they are not a swaps dealer

#11 – Securitization

Overview

- **Tries to align the interests of issuers of asset-back debt with ABS investors and reduce the risks posed by asset-backed securities**

Details

- **Risk retention ("skin in the game")**
  - Lenders required to hold at least a 5% stake in the asset-backed debt they structure and sell
  - Regulators will have flexibility to tailor risk-retention rules to specific products
  - Retained credit risk may not be hedged
  - Importantly, 5% will not be a first loss piece, but rather a "vertical slice" which will have meaningful accounting implications
- **Exemptions**

Key carveout for mortgage market

  - Qualified residential mortgage carveout
    - All of the assets that collateralize the ABS must be qualified residential mortgages
    - Federal banking agencies, the SEC, the Secretary of HUD and the Director of the FHFA to jointly define the term "qualified residential mortgage"
  - Loans guaranteed by the Federal Housing Administration, US Department of Agriculture, and US Department of Veterans Affairs
- **Disclosure**
  - Requires issuers to disclose more information about the underlying assets and to analyze the quality of the underlying assets

#12 – Executive Compensation & Corp Governance

Overview

- **Requires greater disclosure on compensation and provides shareholders with a say on pay and corporate affairs**

Details

- **Pay and performance disclosure requirements**
  - historical relationship between executive compensation and financial performance of company
  - median annual compensation of all employees and annual compensation of the CEO
  - disclose of whether employees can hedge the value of equity securities
- **Say on Pay**
  - Gives shareholders the right to a non-binding vote on executive pay and golden parachutes
- **Nominating directors**
  - SEC has the authority to grant shareholders the proxy access to nominate directors

  Has been a contentious issue
- **Clawback**
  - Requires public companies set policies to take back executive compensation if it was based on inaccurate financial statements that don't comply with accounting standards
- **Enhanced compensation oversight for the financial industry**
- **Exchange listing requirements**
  - Independent compensation committee: companies must have a compensation committee consisting of independent directors, authorized to engage compensation consultants and other advisors
  - Majority vote required for directors: directors must be elected by a majority of votes cast
- **Risk committees**
  - Publicly traded non-bank financial companies and bank holding companies with total consolidated assets > $ 10 billion must have risk committees
  - Fed may impose requirement on companies with assets < $ 10 billion

#13 – SEC and Investor Protection

Overview

- **Several measures have been taken to increase investor protection and improve the management and accountability of the SEC**

Details

- **Broker-dealers giving investment advice**
  - SEC has authority to raise standards for broker-dealers who give investment advice
  - SEC can hold brokers-dealers to **fiduciary duty** similar to investment advisors' standard, after completing study into the effectiveness of regulatory standards for brokers and investment advisers
- **Securities lending**
  - SEC to develop rules increasing transparency of information available regarding securities lending
- **Investor protection**
  - Establishes **Investor Advisory Committee**: advise SEC on its regulatory priorities and practices
  - Establishes **Office of Investor Advocate**: identify areas where investors have significant problems dealing with the SEC and provide them assistance
- **Whistleblower rewards and protection**
  - Encourages people to report securities violations, creating rewards of up to 30% of funds recovered
- **Improvements to the management of the SEC**
  - Outside consultant study of the SEC and annual assessment of SEC's internal supervisory controls
  - GAO review of SEC management every three years; SEC response due within 90 days of GAO report including recommendations on improvement human resource allocation
  - GAO report to Congress every 3 years on SEC's oversight of securities associations
  - Establishment of employee hotline to collect suggestions for improvements and allegations of misconduct by SEC employees; annual report on feedback due to Congress by Inspector General
- **SEC Funding**
  - SEC will continue to have its budget approved by appropriators
  - Access to up to $ 100 million every year to cover expenses

Other mandated studies

- Financial literacy of retail investors (SEC)
- Mutual fund advertising (GAO)
- Conflicts of interest between securities underwriting and securities analysts at the same firm (GAO)
- Investor access to information about investment advisers and broker-dealers (SEC)
- Financial planners (GAOs)

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#14 – Credit Rating Agencies

Overview

- **Credit rating agencies, including Standard & Poor's, Moody's, Fitch and McGraw-Hill, escaped from the legislation relatively unscathed**

Details

- **Ends shopping for ratings of asset-backed securities**
  - SEC conducting 2-year study **(Credit Rating Agency Board Study)** to create a new mechanism preventing ABS issuers from picking the agency they think will provide the highest rating
  - If the SEC cannot determine how to match raters with firms while eliminating rating agency conflicts, the SEC will appoint a panel to establish a random process matching raters with financial firms

  Effectively restores the defeated Franken Amendment if 2 year study is inconclusive
- **Structured finance products**
  - SEC to establish a self-regulatory organization **(Credit Rating Agency Board)** which will designate existing credit rating agencies as qualified to provide initial ratings for structured finance products
- **Office of Credit Ratings**
  - Created within SEC to administer rules, promote accuracy in ratings and ensure ratings are not unduly influenced by conflicts of interest
  - Will conduct an annual review of each credit rating agency and make key findings public
  - Ability to fine raters
  - Authority to deregister a rating agency for providing bad ratings over time
- **Disclosure**
  - Agencies required to disclose their methodologies, use of third parties for due diligence and ratings track record
  - Elimination of rating agency exemption from fair disclosure rule: SEC will revise Regulation FD to remove the exemption for credit rating agencies within 90 days of the date of enactment

  Substantive development
- **More stringent threshold of evidence when bringing lawsuit against credit rater**
  - Investors required to demonstrate they were intentionally misled

#14 – Credit Rating Agencies (continued)

Details

- **Conflicts of interest**
  - Prohibits compliance officers from working on ratings
  - Requires a review when an employee begins working for an underwriter of a security subject to a rating by that agency
  - Requires a report to the SEC when rating agency employees being working for a company that was rated by the agency within the past year
- **Board of directors**
  - Requires at least half the members of boards to be independent, with no financial stake in ratings
  - Directors serve a fixed term up to 5 years and compensation is not linked to business performance
- **Additional Studies:**

Independent Professional Analyst Organization Study
Comptroller General study on creating an organization to establish standards and ethics code for rating agency professionals

Standardization Study
SEC study on establishing standardized ratings terminology and market stress conditions used to evaluate ratings

Alternative Business Model Study
Comptroller General study of compensation alternatives for rating agencies

Independence Study
SEC study on independence of rating agencies and effect on ratings issued

#15 – Hedge Funds and Private Equity Funds

Overview

- **Few onerous provisions beyond SEC registration for funds > $150 million**
- **Potentially much more onerous regulations for funds judged to be systemically important**

Details

- **SEC registration**
  - Hedge and private equity funds with assets >$150 million will be forced to register with the SEC
  - Registration subjects funds to periodic inspections by SEC examiners
  - Exemptions: include venture capital funds and advisers and advisers to private equity funds
- **Information reporting**
  - Required to report information to the SEC about trades and portfolios that is "necessary for the purpose of assessing systemic risk posed by a private fund"
  - Data will be shared with systemic risk regulator and SEC will report to Congress annually on how it uses this data to protect investors and market integrity
- **Systemic risk**
  - Fund placed under Fed supervision if it is determined to have grown too large or too risky

  Significantly higher regulatory requirements for funds with such designation
- **Conflicts of interest**
  - Funds must hire a chief compliance officer and set up policies to avoid conflicts of interest
- **State supervision**
  - Increases the asset threshold for federal regulation of investment advisers from $30 million to $100 million, resulting in more entities being under state supervision
- **Study on self-regulatory organization**
  - GAO to complete a study on feasibility of forming a self-regulatory organization to oversee private funds and submit a report regarding the same to Congress within 1 year of the date of enactment
- **Other mandated studies**
  - Short selling (SEC)
  - Accredited investor status (SEC)

#16 – Municipal Securities

Overview

- **Requires SEC registration for municipal advisors and efforts to create transparency for municipal securities market**

Details

- **Registration and oversight of municipal advisors**
  - Requires registration and oversight of persons engaged in the municipal securities market
  - Carve-outs for registered investment advisers, lawyers, and broker-dealers acting as underwriters, but **not** for credit rating agencies and accountants
- **Municipal Securities Rulemaking Board**
  - Majority of board members cannot be affiliated with broker-dealers, municipal dealers or advisors
  - Rulemaking authority expanded to cover over broker-dealers, municipal securities dealers and municipal advisors with respect to the issuance of municipal securities, investment of proceeds of municipal offerings or derivatives on municipal securities
- **Fiduciary duty**
  - Imposes a fiduciary duty on advisors to ensure that they adhere to the highest standard of care when advising municipal issuers
- **Studies:**
  - GAO to study the value of enhanced municipal issuer disclosure, with report due within 1 year after the date of enactment
  - GAO to study municipal securities markets and issue report on how to improve transparency, fairness and liquidity within 180 days of the date of enactment
  - SEC to study the role of the Governmental Accounting Standards Board in the municipal securities markets and GASB funding, with report due within 270 days of the date of enactment

#17 – Consumer Financial Protection Bureau

Overview

- **Independent authority created with broad sweeping powers within the Federal Reserve, with the specific mandate of consumer protection on financial products**

Details

Significant new bureau with broad, sweeping and "independent" power

- **Independent head, budget and rule writing authority**
  - Established within the Federal Reserve (i.e., not an independent agency)
  - Director appointed by the President and confirmed by Senate
  - Dedicated budget paid by the Federal Reserve system
  - Authority to write rules for consumer protections governing all financial institutions – banks and non-banks – offering consumer financial products or services
- **Accountability and authority**
  - Consolidates responsibilities previously held by various bank regulators, making 1 office accountable for consumer protections
  - Fed cannot prevent Consumer Bureau from issuing a rule
  - Financial Stability Oversight Council, by a 2/3rds vote, can overturn a Bureau rule
  - State attorneys-general empowered to enforce certain rules issued by the Bureau
- **Scope**
  - Banks with assets > $ 10 billion, all mortgage-related businesses, payday lenders, student lenders, large non-bank financials
  - Exemption: Auto dealers
  - No authority over SEC-registered and CFTC-registered persons
- **Educates**
  - Creates Office of Financial Literacy

#18 – Other Consumer Protections

Overview

- **Enhanced policing of businesses for credit-card and mortgage-lending abuses, with increased regulatory scrutiny on a full range of consumer-facing products**

Details

Durbin Amendment

- **Interchange fees**
  - Fed has authority to limit interchange, or "swipe" fees, that merchants pay for debit-card transactions
  - Fed to ensure fees are "reasonable and proportional"
  - Retailers can offer discounts based on form of payment and refuse credit cards for purchases < $10
  - Merchants will be permitted to route debit-card transactions on more than one network
- **Credit Score**
  - Gives consumers free access to their credit score if their score negatively affects them in a financial transaction or a hiring decision
- **Mortgage reform**
  - Institutions must ensure borrowers can repay loans they are sold
  - Prohibits incentives that encourage lenders to steer borrowers into more costly loans
  - Prohibits pre-payment penalties
  - Establishes penalties for irresponsible lending
  - Expands protections for high-cost mortgages
  - Requires additional disclosures for consumers on mortgages, including requiring disclosure of maximum a consumer could pay on a variable rate mortgage
  - Establishes an **Office of Housing Counseling** within HUD to boost homeownership and rental housing counseling

Tackling the effects of the mortgage crisis

Neighborhood Stabilization Program
Provides $ 1 billion to States for rehabilitating foreclosed properties

Emergency Mortgage Relief
Provides $ 1 billion for loans to unemployed homeowners to help cover mortgage payments until they are reemployed

Foreclosure Legal Assistance
Authorizes grants for legal assistance related to home ownership preservation and foreclosure prevention

FDIC #19 – FDIC Deposit Insurance

Overview

- **Changes to deposit insurance**

Details

Retail Deposit Insurance Limits

- **Permanently increases the deposit insurance limit to $ 250,000**
- Make the increase retroactive to cover the period from January 1, 2008 to October 3, 2008 when the limit was first temporarily raised
- Eliminate the 1.5% hard cap on the Deposit Insurance Fund, giving the FDIC discretion to decide whether to rebate any excess over that amount
- Thrift charter preserved

Small Institution Deposit Insurance

- **Extends unlimited deposit insurance on "non-interest bearing transaction accounts" for 2 years (through Dec 31, 2013)**
- Slightly more narrow in scope than the TAG program enacted during the financial crisis
- Congressional Budget Office to estimate government cost savings if program were made permanent

#20 – Other Provisions of the Dodd-Frank Act

- **Increases to the FDIC DIF Reserve Ratio**
  - FDIC reserve ratio of the Deposit Insurance Fund will increase from 1.15% to 1.35% of insured deposits by September 30, 2020, raising ~$ 6 billion (banks with assets < $ 10 billion exempt)
- **Amendments to Sarbanes-Oxley Act**
  - **Sox Section 404(B) Exemption:** permanent exemption from Sarbanes-Oxley Act's Section 404(b) auditor attestation requirements for small companies (< $75 million market capitalization)
  - **Foreign auditor oversight:** enables information to be shared with foreign auditor authorities without waiving confidentiality as long as confidentiality is ensured
- **Preemption:** the OCC is allowed to preempt state laws if they "prevent or significantly" interfere with the business of banking
- **Equity-indexed annuities exempt from SEC oversight**: treated as insurance products and therefore under the regulation of insurance regulator rather than SEC
- **Restriction on use of US funds for foreign governments**: requires a review of IMF loans to countries where public debt is greater than GDP and opposition to loans unlikely to be repaid
- **Provision regarding Congo Minerals**: manufacturers disclosure on source of minerals originating from the Democratic Republic of Congo and requirement for State Department to issue a strategy for addressing trade of conflict minerals
- **Reporting requirements for coal and mine safety**
- **Extraction industry provisions**: requirements for greater transparency including public disclosure on payments related to the commercial development of natural resources

Cautionary statements

This presentation contains forward-looking statements. Forward-looking statements are statements that are not historical facts; they include statements about our beliefs and expectations and the assumptions underlying them. These statements are based on plans, estimates and projections as they are currently available to the management of Deutsche Bank. Forward-looking statements therefore speak only as of the date they are made, and we undertake no obligation to update publicly any of them in light of new information or future events.

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This presentation also contains non-IFRS financial measures. For a reconciliation to directly comparable figures reported under IFRS, to the extent such reconciliation is not provided in this presentation, refer to the 2Q2010 Financial Data Supplement, which is accompanying this presentation and available at www.deutsche-bank.com/ir.

Opening Remarks

Shift Happens: Financial and Regulatory Paradigms in Crisis

Timothy A. Canova

Betty Hutton Williams Professor of International Economic Law,
Chapman University School of Law

8:15am–8:45am

Professor Timothy Canova

2011 *Chapman Law Review* Symposium Speaker and Moderator

Tim Canova joined the Chapman law faculty in 2004, was founding director of the law school's Center for Global Law & Development and is presently the Betty Hutton Williams Professor of International Economic Law at Chapman. Prior to coming to Chapman, Canova was a tenured law professor at the University of New Mexico School of Law. He previously served as a legislative assistant to the late U.S. Senator Paul Tsongas and practiced law with the old Wall Street law firm, Mudge Rose. Canova was an early critic of financial deregulation, warned of the moral hazard from bailing out banks under the 'Too Big to Fail' doctrine, and he sounded early alarms of the dangers of the bubble economy years before the 2008 financial crisis.

Canova's research crosses the disciplines of law, public finance, economics, and history. He was an early critic of financial deregulation and warned of the dangers of the bubble economy. He has authored more than two dozen articles and book chapters, including articles in the *Harvard Law & Policy Review, American Journal of Economics and Sociology, Brooklyn Law Review, Georgetown Journal of Law & Public Policy,* and *UC Davis Law Review*.

Canova teaches Corporations, Regulation of International Financial Institutions, International Business Transactions, International Trade and Development Law, International Monetary Law, History of Economic Thought, Animal Law, and Marine Mammal Protection Law. He has previously taught at the University of Miami School of Law, the University of Arizona College of Law, and the University of New Mexico School of Law where he was first granted tenure.

Canova received his B.A. from Franklin & Marshall College, J.D. degree cum laude from the Georgetown University Law Center, and master's diploma in graduate legal studies from the University of Stockholm where he was a Swedish Institute Visiting Scholar. He previously served as a legislative assistant to the late U.S. Senator Paul E. Tsongas and practiced law with Gibson, Dunn & Crutcher in New York City.

DISSENT

The Legacy of the Clinton Bubble

Books Politics Argument Ideas

By Timothy A. Canova

Bill Clinton after signing the Financial Services Modernization Act in 1999. Photo: Justin Lane/The *New York Times*/Redux

THE CONVENTIONAL wisdom has held that economic policy was a great success under Bill Clinton in the 1990s and a failure ever since. Hillary Clinton has made the comparison often, promising to end "the seven year detour" and "attack poverty by making the economy work again." In January, in response to the president's State of the Union Address, Barack Obama stated that it was "George Bush's Washington that let the banks and financial institutions run amok and take our economy down this dangerous road."

Perhaps this reading of history makes for good politics in an election year, and it is certainly better for the Clintons than for anyone else. The only problem is that the story line is flawed. One could even say that it's a bit of a fairy tale.

For six of eight years, Bill Clinton governed with Republican majorities in Congress. Not surprisingly, there was much continuity between the Clinton and Bush administrations. Both embraced the so-called Washington Consensus, a policy agenda of fiscal austerity, central-bank autonomy, deregulated markets, liberalized capital flows, free trade, and privatization.

On each of these crucial issues, the most significant differences between Clinton and Bush were differences in timing and degree, not in direction. Both administrations were willfully asleep at the wheel. Clinton was fortunate to preside over the early stages of a bubble economy. Bush has had the misfortune of presiding as a lame duck through the final stages of the same bubble and, thanks to the deregulation of the Clinton years, without a regulatory structure capable of containing today's speculative fevers.

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In 1992, Bill Clinton campaigned on the promise of a short-term stimulus package. But soon after being elected, he met privately with Alan Greenspan, chair of the Federal Reserve Board, and soon accepted what became known as "the financial markets strategy." It was a strategy of placating financial markets. The stimulus package was sacrificed, taxes were raised, spending was cut—all in a futile effort to keep long-term interest rates from rising, and all of which helped the Democrats lose their majority in the House. In fact, the defeat of the stimulus package set off a sharp decline in Clinton's public approval ratings from which his presidency would never recover.

It is easy to forget that Clinton had other alternatives. In 1993, Democrats in Congress were attempting to rein in the Federal Reserve by making it more accountable and transparent. Those efforts were led by the chair of the House Banking Committee, the late Henry B. Gonzalez, who warned that the Fed was creating a giant casino economy, a house of cards, a "monstrous bubble." But such calls for regulation and transparency fell on deaf ears in the Clinton White House and Treasury.

The pattern was set early. The Federal Reserve became increasingly independent of elected branches and more captive of private financial interests. This was seen as "sound economics" and necessary to keep inflation low. Yet the Federal Reserve's autonomy left it a captive of a financial constituency it could no longer control or regulate. Instead, the Fed would rely on one very blunt policy instrument, its authority to set short-term interest rates. As a result of such an active monetary policy, the nation's fiscal policy was constrained, public investment declined, critical infrastructure needs were ignored. Moreover, the Fed's stop-and-go interest-rate policy encouraged the growth of a bubble economy in housing, credit, and currency markets.

Perhaps the biggest of these bubbles was the inflated U.S. dollar, one of several troubling consequences of the Clinton administration's free-trade policies. Although Clinton spoke from the left on trade issues, he governed from the right and ignored the need for any minimum floor on labor, human rights, or environmental standards in trade agreements. After pushing the North American Free Trade Agreement (NAFTA) through Congress on the strength of Republican votes, Clinton paved the way for China's entry into the World Trade Organization (WTO) only a few years after China's bloody crackdown on pro-democracy demonstrators at Tiananmen Square in Beijing.

During Clinton's eight years in office, the U.S. current account deficit, the broadest measure of trade competitiveness, increased fivefold, from $84 billion to $415 billion. The trade deficit increased most dramatically at the end of the Clinton years. In 1999, the U.S. merchandise trade deficit surpassed $338 billion, a 53 percent increase from $220 billion in 1998.

In early March 2000, Greenspan warned that the current account deficit could only be financed by "ever-larger portfolio and direct foreign investments in the United States, an outcome that cannot continue without limit." The needed capital inflows did continue for nearly eight Bush years. But it was inevitable that the inflows would not be sustained and the dollar would drop. Perhaps the singular success of Bill Clinton was to hand the hot potato to another president before the asset price bubble went bust.

Financial Deregulation under Clinton

NO ONE could drive a car well for very long on roads without traffic lights, stop signs, or speed limits. There is an obvious need for sensible regulation, even "command and control" regulation, to facilitate safety and traffic flow. Likewise with most markets, particularly the financial markets, where some degree of regulation is necessary to prevent fraud and provide order, stability, and coherence to private transactions. Yet the Washington Consensus has denied the need for regulation of the financial marketplace at every level. Jagdish Bhagwati, a prominent free-trade economist, has referred to the "Wall Street-Treasury-IMF complex" to suggest a policy agenda formulated and pushed by powerful financial interests. Joseph Stiglitz, the 2001 Nobel laureate in economics, has noted the agenda's many unscientific assumptions and refers to its promoters as "free market fundamentalists."

At the very local level of finance—consumer credit and housing loans—the analogue to speed limits and traffic-flow regulation would be limits on loan volumes, interest rates, and minimum down payments. For years the federal government had regulated such lending standards to prevent inflation of asset prices in key sectors of the economy, particularly during wartime and boom times. For instance, Federal Reserve Regulation X required minimum down payments and maximum periods of repayment for housing loans. Federal Reserve Regulation W utilized the same devices for consumer credit for the purchase of automobiles, appliances, and other durable goods.

But starting with the administrations of Jimmy Carter and Ronald Reagan, and continuing under Clinton, such regulations were mostly repealed. Known as "selective credit controls," these policy instruments took a "command and control" approach to regulation. It was an approach that reduced systematic risk by discouraging the development of a subprime mortgage market for borrowers with bad credit. Without such controls, lenders started making a flood of loans without minimum down-payment requirements, and eventually without even requiring documentation of income on many loans. Adjustable interest rates and hidden balloon payments made these loans inherently more risky.

Predatory lending was not an invention of the Bush administration. High-interest payday loans and subprime mortgages took off under Clinton. The morals of the marketplace were once again, "Buyer beware." Many loans, tellingly referred to as "teaser loans," were structured so that the monthly mortgage payments would start off low and rise significantly in the future, even while the overall loan amount—the outstanding principal —would also rise. The borrower would end up worse off several years into the mortgage than when the loan began.

But none of this was considered overly problematic by the Clinton White House. There was simply too much money to be made by lenders, brokers, bankers, bond insurers, ratings agencies, engineers of securitized assets, and managers of special investment vehicles and hedge funds. There was also too much to be gained by elected officials and regulators looking the other way.

By 1995, the subprime loan market had reached $90 billion in loan volume, and it then doubled over the next three years. Rising loan volume led to a significant deterioration in loan quality. Meanwhile, by March 1998, the number of subprime lenders grew from a small handful to more than fifty. Ten of the twenty-five largest subprime lenders were affiliated with federally chartered bank holding companies, but federal bank regulators remained unconcerned.

In 2000, Edward Gramlich, a Federal Reserve governor, proposed to Greenspan that the Fed use its discretionary authority to send bank examiners to the offices of such lenders. But Greenspan was opposed and Gramlich never brought his concerns to the full Federal Reserve Board.

GREENSPAN'S LAISSEZ-faire philosophy also encouraged greater concentration in banking and the proliferation of complex financial instruments known as derivatives. As early as 1997, there were concerns about the growth of collateralized debt obligations (CDOs), derivatives that pooled together millions of subprime mortgages and divided their income streams in complex ways. Rather than reducing risk, the process of securitization served to increase risk throughout the financial system. The CDO and other such derivatives were like rocket fuel, transforming the local greed of subprime lending into a problem of global proportions. Since the recent meltdown in the subprime market, investors have been in a panic to find out which banks and hedge funds are holding CDOs and other exotic mortgage-backed securities that are deflating in value.

As with the housing bubble, so went the stock market bubble. The Federal Reserve has a long history of imposing margin requirements (minimum down payments) on lending for the purchase of securities on major exchanges. Regulations G, T, and U gave the Fed important tools in containing stock-market speculation. But with Clinton in the White House and Robert Rubin as his treasury secretary, Greenspan felt no pressure to raise margin requirements even as the stock market bubble reached new heights. Instead, Clinton reappointed Greenspan as Federal Reserve chair in early 2000, about six months before Greenspan's term was due to expire, and apparently without first discussing margin requirements or any other Federal Reserve policy with Greenspan.

By Clinton's final year in office, the price-earnings ratio on technology stocks reached historic peaks and the level of margin debt borrowed from New York Stock Exchange (NYSE) member firms had risen to the highest percent of market value in twenty-five years. The last time the country had purchased so much stock on borrowed money was September 1987, one month before the Dow Jones Industrial Average fell 23 percent in one day.

In March 2000, alarmed by the growing stock market bubble, Richard Grasso, chair of the NYSE, and Frank Zarb, chair of NASDAQ, issued an unusual joint statement urging member brokerage firms to review the amount of credit they were extending to investors and to consider voluntarily raising their margin requirements. The warning fell on deaf ears. In such a bull market, investors were feeling more greed than fear, and therefore underestimating the downside risks in the market.

Meanwhile, Greenspan refused to exercise any authority and failed to raise margin

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requirements. Instead, he attempted to talk down the market in his widely reported "irrational exuberance" speech. But when the market slid, it was Greenspan who backed down and provided verbal reassurances.

Selective credit controls are like a steering wheel. Margin requirements can steer credit away from speculative and overheated sectors of the economy. When the central bank uses only one blunt policy instrument, the short-term interest rate, it is abandoning the steering wheel for the stop-and-go of an accelerator. As the Fed lowered short-term interest rates, the bubble expanded and asset prices diverged even further from economic fundamentals. When the Fed later raised interest rates to slow the stock market bubble, it ran the risk of puncturing the bubble completely. This is what Greenspan faced while the Fed raised short-term interest rates six times, from 4.75 percent to 6.50 percent, between June 1999 and May 2000. But with each rise in rates, the bubble only expanded—that is, until the dot-com bubble burst in the spring of 2000, a bust that did not help Al Gore's presidential prospects.

This dilemma was not without historical precedent. Frederick Lewis Allen described a similar tension between monetary policy and market psychology in his review of the 1929 stock market crash in *Only Yesterday*. Then, too, the Federal Reserve "waited patiently for the speculative fever to cure itself and it had only become more violent." According to Allen, things had come to such a pass that if the Fed raised interest rates still further, it "ran the risk of bringing about a terrific smash in the market."

In the past, selective credit controls provided a way around this Catch-22. Margin requirements on security loans, housing loans, and consumer credit provided the federal government with the policy tools to prevent inflation in particular asset markets. Deregulation left the Federal Reserve with only one policy instrument. As the Fed lowered interest rates to stimulate the real economy, the bubble in asset prices expanded. When the Fed later raised interest rates, it posed a mortal danger to every bubble, including those in housing, credit, and currency markets.

Deregulation and lax lending practices were part and parcel of the bubble economy. Clinton often boasted of the rise in homeownership during his presidency, foreshadowing the Bush-Cheney "ownership society." But for too many, homeownership became something more speculative, a wager that interest rates would not rise in the future, and that if rates did rise, mortgage lenders would allow them to refinance at fixed interest rates based on constantly rising housing prices.

Risk-Based Deregulation

DURING THE Clinton years, command-and-control regulation was largely replaced by a risk-based approach that was based on inherently flawed estimates of value and risk. According to risk-based capital requirements, the greater the risk of a loan, the greater amount of capital a bank would be required to raise. But this risk-based approach made little sense when regulators were using inflated market prices to build their defenses.

Some commentators have concluded that market-price-based, risk-sensitive models are upside down. Booms are fueled by market estimates that wrongly undervalue risks, thereby encouraging imprudent lending. As the boom matures, everyone undervalues risk, and lenders respond by chasing after the marginal borrower. Regulators fail to pull the banks back. Instead, they send the wrong message that risks are falling and capital is sufficient for more risk-taking.

Some banking and finance experts have proposed making bank capital requirements contra-cyclical by relating the capital adequacy requirements to the rate of change of bank lending and asset prices in relevant sectors, such as the rise in mortgage lending and housing prices. This, they claim, would build up capital reserves and restrain bank lending during asset price booms while encouraging bank lending during asset price deflations. A final benefit of this approach would be "to reduce pressure from the financial system for central banks to adjust monetary policy in the heat of the moment"—or, in other words, to reduce the need for the Fed to step on the accelerator in a crisis.

According to Charles Freeland, former deputy secretary general of the Basel Committee on Banking Supervision, there are problems with making capital requirements contra-cyclical because "the cyclical indicators would need to be derived from national markets and it is difficult to see how they could be applicable to a bank operating in a highly competitive global environment." Moreover, how does one determine the proper cyclical indicator for a particular security held by a financial institution? If tranches of a CDO include parts of mortgage loans pooled from widely varied geographic locations, some from markets where housing is in a boom, others where housing is relatively weaker, it would be impractical to link the required capital reserve to housing prices.

The esoteric debate about capital adequacy requirements only reinforces the simple truth that mortgages and other loans should not be made in the first place to borrowers with limited resources. Although some legal scholars have suggested "suitability" claims against investment banks for selling risky CDOs, these problems began upstream. Underlying mortgage loans with escalating interest rates and balloon payments seem inherently unsuitable when made to borrowers lacking collateral.

There is really no risk-based substitute for the traffic lights and speed limits and other safety standards that keep some cars off the road. At the end of the day, regulators must regulate. Minimum down-payment requirements will keep most of the riskier borrowers off the road. Moreover, with selective credit controls, when bank lending and housing prices escalate too much too quickly in particular regions, bank supervisors could simply clamp down by raising the minimum down payment requirements and restricting the use of adjustable interest rates and balloon payments. Such regulation would mean fewer mortgage loans for marginal borrowers, but it would also reduce the systematic risks facing the financial system.

Free-market fundamentalists will argue that such command-and-control regulations would prevent some borrowers from purchasing their first homes, thereby impeding their ability to build up equity capital. This may be, but other incentives could always be offered to help low- and middle-income families save money for future homeownership, such as a tax deduction for rental payments to match the current mortgage interest rate deduction for homeowners.

The Mother of All Deregulation

THE CLINTON administration's free-market program culminated in two momentous deregulatory acts. Near the end of his eight years in office, Clinton signed into law the Gramm-Leach-Bliley Financial Services Modernization Act of 1999, one of the most far-reaching banking reforms since the Great Depression. It swept aside parts of the Glass-Steagall Act of 1933 that had provided significant regulatory firewalls between commercial banks, insurance companies, securities firms, and investment banks.

IT MAY be helpful to consider what has become of the old Federal Reserve Regulations W and X, the old margin requirements on consumer and housing loans. Since the gutting of Glass-Steagall, the new Regulation W deals with transactions between commercial banks and their securities affiliates. Federal regulatory resources, which in the past were directed to the safety and soundness of mortgage and consumer loans, are now redirected to the opaque transactions between affiliates within financial conglomerates. The former regulatory effort was prudential and preventive in nature, the latter more akin to monitoring the problem only after the horse had left the barn.

Wall Street had been lobbying for years for an end to Glass-Steagall, but it had not received much support before Clinton. Among those with a personal interest in the demise of Glass-Steagall was Robert Rubin, who had months earlier stepped down as treasury secretary to become chair of Citigroup, a financial-services conglomerate that was facing the possibility of having to sell off its insurance underwriting subsidiary. Although Rubin openly boasted of his lobbying efforts to abolish Glass-Steagall, the Clinton administration never brought charges against him for his obvious violations of the Ethics in Government Act.

Rubin also appealed to liberal sentiment. He claimed to have urged Congress and the White House to preserve the Community Reinvestment Act (CRA), which sought to prod banks to channel a portion of their lending to poor, inner city areas. But there was already widespread evidence that CRA was falling short by permitting banks to engage in meaningless reporting requirements in place of substantive investment in low- and moderate-income communities. The real action was not CRA renewal but the demise of the Glass-Steagall firewalls. Banks were suddenly free to load up on riskier investments as long as they did so through affiliated entities such as their own hedge funds and special investment vehicles. Those riskier investments included exotic financial innovations, such as the complex derivatives that were increasingly difficult for even experts to understand or value.

In 1998, the sudden meltdown and bailout of the Long-Term Capital Management hedge fund showed the dangers of large derivative bets staked on borrowed money. But by March 1999, Greenspan was once again praising derivatives as hedging instruments and as enhancing the ability "to differentiate risk and allocate it to those investors most able and willing to take it."

In 1993, the Securities and Exchange Commission (SEC) had considered extending capital requirements to derivatives, but such proposals went nowhere, and Wall Street lobbied to

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prevent any regulation of derivatives. Then in December 2000, in his final weeks in office, Bill Clinton signed into law the Commodity Futures Modernization Act, which shielded the markets for derivatives from federal regulation.

Since then, derivatives have grown in size and become gigantic wagers on the movement of interest rates, commodity prices, and currency values. First came the CDO bubble, which acted as a transmission belt by which the subprime mortgage cancer metastasized and spread through financial institutions around the globe. Warren Buffett, legendary investor and chair of Berkshire Hathaway, would soon refer to such derivatives as "weapons of mass destruction."

Since the collapse of the CDO market, the next derivatives bubble may be the market for credit default swaps, which are credit insurance contracts designed to cover losses to banks and bondholders when companies fail to pay their debts. Today the notional amount of the credit default swap market is at least $45 trillion, about half the total U.S. household wealth and about five times the national debt.

When Bear Stearns melted down this past spring, it was holding $2.5 trillion in credit default swaps that were worth perhaps $40.3 billion in fair market value. The run on Bear Stearns was largely caused by the collapsing mortgage and CDO markets. But it was the market for credit default swaps that may have led the Federal Reserve to intervene. If Bear Stearns had been allowed to fail, countless counterparties on these credit default swaps would have faced enormous losses. The shock waves could have taken down major insurance companies.

This is why George Soros, billionaire hedge-fund manager, has voiced his fears about the unregulated market for credit default swaps. According to Soros, the prospect of cascading defaults hangs over the financial system like a sword of Damocles. He has not called for outlawing the market but for its regulation by establishing a clearinghouse or exchange for the market, capital requirements, and strict margin requirements for all existing and future credit default swap contracts.

Chickens Come Home to Roost

HISTORY SHOULD deal harshly with Bill Clinton. Throughout his terms, real wages stagnated, manufacturing and service jobs moved overseas in large numbers, and the middle class was squeezed. With the federal government asleep at the wheel, there was a significant rise in predatory lending practices by banks and mortgage companies. By Clinton's final years in office, all of these trends had contributed to an ominous rise in delinquencies and foreclosures on subprime mortgage loans. This was particularly pronounced in urban America. In Chicago, for instance, foreclosures on subprime mortgages rose from 131 in 1993 to more than 5,000 in 1999.

By the time Bush took office in 2001, the Federal Reserve was once again stepping on the accelerator. The collapse of Enron, a wave of corporate governance scandals, and then the September 11, 2001, terrorist attacks were a drag on economic activity, and so the Fed lowered interest rates from 6 percent to 1 percent between January 2001 and June 2003.

The lower interest rates helped revive the stock market and housing bubbles. It was like pouring gasoline on a fire. By July 2005, the *Economist* was referring to the U.S. housing market as "the largest financial bubble in history." Some officials began to sound the alarm. The debt of American households was climbing nearly 20 percent a year, the savings rate had fallen below zero, and the cash being pulled out of homes from mortgage refinancings had reached about 5 percent of GDP. This fueled an enormous consumption binge and a growing trade deficit that put downward pressure on the dollar. Oil producing countries, paid in dollars, began raising oil prices to make up the difference.

It was clear the housing bubble had spread into an even larger dollar bubble. Something had to be done. But without margin requirements or any other selective credit controls, the Federal Reserve could only raise short-term interest rates to cool the housing market and encourage household savings. Starting in 2004, the Fed began tapping on the brake, raising short-term interest rates seventeen consecutive times from 1 percent to 5.25 percent over a two-year period.

If Greenspan was worried that the rise in interest rates could lead to panic, he tried not to show it. "The vast majority of homeowners," he said, "have a sizable equity cushion with which to absorb a potential decline in house prices."

Greenspan could not have been more wrong. The steep rise in home foreclosures, now at an all-time record high, has contributed to a downward spiral of housing prices, which in turn has contributed to more foreclosures. By last August, there were more than 200,000 monthly foreclosure filings nationwide. For all of 2007, 1.2 million properties—more than 1 percent of all U.S. households—were in some stage of foreclosure, up 75 percent in only a year. By April 2008, about 2 percent were in foreclosure, and nearly 9 percent, some 4.8 million home loans, were past due or in foreclosure.

Losses from the subprime meltdown have surely passed half a trillion dollars, and some estimates now exceed a trillion dollars. Major U.S. financial institutions have turned for help to central banks and sovereign wealth funds from abroad. The housing market is in its worst decline in memory, the dollar is falling to record lows, and the U.S. economy may be heading into recession.

Many observers have linked the costs of the war in Iraq to economic problems at home, and certainly the billions of dollars being spent in Iraq could be better invested in the nation's declining infrastructure. But perhaps most overlooked has been the adverse impact of the war on the value of the dollar and the price of oil. As America's standing has declined in the world, in large part a result of this war, the dollar and dollar-denominated investments have also suffered. Past U.S. housing declines, such as during the savings and loan crisis of the late 1980s, were somewhat shielded from global financial forces. With the rise of the euro and the yen as viable alternative currencies, a declining dollar now poses a far greater threat to continued American prosperity than in the past.

The war in Iraq, along with the erosion of trust in U.S. financial institutions, will likely continue to undermine the dollar's role as the world's transactional currency, reserve currency, store of value, and safe investment haven. As the dollar continues to fall, higher inflation will be imported into the United States, and the Federal Reserve may find itself unable to reduce interest rates aggressively enough because of fears of inflation and the need to defend the dollar. It will likely seek new ways to push liquidity into the banking system, but as in Iraq itself, this is unfamiliar and uncertain territory.

With the slowdown in the U.S. economy, governments at all levels—federal, state, and local—have been badly crippled by declining tax revenues. A Democratic Congress and Republican president responded with a $168 billion fiscal-stimulus program consisting of rebates of about $600 per taxpayer to put money back in the hands of consumers. Once again, the Federal Reserve is stepping on the accelerator, cutting interest rates aggressively to try to reinflate the bubble economy. Only now the Fed's room for maneuver is cramped by the weak dollar and renewed inflation.

Lessons From the Panic

THOMAS PAINE once suggested that panics have their uses. Their peculiar advantage, he wrote, is that they are "the touchstone of sincerity and hypocrisy, and bring things and men to light which might otherwise have lain forever undiscovered."

The present panic in our markets should bring to light a number of hypocrisies. Perhaps the first is that there was some significant difference between the economic policies of Clinton and Bush. It is true that the Bush tax cuts contributed to a rising federal deficit, but the Clinton years were also marked by large public deficits. It was only at the end that Clinton saw any surplus and that was after racking up more than a trillion dollars in federal debt. Moreover, the Clinton surplus was a function of several troubling trends, including the administration's never-ending policy of fiscal austerity. In fact, federal spending fell to about 18 percent of GDP, the lowest level for the end of any presidency since those of Dwight Eisenhower and, before that, of Herbert Hoover.

Another factor that contributed to the final Clinton surplus was the inflated U.S. dollar and huge capital inflows that were attracted to dollar-denominated investments, all of which pumped up economic growth and tax revenues. It was therefore Clinton's commitment to the Washington Consensus platform of free trade and unrestricted capital mobility that made those hot money inflows possible while also setting the stage for the reversal of portfolio capital flows and today's declining dollar.

During Clinton's first three years in office, the federal government borrowed more than $1 trillion, much from abroad. Then between 1996 and 1998, foreign ownership of U.S. government securities rose 26 percent, from $669 billion to $847 billion. Under Bush, foreign ownership of U.S. government securities rose another 88 percent to $1.6 trillion by 2005.

During the Clinton years, mortgage debt grew by nearly two-thirds, from $4.1 trillion to $6.8 trillion. Under Bush, mortgage debt then doubled to $13 trillion in 2006. Likewise, under Clinton, consumer debt doubled from $856 billion to $1.7 trillion. Under Bush, it grew by another one-third to $2.3 trillion in 2006.

Much of this debt was borrowed from foreigners flush with dollars, a result of our huge trade deficits. This was the underside of the Clinton bubble economy, and it set the course

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for the Bush years. U.S. trade deficits also translated into increased foreign ownership of corporate America. Foreign ownership of U.S. corporate stocks and bonds rose nearly 50 percent in Clinton's final three years, from $1.9 trillion to $2.8 trillion, and then another 53 percent under Bush to $4.3 trillion.

A comparison of all foreign-owned assets in the United States, including U.S. government and corporate securities, foreign direct investment, and private debt, shows remarkable similarities between the administrations. In Clinton's final three years, foreign-owned assets in the United States rose nearly 30 percent from $5.9 trillion to $7.6 trillion. Under Bush, foreign ownership of U.S. assets rose by another two-thirds to $12.7 trillion by 2005.

THE IDEA of market discipline is another hypocrisy revealed by the present panic. The Washington Consensus preaches private competition, transparent markets, and less government regulation. Although many mortgage borrowers have been subject to ruthless, unfettered competition, investment banks and hedge funds are increasingly protected by hidden subsidies. Thanks to the combination of deregulation and Federal Reserve bailouts, profits were privatized while the losses are now socialized.

For instance, when the subprime mortgage crisis started spilling into CDOs and credit markets last July, the Federal Reserve began purchasing billions of dollars of government securities to stabilize the markets as well as the solvency of its financial constituents. On August 9, 2007, the Fed injected $19 billion into the financial system. The next day it purchased another $38 billion. This was coordinated with the European Central Bank, which injected more than $200 billion in euros during the same two-day period. The Bank of Japan also reportedly added liquidity to the marketplace. Likewise, in the final week of December alone, the European Central Bank injected almost 350 billion euros (about $502 billion) into the market through purchases from ailing financial institutions.

Such central bank subsidies are largely hidden from public view. When they become visible, you can be sure that the situation is serious. Last December, the Fed announced a new Term Auction Facility to allow commercial banks to borrow from the Fed at subsidized interest rates and against a wider range of assets, such as their holdings of CDOs and other "dodgy collateral." Within weeks it was reported that banks had quietly borrowed about $50 billion via this new credit facility. In mid-March, as the crisis spread beyond commercial banks to Wall Street investment houses, the Fed dusted off powers it had not used since the Great Depression, when it announced that it would lend its primary dealers in the bond market more than $200 billion in Treasury securities for a month at a time and would accept ordinary mortgage-backed securities as collateral. As the *Financial Times* reported, this took the central bank "a step closer to the nuclear option of actually buying mortgage-backed securities in its own right."

In each of these central bank operations, there has been no public debate among elected officials, no checks, no balances. These market interventions are often reported only after the fact, if at all. Yet these subsidies dwarf in size the fiscal-stimulus packages and other programs of assistance for borrowers facing foreclosure.

A number of Wall Street institutions have looked overseas for help. Under Robert Rubin's leadership, Citigroup and its various affiliates loaded up on CDOs and other mortgage-backed securities. After billions of dollars in losses, Citigroup was forced to raise more than $40 billion in new capital to shore up its balance sheet, and it turned for help to the Persian Gulf state of Abu Dhabi for an infusion of $7.5 billion in new capital. Morgan Stanley, UBS, the Blackstone Group—the list goes on of investment banks that have turned to sovereign wealth funds for bailout from foreign governments, including some rather repressive, antiliberal, and antidemocratic regimes.

Bear Stearns, the fifth-largest investment banking firm in the United States, facing mounting losses in the CDO market, at first found its own "red knight" in Citic Securities, a Chinese state-owned investment firm. But the meltdown continued, and JP Morgan Chase, the third-largest banking institution in the United States, was likely exposed to Bear Stearns through huge holdings of credit default swaps. The Fed stepped in to close down Bear Stearns and arrange a shotgun wedding. JP Morgan purchased Bear Stearns for pennies on the dollar, with the Federal Reserve Bank of New York agreeing to fund up to $30 billion of the less-than-liquid assets acquired by JP Morgan.

Because the Fed's bailout strategy is targeted to the top of the financial pyramid, it has done nothing to stem the decline in the mortgage market. Senator John McCain has voiced the conservative view that homeowners should not be bailed out and that the housing market should be free to find its natural bottom.

Others have seen the mortgage market as quicksand, pulling down leading financial institutions no matter how hard the Fed bails out their investments in CDOs. They also point out the dangers of letting the housing market fall, particularly in today's globalized environment, with a declining dollar and skittish foreign investors. The bottom of the market may be much deeper and more painful than voters will tolerate.

Leading Democrats in Congress, such as Senator Chris Dodd and Representative Barney Frank, have proposed funding for new or existing government agencies to purchase underlying mortgages and refinance them at low, fixed interest rates to keep people in their homes and arrest the downward spiral in housing and credit markets. Such plans have good historical precedent. The Home Owners' Loan Act and the Farm Mortgage Act of 1933 provided mortgage refinancing for tens of thousands of farmers and homeowners facing foreclosure.

In April, the American Federation of State, County and Municipal Employees (AFSCME) called on investors at Citigroup's annual shareholders meeting to support a plan to split Citigroup's investment banking from its commercial banking divisions. The breakup plan questioned "the viability of the Citi business model," an implicit indictment of Rubin himself for his role in dismantling the Glass-Steagall regulatory firewalls.

Financial deregulation and central-bank autonomy were supposed to make the U.S. financial sector stronger. Financial innovation was among the great American exports, along with the model of an independent central bank. The Federal Reserve, insulated from public politics, was supposed to be the guarantor of price stability. Instead, the Fed has presided over what has been one of history's greatest financial bubbles.

Moreover, while trillions of dollars were channeled into housing and stock market bubbles, the public sector remained woefully underfunded. This, too, has been the legacy of the Clinton-Bush bubble economy: fiscal austerity and budget cutbacks in physical and social infrastructure, from structurally deficient roads and bridges and inadequate water and sewage systems to the collapsing levees around New Orleans and declining public education everywhere.

Unfortunately, the myth of the Clinton economy has too often served to limit discussion about the political forces behind the present crisis in the Washington Consensus. For instance, Hillary Clinton, in promising a high-level emergency panel to recommend ways to overhaul at-risk mortgages, proposed in March that such a council of wise men should include two of the people most responsible for undermining the integrity of financial markets, former treasury secretary Robert Rubin and former Federal Reserve chair Alan Greenspan.

The present crisis in the Washington Consensus should present an opening to think anew about the role of government and the meaning of democracy in a mature capitalist economy. There is an obvious need for prudential regulation—selective credit controls, margin requirements, minimum down payments, and other sensible lending standards. One could analogize to traffic regulation, but we could also look to history.

The Greatest Generation was able to invest on a scale much greater than today, spending billions of dollars on the Second World War, the Marshall Plan that rebuilt Western Europe and Japan, and the G.I. Bill of Rights that housed, educated, and integrated more than sixteen million returning war veterans. As a percentage of GDP, the U.S. government spent more than twice as much and borrowed more than fifteen times as much as today. But it borrowed at near-zero interest from domestic instead of foreign sources. What made this possible was a Federal Reserve that was strictly accountable to the elected branches, that imposed selective credit controls to prevent inflation in asset markets, and that steered funds away from private speculative activities and into long-term public investment in physical and social infrastructure. This period in public finance, spanning the war years and the early cold war period, presents an alternative paradigm to the bubble economy of the Washington Consensus.

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The Federal Reserve We Need

It's the Fed we once had -- when a more democratically accountable bank was enlisted to patriotically finance America's war debt.

TIMOTHY A. CANOVA | *October 11, 2010*

Throughout the past year, Federal Reserve Chair Ben Bernanke has led the choir in warning about the size of the federal deficit. In July, he endorsed extending George W. Bush's tax cuts for the wealthiest households, while suggesting the need for spending cuts to offset the revenue loss. Bernanke's repeated alarms have heightened fears that public deficits could "crowd out" private borrowing, force up long-term interest rates, and choke off the anemic recovery.

Bernanke's view may well be the consensus of both Washington and Wall Street. But it is also the polar opposite of the fiscal advice offered by one of Bernanke's most effective predecessors, Marriner Eccles, the Fed chair in the 1930s and 1940s. Eccles called for larger deficits and increases in government-spending programs to pull the country out of the Great Depression. He then went on to enlist the Fed to finance the huge World War II debt at low interest rates, so that the postwar recovery could flourish. Eccles was proved emphatically right, first in 1937 when the economy fell into a steep nosedive after the Roosevelt administration tightened fiscal policy and then again when the massive World War II fiscal stimulus of the 1940s ended the Great Depression once and for all and fueled the highest economic growth rates in American history.

Today's fiscal conservatives prefer to ignore the history of the 1940s, a period when the Federal Reserve was far more accountable to elected officials and far more independent of the private financial interests that have come to dominate the Fed in recent decades. During the 1940s, the federal government spent and borrowed far greater than today as a percentage of overall economic activity. Today, federal spending is about 25 percent of gross domestic product; in the 1940s, spending peaked at nearly 45 percent of GDP. Today's federal deficit is about 9 percent of GDP; in the 1940s, the deficit peaked at 31 percent of GDP. Today, the federal debt held by the public is about 61 percent of GDP; in the 1940s, it peaked at over 114 percent of GDP. Did those higher spending and debt levels bankrupt the U.S. economy? Quite the contrary -- federal spending was critical to the war effort and the success of the U.S. economy.

After the war, massive federal spending funded social policy on a grand scale through the GI Bill of Rights, which made available job training, tuition-free higher education, health care, and housing subsidies to nearly 16 million returning veterans, a third of the workforce. The GI Bill thereby bolstered an expanding middle class and created the conditions for sustainable economic growth. The growing economy pushed up tax revenues, lowering the debt burden and helping the federal government pay down debt.

Although federal spending and borrowing in the 1940s was much higher than it is today, there was no rise in interest rates. From 1942 to 1951, the Federal Reserve was accountable to democratically elected officials. It was directed by the White House and Treasury to peg interest rates at three-eighths of 1 percent on short-term Treasury borrowing and 2.5 percent on long-term borrowing. This so-called pegged period of public finance began in the weeks following the Japanese attack on Pearl Harbor. As the Federal Reserve itself would later describe the division of responsibilities, the amount of government spending was properly determined by Congress, and it was the Treasury's responsibility to determine the rate of interest it would pay on its borrowing. It then became the Fed's duty to purchase government securities in any amount and at any price needed to maintain the interest-rate pegs for Treasury.

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During the past two years, the Federal Reserve has purchased more than a trillion dollars of mortgage-backed securities, the so-called toxic assets held by the Fed's banking and hedge-fund clientele. The actual purchases have been shrouded in secrecy. In contrast, during the 1940s the objective of the Fed's open-market operations was more transparent and socially neutral. It was not to bail out private financial interests but rather to accommodate the federal government's fiscal-policy agenda.

With the 1940s Federal Reserve accommodating the administration's hyperactive fiscal policy, the U.S. economy grew at a real annual rate of 15 percent to 20 percent and more than doubled in output during the war. Private investment was crowded in, not out, as much of the spending went for contracts with the private sector, and a buoyant economy allowed consumers to purchase goods produced by America's corporations. Industry boomed and businesses returned to profitability. The U.S. emerged from the war with enormous productive capacity, as the world's largest creditor, and with huge trade surpluses, conditions which allowed it to play a commanding role on the world stage. By the end of the war, with the jobless rate at 1.2 percent, full employment was a reality for perhaps the first and only time in American history, and the distribution of income became much more equitable as a result of the strong economy, low yields on Treasury securities, and progressive taxation.

Since the Federal Reserve could no longer ratchet up interest rates to preempt potential inflation during this pegged period, the federal government had to find new ways to keep prices stable. During the war, the administration turned to temporary price controls as well as bond sales to the public and highly progressive taxes to dampen consumer purchasing power. Even after price controls ended in 1947, inflation was only a temporary problem, and by 1949 prices were falling across the board. This may well have reflected the country's expanded supply. Federal spending did not simply pump up demand; massive federal investments in infrastructure and factories expanded the nation's industrial capacity, thereby reducing inflationary pressures.

Meanwhile, the Federal Reserve imposed strict lending standards on its member banks, including interest-rate ceilings and selective credit controls to raise margin requirements on private borrowing for purchases of corporate securities, housing, automobiles, and consumer durables. Though many of today's critics blame the crisis on low interest rates, the real problem was low rates coupled with deregulation: When low rates are combined with a well-governed financial sector, they help the economy grow. Likewise, there has recently been much concern expressed that today's federal deficits could result in a global contagion against U.S. securities that would undermine the value of the dollar as foreigners sell off their holdings of Treasury securities. During the pegged period, this was largely prevented by a range of central-bank restrictions on short-term capital flows, including restrictions on the sale of Treasury debt abroad. Although today's proposals for taxing speculative capital flows seem quite tame by comparison, they have nonetheless been rejected for more than a decade by both the Federal Reserve and Treasury.

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Throughout the 1940s, the Federal Reserve's willingness and ability to impose a range of selective credit and capital controls reflected its relative independence from private financial interests and its accountability to democratically elected institutions -- a kind of central-bank role that has been all but ignored in recent decades.

The combined efforts of the Federal Reserve and the Office of Price Administration kept annual inflation below 3 percent for the final three years of the war. But political support for the interest-rate peg was eventually undermined after the war because of the Truman administration's failure to contain inflation. President Harry S. Truman and Congress fought over the OPA's authority, which was weakened, vetoed, lapsed, renewed, and then finally abolished in 1947. Then with the outbreak of the Korean War in June 1950, Truman seriously underestimated the scale and length of the war, its impact on inflation, and the restiveness of the Federal Reserve and its private financial constituency.

In fact, Congress and public opinion were well ahead of Truman on the need for direct controls on prices and wages in wartime. Likewise, Eccles and other members of the Federal Reserve were calling for renewed authority to impose selective controls. Without controls, they argued, the peg would need to be relaxed so the Fed could raise interest rates to stem inflation in consumer prices and asset markets. But Truman resisted until January 1951. By then, the country had experienced six months of sharply rising prices, with retail prices increasing at an annual rate of nearly 12 percent and wholesale prices, at an annual rate of 24 percent. From December 1950 to February 1951, the three peak months before the controls were adopted and took effect, the consumer price index rose at a 19 percent annual rate.

This inflation coincided with a dramatic and effective revolt of the money managers. The banking industry had been pressuring for a return to markets setting interest rates, and the Federal Reserve itself, no longer chaired by Eccles, was painting pegged rates as a relic from World War II. With the help of key conservative allies in Congress, the Fed prevailed, culminating in the Treasury-Federal Reserve Accord of March 1951, which ended the system of pegged interest rates.

Although it was the combination of direct and selective controls that quickly broke the inflationary momentum, the Fed soon began using its newfound freedom to raise interest rates at the first signs of any inflation, thereby bringing on three recessions during the Eisenhower era and raising the interest burdens on federal, state, and local governments, a harbinger of our present troubles. It also returned to its pre-1933 role of looking out for the interests of the big banks, rather than the public interest, as its primary constituency.

During the 1930s, Eccles had pushed for structural reform of the Federal Reserve to remove the "banker interest" from its crucial Federal Open Market Committee, which sets monetary policy. Eccles came up short in that effort, just as Congress did most recently in the Dodd-Frank Wall Street Reform Act when it dropped proposals that would have reduced private control of the FOMC by making the 12 regional Federal Reserve Banks more accountable to elected officials.

Unfortunately, it is the banker interest that has skewed Federal Reserve policy, first in its lax regulatory oversight leading to the financial crisis and since then, in its response to the crisis. The experience of the 1940s suggests that the Fed could accommodate much larger federal deficits to energize a sustainable economic recovery. That, in turn, would transform the current debate about what scale of temporary enlarged debt the economy needs and can sustain. Instead, the Fed has been pushing reserves into the banking system in exchange for toxic assets while hoping the banks will lend to consumers and businesses in an environment of severe economic insecurity. Eccles himself had criticized this approach as "pushing on a string" and largely ineffective. Eccles recognized that central-bank accommodation of large public deficits would prove far more effective than pushing reserves into the banking system as long as the federal government spent wisely in putting people back to work and investing in the long-term infrastructure needs of the nation.

Since the fall of 2008, the Federal Reserve has been pushing on a big string. Its balance sheet has expanded by some $2 trillion, much of which is some $1.25 trillion in purchases of toxic mortgage-backed securities from private financial institutions, including banks with ownership interests in the regional Federal Reserve Banks. In addition, the Federal Reserve has lent more than $1.5 trillion to those same private financial institutions in exchange for more toxic assets as collateral. Instead of investment in the real economy, this strategy has been one of spending on toxic paper assets.

Meanwhile, the scale of all these hidden subsidies to banks, which began when Treasury Secretary Timothy Geithner was heading the New York Fed, far exceeds the cost of the Obama administration's fiscal stimulus. While the Fed's private constituency of large Wall Street banks and hedge funds has enjoyed low-interest loans and outright sweetheart purchases of their toxic assets, governments at all levels must slash budgets, cut public services and payrolls, and thereby undermine the fragile economic recovery.

How different is the current reality from the 1942-1951 Federal Reserve, which provides a model of what a democratically accountable central bank would look like when working with elected branches to achieve the three primary objectives of Keynesian economics: maintaining genuine full employment; reducing the tremendous inequalities in wealth and income that undermine any sustainable recovery; and putting an end to the monopolistic structures and financial practices that harm taxpayers and consumers alike. The Fed in the 1940s supported much higher levels of deficit spending, which were needed for a recovery at low interest rates. In contrast, today we have low interest rates, but they are supporting business as usual in the banking sector, which is not translating into recovery for the real economy, while the Federal Reserve is part of the alarmist chorus about deficits.

Few economists ever learn this period in Federal Reserve history, which has been airbrushed from most mainstream texts, including Bernanke's own economics textbook. To the extent that the Eccles period is discussed at all, it is dismissed as an anomaly -- which, sadly, it was. Today's new normal is a central bank captured by private financial interests that is pursuing an elite agenda of deregulation, fiscal austerity, and bailouts and bonuses for bankers. But as our nation's own history shows at one of America's finest hours, it doesn't have to be that way.

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History Repeating in California Fiscal Crisis

California's recurring fiscal crisis, the worst since the Great Depression, is reminiscent of the movie "Ground Hog Day" in which Bill Murray's character wakes up every day in the same strange reality. Just weeks after closing a $40 billion budget deficit, California is once again facing a multi-billion dollar gap. The Schwarzenneger administration has already forecast a $7.4 billion deficit the next fiscal year. Others are expecting the gap to grow to more than $20 billion.

This is the fourth time in the past year and a half in which we wake up to a huge budget gap, endure deep and painful spending cuts and tax increases, and the deficit is finally closed. Yet the next day we wake up again to the same reality, another large budget gap, and the same fiscal austerity to try to close the shortfall.

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In February 2008, California faced a $2 billion budget gap that was closed by emergency spending cuts. Yet only weeks later an estimated $10 billion budget deficit reappeared, only to rise within days to more than $20 billion. Governor Arnold Schwarzenegger laid off more than 10,000 temporary state workers and proposed a one cent increase in the state sales tax - a proposal that went nowhere. After another compromise of spending cuts and tax hikes, the budget was closed late in the summer.

It was deju vu all over again. Within weeks, in October 2008 another $3 billion to $5 billion budget shortfall was estimated. By early November, the gap was estimated at $11.2 billion. This time, the Governor ordered furloughs of state workers and the gap was closed. That is, until February of this year, when the state budget deficit was projected at $40 billion. A new plan was passed, only to see yet another $8 billion budget gap in March. By May, the deficit was projected to hit $21.3 billion. This time, state voters rejected five of six budget-related ballot measures and legislators failed to reach a compromise with the Governor. In July, California began paying some of its bills with more than 130,000 IOUs worth more than $500 million. The state's bond rating was downgraded.

The last big compromise, barely three months ago, was particularly severe. An estimated $14.5 billion was cut from education, after nearly $10 billion last year. For public education K-12, there were layoffs, unpaid furloughs, rising class sizes, and elimination of summer school programs throughout the state. Higher education was also hit hard. The California State University and University of California systems cut more than $1.4 billion. As a result, student fees were raised, enrollment was cut, and unpaid furloughs were imposed on faculty and university employees, representing pay reductions of more than ten percent in many cases.

Other painful cuts were made to college grants for low income youth, welfare-to-work programs, and In-Home Supportive Services for the disabled and elderly. Many state parks were closed and fees sharply increased. The state also grabbed several billion in tax dollars from cities, counties and special districts at a time when local government was cutting police and public safety budgets.

Each time state legislators and the Governor have faced a budget gap over the past year, they have dealt with it as if it were another short-term problem of over-spending and under-taxing. In fact, we may need to tax less and spend far more.

The real source of the recurring budget gap is not excessive state spending. The problem has been falling tax revenues resulting from a weak economy. When people are out of work and business volume is down, governments at all levels bring in less in tax revenues. This has been true for taxes across the board, for the sales tax, income tax, capital gains tax, business taxes, local property tax, hotel and occupancy and tourism taxes.

This is a variation of the paradox of thrift and reminiscent of the 1930's. As the state cuts spending, it also undermines its own tax base, and the result is falling revenues.

Of course, it has been much the same elsewhere. At end of the 2009 fiscal year, nearly a dozen states across the country labored to close more than $150 billion in combined budget deficits. It has been estimated by the *Wall Street Journal* that states will have combined deficits of $166 billion in fiscal year 2010 and an astounding $350 billion in fiscal year 2011.

This is another historical parallel to the Great Depression when much of the New Deal federal fiscal stimulus was erased by recurring spending cuts and tax increases by state and local governments throughout the 1930's.

It has been said that history repeats itself, but often in different ways. On Oct. 30 - the 80th Anniversary of the 1929 stock market crash - scholars and policy makers will converge on Chapman University School of Law to consider today's financial distress and economic downturn in broad historical terms. Congresswoman Loretta Sanchez and governor candidate Tom Campbell, among a host of cross disciplinary experts, will discuss the state's fiscal crisis and the failure of regulation of financial markets, such as historical comparisons to bubbles in the 1790s and the dollar devaluation of the 1930s.

Many of these discussions will no doubt raise a similar insight, that today's financial and economic crisis was produced by an unholy alliance of Wall Street bankers and lobbyists and Washington insiders. The irony is that these are the people being propped up by taxpayer support through the Treasury bailout and hidden Federal Reserve subsidies. For the five largest banks, there are massive subsidies as well as bonuses. For most everyone else, there is austerity, financial losses, and the fear of job losses, or worse.

How different from the policy agenda that helped the United States emerge from the Great Depression as the world's leading industrial powerhouse. Since it was the federal government that dropped the ball that started this downward spiral, there should be a federal solution to the crisis in state finances. What is needed is a federal revenue-sharing program for state and local governments comparable to that of the Greatest Generation.

On the Contrary, Consistency Counts

When Ralph Waldo Emerson remarked dismissively that "a foolish consistency is the hobgoblin of little minds," he wasn't thinking of motions for summary judgment or adjudication. On the contrary - inconsistency in your evidence can doom your attempt to create a triable issue of fact.

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That was the holding in *Alvis v. County of Ventura*, (Oct. 20, 2009, B212337). In that case, an expert's declaration, submitted in opposition to a motion for summary adjudication, contradicted his earlier statement to a third party. The result was that the declaration failed to defeat the motion.

The case arose out of the deadly 2005 La Conchita landslide. La Conchita is a community at the bottom of an unstable 600-foot cliff in unincorporated Ventura County. A decade earlier, after a similar landslide, the county had considered how to remove debris from Vista Del Rincon Drive, at the base of the cliff, without further destabilization.

In 2000-2001 the county erected a wall, comprising steel beams set into the ground, with horizontal wooden boards attached between the beams. Water was to drain through the spaces between the boards.

The county notified the residents of La Conchita that "[t]he retaining wall will allow the debris removal to occur without adversely affecting the stability of the overall landslide as it currently exists. It is NOT intended to increase the overall stability of the La Conchita landslide mass."

On Jan. 10, 2005, the second, larger la Conchita landslide destroyed 16 houses, and killed 10 people. In the subsequent consolidated legal actions, plaintiffs sued the county for maintaining a dangerous condition of public property. They asserted that the wall actually diverted the landslide towards the affected property, causing the deaths, injuries and property damage.

The county moved for summary adjudication of all causes of action save inverse condemnation. The motion relied on the design immunity of Government Code Section 830.6.

William Brill, the county civil engineer who managed the stabilization project, submitted a declaration in support of the motion. His opinion was that the wall had no effect on the slide. First, there were existing channels that collected and directed the debris flow. Second, only an extremely large debris flow could reach the wall. Such a flow "would engulf everything in its path, including the wall. It is my professional opinion...that the wall would have no more than a trivial impact on such a large debris flow."

In their opposition, plaintiffs countered with the declaration of geotechnical and civil engineer Awtar Singh. Singh reckoned that there was inadequate drainage behind the wall. Water pressure built up behind the wall, contributing to the wall's collapse and the subsequent carnage.

But the county objected to Singh's evidence. It pointed out that the declaration contradicted Singh's previously-expressed opinion: In a report to an insurance company, Singh had concluded that "[f]ailure started as a landslide in the upper reaches and then flowed at a rapid rate down to the developed area below," which would exonerate the county wall.

The trial court granted the county's motion, noting that "The Court finds the declaration of Dr. Singh on those issues unconvincing because it...is contradicted in some respects by his prior report written in February of 2005." Plaintiffs dismissed the inverse condemnation count in order to appeal.

On appeal, the court affirmed in an opinion by Justice Arthur Gilbert, joined by Justices Kenneth R. Yegan and Paul H. Coffee. The court held that conflicting expert declarations typically generate a triable issue of fact. But a declaration does not create a triable issue of fact when it contradicts the expert's own prior statements on a material issue, if the contradiction is unexplained. In that instance, the declaration is no bar to summary judgment or adjudication.

As stated in *Leasman v. Beech Aircraft Corp.*, (1975) 48 Cal.App.3d 376, 382: "[W]hen a defendant can establish his defense with the plaintiff's admissions...the credibility of the admissions are valued so highly that the controverting affidavits may be disregarded as irrelevant, inadmissible or evasive." Thus, a declaration which is just trying to undo the harm caused by earlier testimony simply is not "substantial evidence."

This is the long-standing rule in California. But *Alvis* innovates in two ways.

First, the court, almost casually, extends this rule to *all* prior statements - even those, unlike depositions and discovery responses, which are not verified or made under oath. "Singh's prior statement was not in the form of testimony under oath. But the same reasoning applies. We cannot accept as substantial evidence of a triable issue of fact a declaration that directly contradicts the declarant's prior statement, where the contradiction is unexplained. We may not ignore this significant contradiction."

One wonders how far this will extend. If instead of an insurance company report, Singh had been overheard in a bar making the same assessment, would it still trump his later declaration? Prior admissions made under oath in the course of discovery are, presumably, thoughtful and considered. The further one wanders from that context, the less the prior statements have the character of "admissions." We'll need to see how future cases handle this issue.

The second *Alvis* innovation is to suggest the cure for contradictory evidence: *explain* why the witness has changed his tune. The court

***Alvis* is a gentle reminder (or a kick in the pants) that when opposing a motion for summary judgment or adjudication, check the declarations against the rest of the file.**

doesn't insist that the witness cling like a barnacle to his original story. But counsel can't ignore a material discrepancy. The alteration in the witness's evidence must be justified.

This can be done. New facts coming to light may demand fresh opinions. New discovery responses can justify a new perspective. Assuming that the declarant's new version isn't simply the result of a "Bloody Hell! If that's her story, the case is dead!" realization, tell the court why the current version of reality is accurate, and why the earlier version was mistaken.

Alvis is a gentle reminder (or a kick in the pants) that when opposing a motion for summary judgment or adjudication, check the declarations against the rest of the file. Make sure all the opinions and facts line up. If they don't, figure out a good reason.

If you're defending a summary judgment motion, review the file to trip up the opposing declarant with a clashing prior statement. And since the standard of review on appeal of summary judgments is de novo, you'll get another chance to ferret out contradictions if your opponent is a sore loser.

Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model

*Timothy A. Canova**

Against the background of a close presidential election campaign, the U.S. government responded to the great financial crisis of 2008 with a great financial bailout, a massive federal effort to prop up financial institutions and the economy itself. The crisis in credit and financial markets was the most serious since the collapse of the nation's banking system in March 1933. A seismic generational shift in values has led to our present crisis. The generation that came of age during the Great Depression and World War II, the so-called Greatest Generation, achieved its most important public policy objectives—converting the economy first to enormous wartime production and then to peacetime rebuilding—in large part because of a financial regulatory regime that kept competition within prescribed limits while allocating credit and capital away from private, speculative activity and into longer-term public investment in physical and social infrastructure.[1]

The microeconomic fixations of today's law and economics school have replaced this comprehensive Keynesian model of financial regulation. The economic model underlying today's failing regulatory regime is a neoclassical equilibrium model that is highly abstract and mathematical, often based on unrealistic assumptions and ignorant of historical contexts and the many complex dynamics and interdependencies of human behavior and market psychology.[2] Largely uncontrolled and uncoordinated, the current regulatory approach does not serve the interests of the public, but rather the far

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[1] Adam Smith, the grandfather of neoclassical economics, believed that the state should invest in public works. DOUGLAS F. DOWD, THE TWISTED DREAM: CAPITALIST DEVELOPMENT IN THE UNITED STATES SINCE 1776 8 (1974); *cf.* Press Release, American Society of Civil Engineers, America's Crumbling Infrastructure Eroding Quality of Life (Mar. 9, 2005), http://www.asce.org/reportcard/2005/page.cfm?id=108 (reporting that the United States must spend $1.6 trillion by 2010 to prevent deterioration of public infrastructure).

[2] *See* David Colander, *IS/LM Model and Diagram*, *in* AN ENCYCLOPEDIA OF KEYNESIAN ECONOMICS 259, 260–61 (Thomas Cate ed., 1997) (noting criticisms of this widely employed economic model as simplistic and based on unrealistic assumptions).

narrower interests of the regulated institutions that have captured the agencies of government and the policy-making process.

This Essay seeks to analyze the most important institutional and regulatory factors that have contributed to the ongoing financial market failure and offers a framework for designing a new approach to financial regulation that would meet the demands of the present. Part I, "The Logic of the Keynesian Regulatory Regime," describes the adoption in the United States of a "command-and-control" financial regulatory regime, beginning in the 1930s and 1940s. This regime was part of a larger model, which I refer to as an institutional law and Keynesian economics model, that focused on macroeconomic policy objectives and was designed to achieve full employment, more equitable distributions of wealth and income, and greater transparency and accountability in the regulatory process.[3]

Part II, "The Demise of the Economics of Control," describes the shift away from Keynesian economics and command-and-control regulation toward privatization and deregulation, a dangerous devolution that picked up tremendous momentum beginning in the 1970s. During this period, concern for Keynesian objectives fell by the wayside. Part III, "The Introduction of Risk-Based Capital Standards," focuses on one component of this trend: the movement toward industry self-regulation. This Part argues that the dangers of the deregulatory trend became more apparent as industry self-regulation undermined the transparency of financial institutions and markets while encouraging the development of an unsustainable, bubble economy.

Part IV, "Agency Capture and Revolving Doors," argues that the replacement of an effective system of command-and-control regulation by industry self-regulation was a function of larger institutional flaws. This Part analyzes the failures of regulation in an institutional landscape marked by agency capture and privatized authority—failures that set the stage for the current financial crisis.

Part V, "The Bastard Keynesianism of the Bailout," critiques the economic rationale of the current bailout in the context of continuing market failure due to past deregulatory reforms. The financial crisis of 2008 did not put an end to the flawed institutional super-structure that had been taking root over the preceding thirty years. Part V describes a profound failure in the rule of law and argues that the privatized Federal Reserve System represents the primary institutional roadblock preventing effective financial regulation, a proper balance of constitutional authority on monetary and fiscal policy, and needed reforms in public finance.

In conclusion, Part VI, "A New Economics of Control," presents recommendations for reviving the model of institutional law and Keynesian economics as the best alternative to prevent future financial crises. This Part builds on the original Keynesian model, suggesting a more complete and integrated economic approach to counter the flawed policies that set the

[3] John Maynard Keynes, The General Theory of Employment, Interest, and Money (1936).

stage for our current financial crisis. But this approach can be developed and implemented only if mechanisms for regulation are well-coordinated and safeguarded from a meddling and self-serving financial industry.

I. The Logic of the Keynesian Regulatory Regime

Laissez-faire capitalism was the prevailing orthodoxy in both law and economics from the time of the 1929 stock market crash until the banking crisis of 1933. Financial markets were largely unregulated and unsupervised, and it was not seen as the responsibility of government to stimulate economic activity, even in a recession. British economist John Maynard Keynes turned this orthodoxy on its head in his 1936 book, *The General Theory of Employment, Interest, and Money*.[4] This Section is primarily concerned with Keynes's proposals for financial regulation, but in order to fully appreciate these proposals, it is important to understand the broader economic and policy context in which they were crafted. Accommodation to its broader context sets Keynes's approach apart from the narrowly conceived financial regulations of the last thirty years.

Keynes's proposals rested on a recognition that the economy could become stuck in a liquidity trap in which expectations of falling prices and falling profits, or what he referred to as a "declining marginal efficiency of capital," would choke off new investments no matter how low interest rates fell. According to Keynesian theory, there were complex economic and psychological factors that could lead to such a liquidity trap. A top-heavy distribution of income could drain purchasing power from those segments of the population most likely to spend and maintain demand for goods and services—in economic terms, those with a high marginal propensity to consume. Economic growth would thereby become dangerously dependent on the luxury spending of the wealthy few and on unsustainably high levels of private investment. A reduction in aggregate demand resulting from a steep and sudden fall in prices and wages would bring the economy to a new, lower equilibrium. Monetary policy would be unable to pull the economy out of the trap.[5]

To Keynes, the implications of his theory for macroeconomic policy were clear: if private investment and consumption stalled, the only realistic engine of economic growth would be government spending. In turn, a hyperactive fiscal policy would require a central bank willing to maintain low interest rates for government borrowing and spending programs.[6] Such a policy mix would also require a regulatory system of centralized credit controls to keep credit from flowing back into speculative bubbles and to bring

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[4] *Id.*

[5] *Id.* at 207–08.

[6] *Id.* at 202–06 (arguing that the central bank should maintain low long-term interest rates to facilitate an expansive government fiscal policy).

about adjustments in the propensities to consume and invest.[7] Keynes recognized that such central controls would "involve a large extension of the traditional functions of government."[8] Although he never spelled out the details of those controls in *The General Theory*, an earlier essay on the banking crisis of 1931 gives us a hint of the controls Keynes had in mind.[9]

When addressing the banking crisis of 1931, Keynes observed that much of the speculative rise in stock prices that led to the 1929 market crash was fueled by an enormous increase in loans for stock purchases without any minimum down payments. Existing stock served as collateral to borrow money for further stock purchases. There was no federal authority at the time to set margin requirements, leaving the Federal Reserve, the nation's central bank, with only two choices: moral suasion to encourage the voluntary tempering of these lending practices, or general credit restrictions. The Fed chose the latter, thereby raising interest rates and making the downturn and crash inevitable.[10] Keynes recognized that subsequent financial events were consequences of this failure in regulation and monetary policy: a worldwide collapse in the price of real assets and a wave of foreclosures and business failures that left banks with enormous portfolios of bad loans, all of which led to a liquidity crisis, freezing up the credit system and preventing banks from financing new projects and engaging in new lending.[11]

Consequently, Keynes pointed out the need for strict minimum down payment requirements for loans for housing, consumer, and corporate securities purchases:

> Experience has led to the fixing of conventional percentages for the 'margin' as being reasonably safe in all ordinary circumstances. The amount will, of course, vary in different cases within wide limits. But for marketable assets a 'margin' of 20 per cent to 30 per cent is conventionally considered as adequate, and a 'margin' of as much as 50 percent as highly conservative.[12]

Keynes viewed such margin requirements as important means to limit systematic risk and protect financial institutions from any downward change in the money value of assets by limiting the amount of credit allocated to marginal borrowers.

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[7] *Id.* at 379.

[8] *Id.*

[9] John Maynard Keynes, *The Consequences to the Banks of the Collapse of Money Values* (1931), *in* Essays in Persuasion 168, 170–71 (1963).

[10] For more on this theory of the crash, see Allan H. Meltzer, A History of the Federal Reserve: 1913–1951, at 248–49 (2003); Frederick Lewis Allen, Only Yesterday 306 (1931). Milton Friedman and Anna Jacobson Schwartz concluded that the Fed "followed a policy which was too easy to break the speculative boom, yet too tight to promote healthy economic growth" in the year leading up to the 1929 crash. Milton Friedman & Anna Jacobson Schwartz, A Monetary History of the United States, 1867–1960, at 291 (1963).

[11] Keynes, *supra* note 9, at 171–73.

[12] Keynes, *supra* note 9.

In 1944, in *The Economics of Control: Principles of Welfare Economics*, Abba Lerner, one of the leading Keynesian economists in the United States, sought to provide a more detailed theoretical framework for market regulation and public finance in accordance with Keynes's observations. According to Lerner, within a system of private enterprise and private ownership, the government should achieve regulatory coordination by taking on responsibility for controlling the allocation of resources among consumption, investment, foreign trade, and government spending.[13] Lerner understood that government at all levels imposed all kinds of regulations on a wide range of industries, institutions, and private transactions. "Yet," he wrote, "we may refer to the actual economy as 'uncontrolled' because all these activities are partial and haphazard and are not organized as they would be if it were a recognized responsibility of the government to control the resources of society to see that they are utilized in the best possible manner."[14]

Lerner likened the uncontrolled economy "to an automobile without a driver but in which many passengers keep reaching over to the steering wheel to give it a twist while complicated regulations prescribe the order and degree to which they may turn the wheel so as to prevent them from fighting each other about it."[15] He contrasted this with a controlled economy, with one driver and a clear purpose, which would be simpler and have many fewer regulations than an uncontrolled economy.

Likewise, in the field of finance much regulation can be quite complex and yet ineffective in managing risk for lenders and protecting borrowers. In contrast, margin requirements are far simpler yet also more successful at limiting systematic risk. With high margin requirements there is less need to rely on complex capital adequacy and truth-in-lending regulations to protect borrowers and ensure the safety and soundness of the banking system.

In addition to promoting a controlled, coordinated financial system, Lerner argued that government regulation should be aimed at achieving at least three primary policy objectives: maintaining full employment, diminishing the tremendous inequality of income and wealth, and putting an end to the monopoly structures that contribute to exploitation and economic waste.[16] These objectives of control are designed to reduce the factors that

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[13] *See* Abba Lerner, The Economics of Control: Principles of Welfare Economics 3 (1947).

[14] *Id.* at 3. Government regulation, when uncoordinated and without control, can lead to market failure. For instance, Bert Ely identified several regulatory causes of the savings and loan crisis—the problem may be the wrong regulatory mix. *See* Bert Ely, *Savings and Loan Crisis*, *in* The Concise Encyclopedia of Economics (2d ed. 2007), *available at* http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html.

[15] Lerner, *supra* note 13, at 4 (citing A.P. Lerner, *The Economic Steering Wheel*, 7 The Univ. Review 257 (1941)).

[16] Lerner, *supra* note 13, at 3. Lerner also emphasized that these objectives would prove elusive if the regulated industries themselves were able to capture the regulatory agencies—in essence to cartelize their industries under the veil of regulation. *Id.* at 43, 46 (criticizing cartelization through the New Deal's Agricultural Adjustment Act). Lerner's concern with monopolistic exploitation can be seen as anticipating the Public Choice School concern with agency

Keynes diagnosed to be at the heart of depression and business cycles. For instance, the promotion of full employment and the reduction of income inequality would help maintain aggregate demand and thereby keep the economy from falling into recession and potential liquidity traps.[17]

In 1934, Congress began to move toward the vision of financial regulation that Keynes expressed and Lerner would later develop. In that year, Congress delegated to the Federal Reserve Board of Governors the authority to set margin requirements on security loans.[18] For the next two decades, these and other "selective credit controls" came to be seen as important policy tools to supplement general monetary measures that regulate the total supply of money and bank credit and the general level of interest rates. In contrast to these general monetary measures, selective credit controls influence the allocation of credit, "at least to the point of decreasing the volume of credit used for selected purposes without the necessity of decreasing the total supply and raising the cost of credit for all purposes."[19] During this period, the Fed was given authority to set margin requirements on consumer credit and real estate credit in the form of minimum down payments and maximum periods of repayment.[20] Consumer credit controls were instituted

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capture. George J. Stigler, *The Theory of Regulation*, 2 Bell J. Econ. & Mgmt. Sci. 3 (1971) (describing how the political process allows relatively small groups to obtain favorable regulation); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J. Law & Econ. 211 (1976); Thomas W. Merrill, *Capture Theory and the Courts: 1967–1983*, 72 Chi.-Kent L. Rev. 1039 (1997). These ideas will be discussed more fully in Parts III through VI, where I observe that agency capture has become all too common in the U.S. political system, as special interest groups through money, lobbying, and the lure of private sector employment (the so-called "revolving door") have come to accumulate great influence over key congressional committees and regulatory agencies to avoid genuine competition. *See* Theodore Lowi, The End of Liberalism: The Second Republic of the United States (2d ed. 1979); Mancur Olson, The Rise and Decline of Nations (1982).

[17] Lerner claimed that the fundamental cause of the business cycle was the inadequacy of demand because of the very unequal distribution of income. Lerner, *supra* note 13, at 296. This was consistent with the view of other leading Keynesians. *See, e.g.*, John Kenneth Galbraith, The Great Crash 182 (1961) (arguing that the Great Depression and 1929 stock market crash were due in part to a highly unequal distribution of income that made the economy "dependent on a high level of investment or a high level of consumer spending or both").

[18] Lester V. Chandler, The Economics of Money and Banking 248–49 (5th ed. 1969). Hearings by the Senate Committee on Banking and Currency beginning in 1931 and spearheaded by Ferdinand Pecora, special counsel for the committee, revealed the dangers of buying stocks on margin, and led to stricter margin requirements under the Securities Exchange Act of 1934. *See generally* Broadus Mitchell, Depression Decade: From New Era through New Deal 1929–1941 154–59 (1947).

[19] Chandler, *supra* note 18, at 247. Margin requirements were just one tool in the arsenal of selective credit controls. During the 1960s and into the 1970s, the federal government also employed selective controls including, but not limited to, differential taxes, lending quotas, and ceilings on foreign investments to restrain credit to foreign borrowers. For a description of these selective controls, see Donald R. Hodgman, *Selective Credit Controls*, 4 J. Money, Credit & Banking 342, 342–44 (1972).

[20] For instance, demand for credit for particular purchases could be reduced by raising minimum down payment requirements, which would lower the maximum loan value, or by shortening the maximum period of repayment, which would increase monthly payments on loans. *See* Chandler, *supra* note 18, at 250.

in late 1941 and remained in effect almost continuously until 1952.[21] Credit controls for new residential construction were used from 1950 to 1952 as part of an anti-inflation program during the Korean War.[22] Together, these controls diverted financial resources from nonessential uses and assisted the government in meeting its wartime funding requirements by keeping interest rates low on government debt.[23]

Throughout the 1940s and 1950s, economists and policymakers saw margin requirements as an effective way to prevent bubbles in real estate and other sectors without raising interest rates for the entire economy and without raising borrowing costs for all levels of government. Ervin Miller, a University of Pennsylvania economist writing in the 1950s, argued that selective credit controls were more precise than general credit restrictions and therefore "very useful in periods of uncertainty when some areas of the economy show undue expansion" and other sectors are weak.[24] Throughout this period of time, even Fed officials who opposed the use of selective credit controls on ideological grounds wanted such policy tools at their disposal in case emergency conditions might suddenly arise.[25]

These policymakers, like Keynes and Lerner, recognized that when the central bank uses one blunt instrument—the short-term interest rate—it is abandoning the steering wheel for the stop-and-go of an accelerator. When the central bank seeks to contain speculative bubbles in stocks or housing through general monetary measures alone, the results can be destabilizing. Lowering interest rates for all may invite speculative bubbles in already heated sectors of the economy. Raising interest rates for the entire economy can collapse asset markets, increase unemployment, raise the debt burdens of private and public borrowers, redistribute income to top brackets, increase foreclosures and bankruptcies, and reinforce the monopolistic powers of big financial institutions.[26]

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[21] *Id.* at 247 (reporting brief interruptions in consumer credit control authority for some months in 1947–1948 and again in 1949–1950).

[22] *Id.*

[23] *Id.* at 250–51. *See also* Ervin Miller, *Monetary Policy in a Changing World*, 70 Q. J. Eco. 22, 34 (1956). Regulation X, which set margin requirements on real estate credit, was supported on broad social and economic grounds. Its proponents claimed that the terms imposed by Regulation X were not always stiff enough to produce their desired effect. *See* R.J. Saulnier, *An Appeal of Selective Credit Controls*, 42 Am. Econ. Rev. 247, 251–52, 261–62 (1952).

[24] Miller, *supra* note 23, at 38.

[25] *See A Bill to Provide Standby Economic Controls, and a Bill to Provide Authority for Temporary Economic Controls: Hearing on S. 753 and S. 1081 Before the S. Banking and Currency Comm.*, 83d Cong. 1472–89 (1953) (statement by William McChesney Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System), *available at* http://www.docstoc.com/docs/986181/Statement-before-the-Banking-and-Currency-Committee-of-the-Senate-March-30-1953.

[26] *See* James Medoff & Andrew Harless, The Indebted Society: Anatomy of an Ongoing Disaster 72–74 (1996); Leon H. Keyserling, Money, Credit, and Interest Rates: Their Gross Mismanagement by the Federal Reserve System (1980) (Keyserling was the Chairman of the Council of Economic Advisers to President Harry Truman from 1949–1953).

No one could drive a car for long without the command-and-control regulations of traffic lights, speed limits, and traffic lanes. Likewise with financial markets, margin requirements serve important functions by steering credit away from speculative risk and overheated sectors of the economy without the need to resort to general monetary measures.

II. The Demise of the Economics of Control

Over the past four decades, there has been a profound political and ideological shift away from Keynesian economics and toward deregulation. The leadership in both major political parties came to see government as intrusive and incapable of achieving genuine full employment and other Keynesian policy objectives.[27] Deregulation created an ineffective patchwork of federal regulations. Meanwhile, replacing selective credit controls with general monetary measures to manipulate short-term interest rates helped to fuel unsustainable asset bubbles.

Selective credit controls were first discredited during the latter part of the Vietnam War, largely a case of guilt by association with President Nixon's inept and loophole-ridden use of price controls and a symptom of the general backlash against executive power stemming from Watergate and related scandals.[28] President Carter rejected the economics of control and soon after was left without any selective policy instruments to contain inflationary forces in commodity markets and consumer goods.[29] The Federal Reserve eventually stepped in by using general monetary policy instruments quite aggressively to restrict the money supply and push up interest rates for the entire economy. This in turn undermined the viability of other selective policy instruments, such as depository interest rate ceilings and usury ceilings on mortgage loans.[30]

Once the government lost control of the general macroeconomic environment, the political agenda shifted to formally abolishing selective credit controls and deregulating banking and finance.[31] The Depository Institutions Deregulation and Monetary Control Act of 1980 liberalized depository interest rate ceilings, preempted state usury ceilings on mortgage loans, and permitted new financial innovations to evade various other legal restrictions.[32]

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[27] Medoff & Harless, *supra* note 26, at 72–74.

[28] Neil W. Chamberlain, Donald E. Cullen & David Lewin, The Labor Sector 617–25 (3d ed. 1980) (analyzing the flaws and loopholes of Nixon's price controls).

[29] Alexander Cockburn, The Golden Age Is in Us 264 (1995) (discussing President Carter's rejection of the economics of control as a backlash after the failures of Nixon).

[30] Depository interest rate ceilings limited the payment of interest on saving deposits and prohibited the payment of interest on checking deposits; usury ceilings limit interest rates on mortgage and other loans. Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 Brook. L. Rev. 1295, 1310–11, 1315–16 (1995).

[31] *See generally id.* at 1314–26 (1995).

[32] Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

Two years later, the Garn-St. Germain Depository Institutions Act[33] completed the deregulation of depository interest rates, removed regulatory firewalls between commercial banks and savings and loan associations, and removed numerous other lending restrictions on loan-to-value ratios, amortization, aggregate limits, and loan maturities, thereby setting the stage for such financial innovations as subprime and adjustable rate mortgage loans.[34]

The 1980s saw the dismantling of the intricate patchwork of selective credit controls that had served for decades to reduce systematic risk by discouraging the development of a subprime mortgage market for borrowers with bad credit. Without such controls, and with the added incentive of securitization of subprime loans, lenders started making more and more loans with no minimum down-payment requirements, and eventually without requiring documentation of income on many loans.[35] Variable-rate loans and loans of shorter maturity soon shifted the risks of rising interest rates from lenders to borrowers, just as opponents of deregulation had predicted at the time. Not surprisingly, the rate of business failure and foreclosure increased almost immediately.[36]

The deregulatory agenda was politically and ideologically sustained during the Clinton and Bush II years, fueling a bubble economy based on easy credit, high debt, low or no margin requirements, and the deterioration of lending standards. Lending standards were relaxed on Fannie Mae and Freddie Mac, government-sponsored entities (GSEs) that purchase mortgages on the secondary market to pool and sell as mortgage-backed securities.[37] Those who opposed higher margin requirements on housing loans argued that they would prevent some borrowers, particularly from poor and minority communities, from purchasing their first homes, thereby impeding

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[33] Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified as amended at 12 U.S.C. 1823(c) (1994)).

[34] *See* Canova, *supra* note 30, at 1320, 1327.

[35] DEP'TS OF THE TREASURY AND HOUSING AND URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING 29–30 (June 20, 2000), *available at* http://www.huduser.org/publications/pdf/treasrpt.pdf.

[36] *The Depository Institutions Deregulation Act of 1979: Hearings on S. 1347 Before the Subcomm. on Financial Institutions of the S. Comm. on Banking, Housing, and Urban Affairs*, 96th Cong. 131 (1979) (statement of Henry B. Schechter, Director, AFL-CIO Dep't of Urban Affairs).

[37] Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES, Sept. 30, 1999 at C2 (discussing Fannie Mae's decision to ease lending standards in response to pressure from the Clinton administration and banks, thrift institutions, and mortgage companies); Jay Romano, *A Baedeker for First-Time Homebuyers*, N.Y. TIMES, March 14, 1999 at RE1 (reporting three percent margins on Fannie Mae approved mortgage loans). The Comptroller of the Currency defended the Community Reinvestment Act (CRA), the convenient scapegoat of Wall Street, arguing that it was not the cause of the wave of subprime lending. Press Release, Comptroller of the Currency, Comptroller Dugan Says CRA not Responsible for Subprime Lending Abuses (Nov. 19, 2008), *available at* http://www.occ.treas.gov/ftp/release/2008-136.htm. *But see* Eliot Spitzer, Op-Ed., *Predatory Lenders' Partner in Crime*, WASH. POST, Feb. 14, 2008, at A25 (criticizing the Comptroller of the Currency for preempting all state predatory lending laws in 2003).

their ability to build up equity capital.[38] While such arguments are true, other approaches might have been used to help low- and middle-income families save for future homeownership, such as a federal tax deduction for rental payments to match the current mortgage interest deduction for homeowners. Policymakers, however, ignored such alternatives, continuing instead to resist implementation of margin requirements.

Meanwhile, Federal Reserve Board Chairman Alan Greenspan's laissez-faire approach encouraged greater consolidation within the financial sector and the proliferation of complex financial instruments known as derivatives. As early as 1997, concerns were raised about the growth of collateralized debt obligations (CDOs), derivatives that pooled together millions of subprime mortgages and divided their income streams in complex ways.[39] Rather than reducing risk, the process of securitization served to increase risk throughout the financial system. CDOs and other such derivatives transformed the local risks of subprime lending into a far wider global and systematic problem. As the size of the subprime mortgage market grew, some officials became increasingly concerned. In 2000, Edward Gramlich, a Federal Reserve governor, proposed to Greenspan that the Fed use its discretionary authority to send bank examiners to the offices of such lenders. But Greenspan was opposed, and Gramlich never brought his concerns to the full Federal Reserve Board.[40]

By June 2005, *The Economist* was referring to the U.S. housing bubble as "the largest financial bubble in history."[41] The debt of American households was climbing nearly twenty percent a year, the savings rate had fallen below zero, and the cash being pulled out of homes from mortgage refinancing had reached about five percent of GDP, creating a bubble in consumer spending, imported goods, and the value of the dollar itself.[42] Fully one out of every five new mortgages in the United States was subprime. Greenspan has recently claimed that when he was informed of this alarming statistic in 2005, his original response was that he did not believe the number: "It became a huge revelation."[43]

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[38] These arguments were made by officials within both the Clinton and Bush II administrations. *See, e.g.*, David Streitfeld & Gretchen Morgenson, *Building Flawed American Dreams*, N.Y. Times, Oct. 19, 2008, at A1; Jo Becker, Sheryl Gay Stolberg, & Stephen Labaton, *White House Philosophy Stoked Mortgage Bonfire*, N.Y. Times, Dec. 21, 2008, at A1.

[39] Frank Partnoy, Fiasco: The Inside Story of a Wall Street Trader 124–25, 172–76 (1999); *See generally* Evan M. Gilreath, *The Entrance of Banks into Subprime Lending: First Union and The Money Store*, 3 N.C. Banking Inst. 149, 152–54 (1999); Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 Creighton L. Rev. 503 (2002).

[40] Paul Krugman, *A Catastrophe Foretold*, N.Y. Times, Oct. 26, 2007, at A25.

[41] *In Come the Waves: The Global Housing Boom*, Economist, June 16, 2005, at 66–68.

[42] Timothy A. Canova, *Legacy of the Clinton Bubble*, Dissent, Summer 2008, at 47.

[43] *House of Cards* (CNBC broadcast Feb. 12, 2009), *available at* http://hnn.us/roundup/comments/67377.html. In fact, Greenspan may have missed the significance of the housing bubble as late as September 2005. *See* Edmund L. Andrews, *Most Homeowners Not Overly in Debt, Fed Chief Says*, N.Y. Times, Sept. 27, 2005, at C1 (Greenspan stating: "The vast major-

Since the collapse of the housing bubble, there has been much criticism of the Fed's easy monetary policy and the low interest rates that had fueled the rise in housing prices throughout the past two decades.[44] There has been far less attention paid to the Fed's ideological hostility to selective credit controls, which could have prevented the growth in all of these bubbles. Although Greenspan testified to Congress in the middle of the financial panic of October 2008 that he had discovered a flaw in his model of how the world works,[45] he remains unwilling to consider the use of margin requirements as a tool to prevent housing bubbles by preventing the growth of a large subprime mortgage market.[46]

In the aftermath of the crash, there has been a lively debate between monetary economists on the question of how housing and other asset bubbles can best be avoided. One school of thought says that central banks should stop the growth of asset bubbles by raising interest rates[47]—a blunt general monetary policy instrument that inflicts damage indiscriminately through higher foreclosure and bankruptcy rates.[48] Others say that central banks should not attempt to stop asset bubbles because regulators are incapable of knowing when market prices are too high.[49] Neither school of thought appears to have seriously considered the use of selective credit controls as a way to prevent unsustainable bubbles in the first place by deterring the overleveraging of assets.[50]

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ity of homeowners have a sizable equity cushion with which to absorb a potential decline in house prices.").

[44] *See, e.g.*, John B. Taylor, Op-Ed, *How Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, at A19; Brian M. Carney, *Bernanke Is Fighting the Last War*, WALL ST. J., Oct. 18–19, 2008, at A11.

[45] Edmund L. Andrews, *Greenspan Concedes Flaws In Deregulatory Approach*, N.Y. TIMES, Oct. 24, 2008 at B1. *See also Obamanomics: Is This Real Change?*, (Real News Network internet video posted Nov.25, 2008), *available at* http://therealnews.com/t/index.php?option=com_content&task=view&id=31&Itemid=7&jumival=2852 (at 4:22 into the video).

[46] According to Greenspan, "The presumption that you could incrementally defuse a bubble was a fantasy." *House of Cards*, *supra* note 43. *See also* Alan Greenspan, Op-Ed., *The Fed is Blameless on the Property Bubble*, FIN. TIMES, Apr. 7, 2008, at 11 (claiming the Fed was powerless to "lean against the wind" or eliminate asset bubbles).

[47] *See, e.g.*, Paul De Grauwe, Op-Ed., *Central Banks Should Prick Asset Bubbles*, FIN. TIMES, Nov. 2, 2007, at 9.

[48] *See* Justin Lahart, *Fed Rethinks Stance on Popping Bubbles*, WALL ST. J., Oct. 17, 2008, at A4 (recognizing the dangers of fighting asset bubbles by raising interest rates, "a blunt instrument with economy-wide effects," and reporting Fed officials as leaning toward regulating financial firms "with more focus on how they are contributing to risk throughout the financial system").

[49] *See, e.g.*, Arthur Levitt, Op-Ed., *You Can't Control Animal Spirits*, WALL ST. J., Aug. 5, 2008, at A19; Gerald P. O'Driscoll Jr., Op-Ed., *To Prevent Bubbles, Restrain the Fed*, WALL ST. J., Nov. 17, 2008, at A19. *But cf.* Kevin J. Lansing, *Asset Price Bubbles*, FRBSF ECONOMIC LETTER, Oct. 26, 2007, at 1 (arguing for quantitative economic models to determine when asset prices have strayed above fundamentals, but silent as to policy tools to prevent rise in asset prices).

[50] *See, e.g.*, Lansing, *supra* note 49 (silence regarding policy tools to prevent rise in asset prices).

As explained above, this blind spot has its costs. For too long, policymakers have relied on one general policy instrument to solve all problems—the adjustment of short-term interest rates. This has been like driving a car with only an accelerator and a brake, lowering interest rates to spur economic growth, then raising interest rates to slow inflation, and all the while inflating asset bubbles in housing and stock prices, and then bursting those bubbles. Throughout the past two decades, this approach has undermined all three of Lerner's main policy objectives. The cycles of inflating and then deflating asset bubbles have coincided with and exacerbated the booms and busts of the business cycle, thereby contributing to persistently high levels of unemployment and underemployment[51] and the most top-heavy distribution of income since the stock market crash of 1929.[52] Meanwhile, the financial industry has become more consolidated, enabling it to capture regulatory agencies and to engage in monopolistic exploitation of consumers and homebuyers. Keynes' and Lerner's economics of control were replaced by the out-of-control economics of unsustainable debt-fueled bubbles.

All of the major players in the subprime fiasco were regulated, but according to Lerner's schematic, they were regulated in haphazard and uncoordinated ways. Lenders, brokers, appraisers, bankers, bond insurers, ratings agencies, and financial engineers of mortgage-backed securities were subject to various licensing and reporting requirements and to some degree of oversight, but often these were requirements that suited their own purposes, such as limiting competition from potential entrants into their markets. What was missing was an economics of control specifically designed to contribute to the objectives of full employment, equitable distributions of income, and the containment of systematic risk—objectives which, by the 1990s, were considered either outdated or outside the province of government planning.

III. The Introduction of Risk-Based Capital Standards

The post-war Keynesian model of financial regulation, based in large part on the use of selective credit controls, gradually gave way to deregula-

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[51] Much unemployment and underemployment is hidden and no longer reported in official government statistics.*See* Joseph Rosta, *U.S. Government Data Needs a Redo*, U.S. Banker, Feb. 1, 2009, http://www.americanbanker.com/usb_article.html?id=20090126NYI3ZJ30 (quoting author that the U-7 measure of underemployment, which used to include discouraged workers and part-time workers unable to find full-time employment, was politically unpalatable and discontinued by the Bureau of Labor Statistics in January 1994).

[52] Jesse Drucker, *Richest See Income Share Rise*, Wall St. J., July 23, 2008, at A3 (richest one percent of Americans had the highest share of the nation's adjusted gross income for two decades, and "possibly the highest since 1929," according to Internal Revenue Service data); Meteor Blades, *Wall Street. Main Street. Why No Mention of Side Streets and Alleys?*, Daily Kos, Oct. 26, 2008, *available at* http://www.dailykos.com/storyonly/2008/10/26/202810/29 (discussing slide in U.S. real wages and increase in the Gini coefficient measure of income inequality in the U.S.); Anton Troianovski, *Majority of Jobless in U.S. Don't Get Benefits*, Wall St. J., July 29, 2008, at A4 (reporting that only thirty-seven percent of unemployed received benefits in 2007, down from fifty-five percent in 1958).

tion. Policymakers came to rely instead on general monetary measures as a response to the asset bubbles that formed in the wake of financial deregulation. Meanwhile, beginning in the 1990s, risk-based capital requirements largely replaced margin requirements as the primary regulatory tool for ensuring the strength of financial institutions and containing systematic risk. In other words, instead of limiting risk through margin requirements at the initial lending stage by requiring borrowers to post collateral, the new regulatory regime permitted all kinds of risky loans to be made and then sought to contain the risk by requiring banks to keep sufficient capital in reserve. Although it was not so apparent at first, this represented a transition from command-and-control margin requirements to self-regulation, as banks were able to set their own risk-based capital standards.

Capital adequacy rules were supposed to ensure that financial institutions would have sufficient invested capital on hand to absorb likely losses.[53] The capital that banks were required to keep in reserve ranged from equity issued by banks to long-term debt and other financial instruments. The amount of capital required to be held in reserve would vary depending on the nature of a particular asset, with riskier assets requiring more capital in reserve. The measurement of risk, therefore, would become crucial to determine whether a bank had sufficient capital in reserve. But regulators began to allow banks to rely on their own mathematical calculations to measure the riskiness of their assets and thus effectively to set their own capital requirements.[54] The banks' mathematical models often gave only the illusion of safety by measuring the boundaries of risk over short durations and assuming a "normal" market.[55] With regulators asleep at the wheel, the banks themselves had every incentive to under-measure the risk of their assets, and thereby keep less capital in reserve.

Economists and policymakers failed to learn from history that their risk models were unrealistic. Greenspan would later testify that he "did not forecast a significant decline [in the housing market] because we had never had a significant decline in prices."[56] He was apparently not aware of the enor-

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[53] Peter Moles & Nicholas Terry, The Handbook of International Financial Terms (1997), at 40–41, 71 (defining "Basle [sic] Capital Convergence Accord" and "capital adequacy," respectively).

[54] This was done by the Basel Committee on Banking Supervision, the international body that governs how banks set their capital requirements through an accord known as Basel II. *See generally* Jeffery Atik, Basel II and Extreme Risk Analysis (Feb. 13, 2009) (working paper for American Society of International Law, International Economic Law Research Colloquium, UCLA School of Law), *available at* http://www.asil.org/files/atik.pdf; Joe Nocera, *Risk Management*, N.Y. Times, Jan. 4, 2009, § 6 (Magazine), at 24.

[55] *See* Nocera, *supra* note 54. Ida Hoos criticized the technical focus of traditional systems analysis: "A kind of quantomania prevails in the assessment of technologies. What cannot be counted simply doesn't count, and so we systematically ignore large and important areas of concern." Ida R. Hoos, *Societal Aspects of Technology Assessment*, 13 Technological Forecasting and Soc. Change 191, 193 (1979).

[56] Tim Rutten, Op-Ed., *What the Oracle Didn't See*, L.A. Times, Oct. 25, 2008, at A23 (quoting Greenspan testimony to a House committee). *See also* Alan Greenspan, Op-Ed., *We Will Never Have a Perfect Model of Risk*, Fin. Times, March 17, 2008, at 9 (claiming risk

mous drop in housing prices between 1929 and 1931[57] and therefore did not consider the possibility of significant housing price declines in his model.

Similarly, credit rating agencies like Moody's, Standard & Poor's, and Fitch routinely gave high ratings to mortgage-backed securities[58] by estimating low delinquency rates on the underlying mortgages, basing their calculations on a relatively short view of historical performance. The ratings agencies, like the banks, determined their risk-based mathematical models by looking through a rearview mirror to determine future performance; but the rearview mirror reflected constantly rising housing prices and inflated appraisals, conditions that could not possibly last.[59]

Some banking and finance experts have proposed making bank capital requirements contra-cyclical by relating the capital adequacy requirements to the rate of change of bank lending and asset prices in relevant sectors, such as changes in mortgage lending and housing prices.[60] These experts claim that the contra-cyclical approach would build up capital reserves and restrain bank lending during asset price booms while encouraging bank lending during asset price deflations. A final benefit of this approach would be "to reduce pressure from the financial system for central banks to adjust monetary policy in the heat of the moment"[61]—or, in other words, to reduce the need for the Fed to step on either the brake or the accelerator in a crisis.

But others criticize this proposal because it could be extremely difficult to determine the proper cyclical indicator for a particular security held by a financial institution.[62] For example, if tranches of a CDO[63] included parts of mortgage loans pooled from widely varied geographic locations, some from markets where housing is booming and others where housing is relatively

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management systems can never anticipate wild swings between euphoria and fear, and therefore what's needed is market flexibility and open competition).

[57] *See.* Keynes, *supra* note 9, at 174–75 (reporting steep declines in the U.S. in farm values, urban properties, and housing, down thirty to forty percent across the board, an immense problem because "such property is ordinarily regarded as relatively free from risk").

[58] *See generally* Moles & Terry, *supra* note 53, at 361 (defining mortgage-backed security as a "security issued on the basis of a share in a group (or pool) of mortgages or trust deeds").

[59] As a result of its flawed ratings, Moody's had to downgrade more than five-thousand securities in 2007 alone. *See* Mathew Padilla, *Did the Agencies Rating Mortgage Bonds Let Greed Trump Common Sense?*, Orange County Reg. (Cal.), May 10, 2008, *available at* http://mortgage.freedomblogging.com/2008/05/10/did-the-agencies-rating-mortgage-bonds-let-greed-trump-common-sense/.

[60] *See, e.g.*, Charles Goodhart & Avinash Persaud, Op-Ed, *A Proposal for How to Avoid the Next Crash,* Fin. Times, Jan. 31, 2008, at 9 (discussing the Basel II capital adequacy regime).

[61] *Id.*

[62] *See* Charles Freeland, Letter to the Editor, *Basel II a Big Improvement on Outdated Model*, Fin. Times, Feb. 7, 2008, at 10. Freeland is a former deputy secretary general of the Basel Committee on Banking Supervision.

[63] A CDO is a type of mortgage-backed bond where ownership of the mortgages have been sold to individual investors and the repayments of principal and interest are separated into different maturity streams, known as tranches. *See* Moles & Terry, *supra* note 53, at 91 (defining "collateralized mortgage obligation"), 361 (defining "mortgage-backed security"), and 560 (defining "tranche").

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weaker, it would be impractical to link the required capital reserve to housing prices.

Some liberal legal scholars have suggested a second alternative to the use of margin requirements for containing risk in the financial markets, namely the creation of so-called "suitability claims" against financial institutions for predatory lending in the markets for housing and consumer loans.[64] But suitability claims would be a way of shifting losses, not necessarily preventing losses. This litigation approach would also require a case-by-case determination of when a particular loan was not suitable to the needs of a particular borrower. A bright line rule would be more effective: adjustable rate mortgages with no minimum down payment requirements should be seen as inherently unsuitable for borrowers, and inherently unstable for the financial system. Like an unsafe vehicle, they should simply be prohibited from the highway of commerce.

A third alternative to margin requirements would be to require greater transparency in underlying mortgage loans and perhaps for investment banks and hedge funds involved in creating and trading mortgage-backed securities.[65] But it is unclear how disclosure would dissuade borrowers from staking bets on the movement of asset prices during the boom stages of a bubble. There was already plenty of disclosure to borrowers mandated through Truth in Lending regulations and to purchasers of securities through federal securities disclosure requirements.[66] With no minimum down payment requirements, a significant percentage of the underlying mortgage loans will always be suspect and inherently unstable.[67]

Margin requirements are the best way to remedy this situation, by ensuring that borrowers are credit-worthy, have sufficient savings, and are not over-leveraged in their borrowing. This will strike some liberal scholars as overly paternalistic, as the logic of margin requirements suggests that mortgages and loans for autos and other large consumer purchases should not be made in the first place to borrowers with limited resources. But in the end, there really is no risk-based substitute, nor litigation nor disclosure substitute, for selective credit controls—the traffic lights and speed limits and other safety standards that keep some cars off the road. Minimum down payment requirements will keep most of the riskier borrowers from taking

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[64] *See* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255, 1317–39 (2002).

[65] *See* Richard H. Thaler & Cass R. Sunstein, Op-Ed., *Disclosure Is the Best Kind of Credit Regulation*, Wall St. J., Aug. 13, 2008, at A17; Richard Thaler & Cass Sunstein, Op-Ed., *Human Frailty Caused This Crisis*, Fin. Times, Nov. 12, 2008, at 11; Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. Chi. L. Rev. 1159 (2003).

[66] *See* Truth in Lending Act, 15 U.S.C. §§ 1601-1667f (2006); *see also* Engel & McCoy, supra note 64, at 1334–35 (arguing that disclosure is inadequate since it fails to mandate precise and essential information, and thereby fails to provide adequate protection to investors).

[67] *Cf.* Alan M. White, *The Case for Banning Subprime Mortgages*, U. Cin. L. Rev. (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133609.

on debts that they likely cannot afford. Moreover, with selective credit controls, when bank lending and housing prices in particular regions escalate too much too quickly, bank regulators could simply clamp down by raising minimum down payment requirements and restricting the use of adjustable interest rates and balloon payments. Such regulation would mean fewer mortgage loans for marginal borrowers, but it would also reduce the systematic risks facing the financial system.

IV. Agency Capture and Revolving Doors

The failure of regulatory policy and the headlong rush into deregulation was the natural consequence of major institutional flaws. Several factors have contributed to the capture of key federal regulatory agencies by the nation's financial services industry. One of these is the so-called "revolving door," the tendency of regulatory officials to leave their government posts for lucrative positions in the private financial industry. The movement of key personnel back and forth between regulators and regulated has become incestuous. Policy naturally comes to reflect the bargain of the moment between the most powerful private interests.

For instance, in 2003 and 2004, the biggest Wall Street investment banks, led by Henry Paulson, then the head of Goldman Sachs, lobbied the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) for a number of key regulatory changes. The SEC commissioners unanimously granted the banks an exemption from the net capital rule, thereby permitting their brokerage units to transfer their reserves up to their parent companies and enabling the banks to invest more funds in mortgage-backed securities, credit derivatives, and other exotic financial instruments.[68] Meanwhile, the FASB, with SEC acquiescence, ruled that these same banks could use off-balance-sheet entities to evade capital requirements for these same asset-backed securities.[69] As a result of these two regulatory changes, the nation's largest investment banks were able to hide massive holdings of toxic assets, such as commercial and residential mort-

[68] *See* Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. Times, Oct. 3, 2008, at A1.

[69] See *Corporate Accounting Practices: Is There a Credibility GAAP?: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Fin. Services*, 107th Cong. 152–63, 293 (2002) (testimony of Robert K. Herdman, Chief Accountant, SEC). Reagan era financial deregulation foreshadowed the hiding of worthless assets through phony accounting, the lifting of capital requirements and overleveraging of financial institutions, and the bailout of those same institutions. For instance, in 1981 the Reagan administration sat idly by as the Federal Reserve authorized U.S. financial institutions to establish International Banking Facilities as bookkeeping entities to attract offshore deposits. IBFs were exempt from various federal regulations, including reserve requirements, federal deposit insurance requirements, and interest rate ceilings. Canova, *supra* note 30, at 1308.

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gage-backed securities containing subprime mortgages made without margin requirements.[70]

The role of Henry Paulson illustrates how the revolving door spins both ways. Paulson succeeded in his efforts to allow Goldman Sachs and other financial institutions to hide their toxic assets by excluding them from their balance sheets, to evade capital requirements, and to use their reserves to become over-leveraged—in effect, to perpetuate a giant fraud on investors and the public alike. He then moved on to become Treasury secretary, from which position he was able to help prop up these same investment banks, eventually through the Troubled Asset Relief Program (TARP).[71] Paulson's pattern of behavior was consistent with theories of "control fraud," which suggest that defrauders will use corporate and other entities to engage in massive frauds, and then use their control over the same corporate entities and the agencies of government to cover their tracks and hide their malfeasance.[72]

Paulson's path through the revolving door was paved by others who had jumped from top Wall Street positions into top posts in previous administrations. Robert Rubin, for example, was the head of Goldman Sachs before becoming a top White House advisor and then Treasury secretary in the Clinton administration. He then returned to the private sector, joining Citigroup's top management. While he worked in the Clinton administration, Rubin influenced policy to the benefit of the short-term interests of the financial industry and in ways that would undermine the stability of the financial system. For instance, even as Rubin was negotiating to step down from his position as Treasury secretary and become co-chair of Citigroup with a lucrative compensation package, he was taking part in the lobbying effort that culminated in the Gramm-Leach-Bliley Financial Services Modernization Act of 1999.[73] This Act swept aside significant portions of the Glass-Steagall Act,[74] an early New Deal measure that created regulatory firewalls to keep commercial banks and insurance companies out of the riskier busi-

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[70] *See* Alan Reinstein et al., *Consolidation of Variable-Interest Entities: Applying the Provisions of FIN 46(R)*, CPA J., Aug. 1, 2006, at 28; Pierre F. de Ravel d'Esclapon, FASB Interpretation No. 46, An Overview (Feb. 10, 2004); Press Release, SEC, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008), *available at* http://www.sec.gov/news/press/2008/2008-234.htm.

[71] *See* Greg Ip, *Fed Balance Sheet Worries Volcker*, WALL ST. J., May 15, 2008, at A3.

[72] *See* WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE (2005); William K. Black, *Control Fraud and Control Freaks*, *in* CONTEMPORARY ISSUES IN CRIME AND CRIMINAL JUSTICE 67–80 (Henry N. Pontell & David Shichor eds., 2000); William K. Black, *"Control Frauds" as Financial Super-Predators: How "Pathogens" Make Financial Markets Inefficient*, 34 J. OF SOCIO-ECONOMICS 734 (2005); William K. Black, *Control Fraud as an Explanation for White-Collar Crime Waves: The Case of the Savings & Loan Debacle*, 43 CRIME, L. & SOC. CHANGE 1 (2005).

[73] Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12 U.S.C.).

[74] *See* Keith Bradsher, *Rubin's Plan for Banking Spurs Fight*, N.Y. TIMES, Feb. 28, 1995, at D1 (reporting Rubin's early attempt to abolish the Glass-Steagall Act).

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ness of investment banking.[75] Until these provisions of Glass-Steagall were repealed, Citigroup had faced the possibility of having to sell off its Travelers Insurance underwriting subsidiary.[76]

At the time, Rubin openly boasted of his lobbying efforts on behalf of the 1999 deregulation measures, though he later backtracked by claiming that his role was limited to urging preservation of Community Reinvestment Act (CRA) provisions in the final bill.[77] Nevertheless, the Clinton Justice Department never brought charges against Rubin for violating the Ethics in Government Act.[78] In fact, some of those who warned against gutting the Glass-Steagall Act were punished. John Moscow, the New York Federal Reserve Bank's deputy general counsel, was forced to resign after warning that the results of combining the prudential culture of commercial banking and insurance with the risk-taking culture of securities "could be catastrophic" and that there was not a regulator capable of fully monitoring the multi-state, multi-national full-service financial giants that would result from repeal of Glass-Steagall.[79]

The case of Robert Rubin may seem more egregious than most, with its revolving door from Goldman Sachs to the White House to Treasury to Citigroup, coinciding with his involvement in gutting the Glass-Steagall Act to the benefit of his future employment and a sanctimonious defense of his actions. But the dynamic at play in the cases of Paulson and Rubin has become all too routine in the world of financial regulation, and it has helped to foster a group-think mentality—an echo chamber—within the top echelons of decision-making.

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[75] *See* Joseph Kahn, *Former Treasury Secretary Joins Leadership Triangle at Citigroup*, N.Y. Times, Oct. 27, 1999, at A1.

[76] *See id.* With the demise of the Glass-Steagall firewalls, banks were free to load up on riskier investments, including CDOs and other mortgage-backed securities, through affiliated entities such as their own hedge funds and other special investment vehicles. The old Regulation W that had authorized margin requirements for consumer credit was re-written to cover the transactions between banks and their securities affiliates. The old Regulation W was directed to the safety and soundness of lending, and was prudential and preventive in nature. The new Regulation W was now directed to the opaque transactions between affiliates within financial conglomerates, and its approach was more akin to monitoring problems only after the horse has left the barn. *See* Canova, *supra* note 42, at 46.

[77] *See* Kahn, *supra* note 75, at C15.

[78] *See* Joseph Kahn, *Consumer Groups Seek Ethics Inquiry on Rubin's New Job*, N.Y. Times, Nov. 18, 1999, at C17.

[79] *See* John W. Moscow, Op-Ed, *Bigger Banks, Bigger Problems*, N.Y. Times, June 28, 1995, at A19 (warning that "what we do not have is an agency capable of overseeing the monster companies that would follow the repeal of Glass-Steagall"); Peter Truell, *New York Fed Official Resigns Over Article in The Times*, N.Y. Times, July 21, 1995, at B6. Those in favor of deregulation, such as Charles Calomiris and David Leonhardt, claim that the gutting of Glass-Steagall has allowed large financial firms to merge and come to each other's rescue, and thereby to act as stabilizers when the financial system went into crisis in 2008. Charles W. Calomiris, Op-Ed., *Most Pundits are Wrong About the Bubble*, Wall St. J., Oct. 18, 2008, at A13; David Leonhardt, *Washington's Invisible Hand*, N.Y. Times, Sept. 28, 2008, § MM (Magazine), at 32. But it was the Federal Reserve and the federal taxpayer that ultimately had to come to the rescue of even these financial behemoths.

The revolving door is now sometimes less visible than in the past, as former regulatory officials, former members of Congress, and even former presidents have begun moving seamlessly into unregistered and unregulated hedge funds, either managing such funds or simply parking their financial holdings there. For instance, when the Long-Term Capital Management (LTCM) hedge fund suddenly melted down in October 1998, it was revealed that a former vice chairman of the Federal Reserve Board was among its top partners.[80] Likewise, Larry Summers was a managing director for D.E. Shaw & Co., one of the nation's largest and most successful hedge funds, before becoming a top economic advisor to President Obama.[81] Perhaps it should not be a surprise that the Obama administration's attempt to revamp TARP has produced a murky plan to spend as much as two trillion dollars to guarantee purchases by hedge funds of unmarketable mortgage-backed assets from the nation's largest financial institutions, with the prices set by the hedge funds themselves.[82]

Rubin and other policymakers with Wall Street ties also played a significant role in the deregulation of derivatives, those complex financial instruments whose values are derived from other underlying assets or indices.[83] Throughout the 1990s, there were periodic calls for extending capital requirements to derivatives, but these attempts were stymied by Greenspan, Rubin, and Summers,[84] and in his final weeks in office, Bill Clinton signed into law the Commodity Futures Modernization Act of 2000, which shielded the market for derivatives from federal regulation. Rubin has since denied wrongdoing, claiming that he supported regulating derivatives but saw no way of doing so since all the forces in the industry were arrayed against it. But Michael Greenberger, who was a senior director at the Commodity Futures Trading Commission (CFTC) at the time, has argued that the political climate would have been different had Rubin, the Treasury secretary, called for regulation.[85]

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[80] *See* Judith H. Dobrzynski, *the Markets Are Back. But More Problems Await*, N.Y. TIMES, Oct. 14, 2001, at C1 (noting that former Fed vice chairman David W. Mullins, Jr. was among Long-Term Capital Management's partners).

[81] *See* Eamon Javers, *Summers Has Ties to Prominent Hedge Fund*, POLITICO, Nov. 28, 2008, http://www.politico.com/news/stories/1108/15995.html.

[82] *See* Krishna Guha & Alan Beattie, *$2,000bn Financial Clean-Up*, FIN. TIMES, Feb. 11, 2009, at 1 (reporting plan to create Public Private Investment Fund to buy up to $1 trillion of toxic assets "at prices established by private co-investors"); Edmund L. Andrews, Eric Dash, & Graham Bowley, *Toxic Asset Plan Foresees Big Subsidies for Investors*, N.Y. TIMES, Mar. 21, 2009, at A1.

[83] On the danger of derivatives generally, see BBC News, Buffett Warns on Investment 'Time Bomb', Mar. 4, 2003, http://news.bbc.co.uk/1/hi/business/2817995.stm (containing Warren Buffett's description of derivatives as "financial weapons of mass destruction").

[84] *See* Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A1 (reporting how Greenspan, Rubin, and Summers undermined the efforts of Brooksley Born, head of the Commodity Futures Trading Commission (CFTC), when she sounded the alarm about unregulated derivatives in 1997 and again after the meltdown of Long-Term Capital Management).

[85] *See id.*

Without margin or capital requirements on derivatives, these complex instruments have grown in size and become gigantic wagers on the credit-worthiness of major companies and the movement of interest rates, commodity prices, and currency values.[86] Today the notional amount (face value) of the credit default swap (CDS) market is roughly forty-five trillion dollars—about half the total U.S. household wealth; five times the national debt; and more than three times the U.S. gross national product, the total sum of all goods and services produced annually in the United States.[87] The notional amount of interest rate derivatives and exchange rate derivatives is even more mind-boggling, at more than $500 trillion and growing, approaching the disturbing milestone of one quadrillion dollars.[88] These speculative bets have indeed become the tail wagging the dog. As Keynes famously wrote in *The General Theory:*

> Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirl-pool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.[89]

Unfortunately, it is not possible to conclude with any certainty that "but for" any particular regulatory reform the current financial crisis could have been averted. However, it is likely that a coordinated regulatory scheme in accordance with the economics of Keynes and Lerner would have provided substantial protection to the stability of the financial system. But perhaps it should not be a surprise that, instead of an economics of control, we now have an economy out of control. The officials who have been responsible for designing our financial regulatory system are so often only a revolving door away from reaping the rewards of unregulated speculation.

V. The Bastard Keynesianism of the Bailout

The British economist Joan Robinson, who worked with Keynes, first coined the term Bastard Keynesianism to refer to a narrow interpretation of Keynes's *General Theory* that ignores the larger Keynesian regulatory framework and reduces Keynesian principles to an embrace of short-run

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[86] In the 1990s, as chair of the House Banking Committee, the late Henry B. Gonzalez had warned that the Federal Reserve was creating a giant casino economy supported by a "monstrous bubble." Canova, *supra* note 42, at 41.

[87] *See* George Soros, Op-Ed., *The False Belief at the Heart of the Financial Turmoil,* Fin. Times, Apr. 3, 2008, at 15.

[88] *See* Paul B. Farrell, *Derivatives the New 'Ticking Bomb': Buffett and Gross Warn: $516 Trillion Bubble Is a Disaster Waiting to Happen*, Market Watch, Mar. 10, 2008, *available at* http://www.marketwatch.com/story/derivatives-are-the-new-ticking-time-bomb.

[89] Keynes, *supra* note 3, at 159.

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countercyclical stabilization through monetary and fiscal stimulus.[90] Lynn Turgeon later expanded on Robinson's description to classify those who would use Keynesian analysis to justify fiscal stimulus while departing from other important Keynesian policy goals.[91] For instance, Commercial Keynesians pursue fiscal stimulus as Keynes prescribed, but by favoring tax-cutting fiscal stimulus over public investment they often depart from such key Keynesian objectives as better income distributions. The current orthodoxy in Washington and on Wall Street resembles a Bastard Keynesian approach to financial regulation: it focuses on monetary and fiscal stimulus while missing the significance of other aspects of Keynesian analysis, most particularly its emphasis on an economics of control.[92] Perhaps it would be fair to label today's Bastard Keynesians "Wall Street Keynesians" because of their emphasis on policies that will help the financial elite rather than investing in jobs and income support for the largest sectors of the polity. The current economic recovery program, centered on the financial bailout described below, is a typical product of their approach.

A. *A Bailout for Wall Street Before Main Street*

The Troubled Assets Relief Program (TARP) is a prime illustration of the current uncoordinated approach to regulation. It is without clear objectives or sufficient transparency. From the beginning, the program has been administered by officials almost straight from Wall Street. Paulson chose Neel Kashkari, his former lieutenant at Goldman Sachs, to head the new Office of Financial Stability and administer the $700 billion program.[93] Similarly, Timothy Geithner moved directly from his position as head of the New York Federal Reserve Bank to Treasury secretary. He chose Mark Patterson, a top lobbyist at Goldman Sachs, to serve as his chief of staff, which required an immediate exemption from President Obama's new lobbying ethics rules.[94]

The ongoing operation of the revolving door in the Obama administration suggests that many of the problems discussed above will continue, in particular the tailoring and administration of financial regulatory policy to

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[90] *See generally* Amitava Krishna Dutt, *Joan Robinson*, in An Encyclopedia of Keynesian Economics 554, at 556 (Thomas Cate ed., 1997) (reporting Bastard Keynesianism as an interpretation of *The General Theory* as simply an "economics of disequlibrium" and a tendency of neoclassical economics to interpret equilibrium as the outcome of a process and its use of the mechanical concept of logical time).

[91] *See* Lynn Turgeon, Bastard Keynesianism: The Evolution of Economic Thinking and Policymaking since World War II (1996). Turgeon also characterized those who seek fiscal stimulus based on defense spending and constructing prisons rather than creating a full-employment economy as military-Keynesians and penal-Keynesians, respectively.

[92] *See* Interview by Chris Wallace with Barack Obama, President of the United States, in Marion, Ind. (Fox News television broadcast Apr. 27, 2008), *available at* http://www.foxnews.com/story/0,2933,352785,00.html.

[93] David Cho, *Paulson Advisor to Oversee Rescue*, Wash. Post, Oct. 6, 2008, at A12.

[94] *See* T.W. Farnam, *Ethics Order Affects Aide to Geithner*, Wall St. J., Jan. 28, 2009, at A4.

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serve the narrow interests of Wall Street, rather than the public interests of Main Street. For example, within three months of Kashkari's appointment, the Congressional Oversight Panel headed by Harvard Law professor Elizabeth Warren released a report that TARP had overpaid at least $78 billion to Wall Street banks and financial institutions for stocks and other assets.[95] Meanwhile, the banks receiving TARP money continued paying large compensation packages to their executives and dividends to shareholders, including foreign shareholders.[96]

One stated objective of TARP is to get banks to lend to businesses and consumers again. But its approach is trickle down, injecting funds into banks while ignoring the deterioration of the real economy and the rising tide of mortgage foreclosures, bankruptcies, and defaults at the base of the credit pyramid.[97] In short, it is an approach that has ignored the fundamental Keynesian lessons that mass purchasing power must be maintained in the middle class by promoting high employment and an equitable distribution of income.

The disregard of Keynesian insights is replicated in the legal academy. For instance, Lucian Bebchuk has written about credit market failure simply as the result of banks' irrational lack of confidence in the lending of other banks.[98] Bebchuk's approach could marginalize rational concerns about the declining financial prospects of borrowers due to recessionary economic conditions. He assumes that there are "good projects" not being financed simply because of a somewhat technical "coordination failure" among fi-

[95] *See Regulator Says Bailout Fund is Misleading the Public*, N.Y. Times, Feb. 6, 2009, at B2.

[96] *See* Ben White, *What Red Ink? Wall Street Paid Hefty Bonuses*, N.Y. Times, Jan. 28, 2009, at A1 (reporting financial industry executive bonuses of $18.4 billion); Binyamin Appelbaum, *Banks to Continue Paying Dividends*, Wash. Post, Oct. 30, 2008, at A1 (reporting that U.S. banks receiving $163 billion in TARP funds were paying shareholders about $7 billion in the 4th quarter of 2008); William Patalon III *How Are Banks Spending Bailout Money? Anyone's Guess*, Seeking Alpha, Jan. 6, 2009, http://seekingalpha.com/article/113464-how-are-banks-spending-bailout-money-anyone-s-guess (citing Associate Press survey of twenty-one banks receiving at least one billion dollars in TARP funding, with the biggest banks refusing to disclose information on how the money was spent).

[97] *See* David Enrich et al., *Bank Lending Keeps Dropping*, Wall St. J., April 20, 2009, at A1, *available at* http://online.wsj.com/article/SB124019360346233883.html (concluding, according to analysis of Treasury Department data, that the biggest recipients of TARP aid made or refinanced twenty-three percent less in new loans in February 2009 than in October 2008); *Business Digest: Lending Declines at Bailed-Out Banks*, Wash. Post, June 16, 2009, at A14, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/06/15/AR2009061503066_2.html (reporting that the value of loans held by the 21 largest financial institutions receiving TARP support fell in April 2009 by 0.8 percent from the previous month, the fifth decline in six months, and that consumer lending fell one percent during the same period); Peter S. Goodman and Jack Healy, *Job Losses Push Safer Mortgages to Foreclosure*, N.Y. Times, May 25, 2009, at A1, *available at* http://www.nytimes.com/2009/05/25/business/economy/25foreclose.html.

[98] *See* Lucian A. Bebchuk, *Unfreezing Credit Markets*, (Jon M. Olin Ctr. for Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 622, 2008), *available at* http://papers.ssrn.com/abstract=1315436.

nancial institutions.[99] Although he supports government financing and loan guarantees for bank lending, Bebchuk's approach could prove ineffective precisely because it does nothing to firm up declining aggregate demand.

The financial bailout approaches of both the Bush and Obama administrations have suffered the same deficiencies. They have pumped trillions of dollars into failing banks and financial markets but without receiving adequate control over their operations. For instance, without any seats on the boards of these financial institutions, the federal government has lacked the ability to command or control any changes in management policies, including the payment of obligations to counterparties on derivative contracts, bonuses to executives, and dividends to shareholders.[100] TARP's shortcomings illustrate that the ideological resistance to an economics of control—the same market fundamentalist ideology that helped create the financial crisis—is now impeding recovery.

B. A Crisis in the Rule of Law

The institutional flaws of the present regulatory system are profound. As predicted by public choice theories, special interests—the financial institutions themselves—have largely captured the most important regulatory agencies, thereby ensuring that regulation will be uncoordinated and ineffective.[101] While TARP has received the lion's share of public scrutiny, a larger and more significant bailout has been proceeding off the Treasury's balance sheet, through the Federal Reserve System. Throughout 2008, the Fed stumbled from one subsidy to another, granting them first to its commercial banking constituency, then to investment banks that were not even members of the Federal Reserve System, and finally to the money markets themselves.[102]

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[99] *See* Lucian Bebchuk & Itay Goldstein, *Self-fulfilling Credit Market Freezes* (John M. Olin ctr. For Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 623, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1315462#.

[100] Contrast the U.S. bailout approach with Sweden's 1992 bank bailout. *See* Peter Thar Larsen & Chris Giles, *Self-assembly Solution*, FIN. TIMES, March 18, 2009, at 8 (quoting Arne Berggren, Sweden's finance ministry official responsible for its bank restructuring: "'We were a no-bullshit investor—we were very brutal.' The authorities also insisted on *control*. 'You take *command*. If you put in equity, you have to get into the management of the business, [otherwise] management is focused on saving the skins of the [remaining private] shareholders.'") (emphasis added).

[101] *See, e.g.*, Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983). Regulatory policy will tend to benefit coherent special interest groups at the expense of the general public. Jonathan A. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 230–32 (1986).

[102] In the fall of 2008, the Federal Reserve began using a new tool, paying banks interest on their reserves held by the Fed. In the first four months, from September 2008 to January 2009, the volume of bank reserves held by the Fed rose from \$44 billion to \$901 billion. Through this program, the Fed has been paying banks not to lend, a policy at odds with the needs of the U.S. economy and the stated objectives of Congress and the president, but apparently aligned with the interests of the Fed's banking constituency. *See* Robert D. Auerbach, *The Fed's Backroom Bailout Policy*, 12 CHAPMAN L. REV. (forthcoming 2009) (manuscript at 5, on file with the Harvard Law School Library).

In May 2008, former Federal Reserve chairman Paul Volcker, now an Obama economic advisor, worried out loud that the Fed's independence could be hurt by the wide variety of assets it had taken onto its balance sheet to help its banking constituency. His concern was that the Fed might be viewed "as the rescuer or supporter of a particular section of the market, [which] is not strictly a monetary function in the way it's been interpreted in the past."[103] By year's end, the Fed was outright purchasing commercial paper as well as toxic assets such as mortgage-backed securities. The Fed's balance sheet skyrocketed from around $850 billion in assets in late 2007 to more than $1.7 trillion in October 2008.[104] In March 2009, the Fed expanded its support to the long-term Treasury bond market and other securitized assets by announcing it would pump another $1.2 trillion into those markets.[105] As Volcker predicted, the perception of the Fed as working in the service of the financial services industry is increasingly accurate.

Lerner warned against monopoly exploitation. Perhaps the greatest of the monopolies is the one hidden in plain sight, the Federal Reserve itself.[106] Perhaps the time has come to consider significant institutional reform of the Federal Reserve. Over the years there have been numerous constitutional challenges to the Federal Reserve and its policy-making Federal Open Market Committee based on the private non-delegation doctrine as well as the Appointments Clause. The D.C. Circuit has dismissed each challenge on narrow procedural grounds, including lack of standing for private plaintiffs and the doctrine of equitable discretion for claims brought by congressional plaintiffs. The U.S. Supreme Court has rejected petitions for certiorari in each case.[107]

Meanwhile, the legal academy has been largely silent and therefore complicit in the enormous violation of the rule of law at the nation's central bank.[108] Conservative scholars rail against unconstitutional delegations but then ignore the most flagrant example of the Federal Reserve. Liberal scholars who purportedly care about a progressive social agenda defer to dogmatic law and economics assumptions about the wisdom of central bank independence. Arguments are routinely made that it is better to have unelected bureaucrats decide monetary policy than to trust elected officials.

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[103] Greg Ip, *Fed Balance Sheet Worries Volcker*, Wall St. J., May 15, 2008, at A3.

[104] Posting of Phil Izzo to Wall St. J. Blogs, http://blogs.wsj.com/economics/2008/10/22/feds-balance-sheet-keeps-growing-and-growing/ (Oct. 22, 2008 15:52 EST).

[105] Neil Irwin, *Fed to Pump $1.2 Trillion Into Markets*, Wash. Post, Mar. 19, 2009, at A01.

[106] *See generally* Timothy A. Canova, *Closing the Border and Opening the Door: Mobility, Adjustment, and the Sequencing of Reform*, 5 Geo. J. L. & Pub. Pol'y 341, 403–09 (2007).

[107] *See id.* at 404.

[108] *See, e.g.*, Cass R. Sunstein, The Second Bill of Rights 54–55 (2004) (defending broad delegations of congressional authority to administrative agencies); Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. Chi. L. Rev. 407, 441 n.89 (1990) (characterizing the Federal Reserve Board as an independent agency not susceptible to capture, while ignoring the private industry ownership of the regional Federal Reserve Banks); Cass R. Sunstein, *Nondelegation Canons*, 67 U. Chi. L. Rev. 315 (2000) (dismissing the nondelegation doctrine without reference to delegations to private groups).

The empirical evidence, it is asserted, shows that independent central banks ensure low inflation. But the autonomous Fed has presided over the greatest inflation of asset prices in human history, a bubble that has now gone bust.

VI. A New Economics of Control: Connecting Functional Regulation to Functional Finance

It is crucial that the proper balance of functional regulation be put in place now. As Keynes wrote in 1931, after the stock market collapse but when there still may have been time to correct course: "Modern capitalism is faced, in my belief, with the choice between finding some way to increase money values towards their former figure, or seeing widespread insolvencies and defaults and the collapse of a large part of the financial structure."[109] Between 1931 and 1933, the wrong course was chosen, as insufficient stimulus was directed toward raising either money values of assets or the income levels of debtors. As a result, the financial structure crumbled. Much the same is happening today as the portion of the financial rescue effort committed to large institutions continues to dwarf assistance for debtors, either in the form of mortgage loan modification programs or jobs programs. Without the proper regulatory system in place, there could be an intensification of financial crisis in any of a number of markets.

Because of the vital need for coordinated regulation, the intellectual resistance to the economics of control should be set aside. This resistance has always been muddled. It fails to recognize that command-and-control regulation is not necessarily a movement away from the price mechanism. According to Robert Skidelsky, Keynes himself rejected rationing and saw his framework as a defense of the price system and consumer choice.[110] It is important to remember that advocates of margin requirements have never sought to outlaw consumer choice but simply to constrain consumer choice at the margins. Without such discipline—without traffic lights, stop signs, and an occasional toll booth in the financial marketplace—those with privileged positions in the marketplace will follow their incentives to become overleveraged and to gamble with other people's money. They will continue to present a moral hazard to the marketplace as a result of their ability to benefit from bailouts and hidden subsidies.[111]

The regulatory devices of capital, margin, and reserve requirements are best seen as a way to ensure that incentives are properly aligned. In recent years, there has been a growing literature in the law and development field, popularized by Hernando de Soto, promoting the protection of property

[109] Keynes, *supra* note 9, at 177.

[110] Robert Skidelsky, John Maynard Keynes, Volume Three: Fighting for Freedom 1937–1946 67 (2000).

[111] *See generally* Melvin I. Urofsky, Op-Ed, *The Value of 'Other People's Money'*, N.Y. Times, Feb. 7, 2009, at A24 (recounting the history of the 1914 book by Louis Brandeis, *Other People's Money, and How the Bankers Use It*).

rights of investors.[112] What has been missing, in the United States more than in the developing world, has been an appreciation of the obligations of investors, beginning with the obligation to put some portion of their own capital at risk. If the present financial crisis is to be contained, and if modern capitalism is to be saved from its own excesses, the "capital" must be put back into capitalism, a project that will require coordinating anew the tools of capital, margin, and reserve requirements that helped to create financial stability in the decades after World War II. During World War II, the federal government spent twice as much as today, as a percentage of GDP, and the Federal Reserve kept interest rates at near zero to facilitate such public sector efforts. But such low interest rates did not spill over into speculation in asset markets such as the stock market or housing precisely because margin requirements steered credit away from those markets.

It should be noted that although margin and capital requirements could limit the growth of derivatives in the future, they would not address the overleveraging that already exists in these markets. For instance, while news of the American Insurance Group's (A.I.G.) payment of $165 million in executive bonuses received much criticism in March 2009, more troubling but less discussed were the $40 billion in taxpayer funds that A.I.G. paid out during the same period to settle its credit default swaps, mostly with large U.S. and foreign banks and unregistered hedge funds.[113] With A.I.G. still holding more than $1.6 trillion in "notional derivatives exposure," there have been estimates that taxpayers could face more than $300 billion in further losses. Some analysts have called for putting A.I.G. into Chapter 11 bankruptcy to avoid the claims of derivative counterparties, while others suggest that credit default swaps simply be declared unenforceable contracts in which counterparties lack any insurable interest in the underlying bonds.[114]

There will likely be battles in the Obama administration and Congress over issues like these. For example, those taking a more Bastard Keynesian, "regulation-light" approach seek a central clearinghouse to help settle transactions. Those who understand the necessity for an economics of control

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[112] Hernando de Soto, The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else 57 (2000).

[113] *See* Mary Williams Walsh, *A.I.G. Lists Firms to Which It Paid Taxpayer Money*, N.Y. Times, March 16, 2009, at A1; Gretchen Morgenson, *Covering Foreign Institutions Further Upsets Some in U.S.*, N.Y. Times, March 18, 2009, at B1; Serena Ng, *Hedge Funds May Get AIG Cash*, Wall St. J., March 18, 2009, at A1.

[114] *See, e.g.*, Lucian Bebchuk, Op-Ed., *AIG Still Isn't Too Big to Fail*, Wall St. J., March 20, 2009, at A13 (arguing for Chapter 11 bankruptcy for AIG); Bert Ely, *Bad Rules Produce Bad Outcomes: Underlying Public Policy Causes of the U.S. Financial Crisis*, 29 Cato J., 13–14 (2009), *available at* http://www.cato.org/pubs/journal/cj29n1/cj29n1-8.pdf (arguing that credit default swaps be held unenforceable when the insured has no insurable interest in the bonds being insured).

seek a derivatives market exchange with the authority to impose capital and margin requirements on these complex financial instruments.[115]

There is some reason to believe an exchange will ultimately be adopted for credit derivatives. At first glance, this would appear to be significant because it would provide regulators with the authority to impose margin and capital requirements, thereby limiting the leverage and growth in credit default swaps. However, non-standard derivatives—the so-called exotic derivatives created by the largest financial institutions—would be exempt. As Joe Nocera points out, it was these "customized, one-of-a-kind products that generated enormous profits for institutions like A.I.G. that created them, and, in the end, generated enormous damage to the financial system."[116]

Moreover, in the economics of uncontrolled and haphazard regulation, policymakers always seem to be fighting yesterday's battles. Credit default swaps, which have been so significant in the current crisis, may be less important to future stability than other derivatives. For example, there is a danger that the nearly one trillion dollar fiscal stimulus package, along with all of the liquidity the Federal Reserve is creating and pumping into the financial system, could undermine confidence, push down the value of the dollar, and/or push up U.S. interest rates and bond yields.[117] If so, this could lead to trouble in other derivative markets, namely the markets for interest rate derivatives and exchange rate derivatives. Unfortunately, since these markets have thus far been relatively quiet compared with credit default swaps, most of the regulatory attention has focused on credit derivatives while ignoring these looming threats. This inability to anticipate and address the various threats to the stability of our financial system results from the failure to establish a coherent, coordinated approach to financial regulation.

There are other looming dangers to not returning to an economics of control. Unregulated hedge funds now exceed one trillion dollars in equity. Due to their high level of leverage, these hedge funds probably control tens of trillions of dollars of other people's money. A failure in any large hedge fund could have destabilizing ripple effects throughout the financial markets.

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[115] George Soros, billionaire hedge fund manager, has voiced fears about the unregulated market for credit default swaps. According to Soros, the prospect of cascading defaults hangs over the financial system like a sword of Damocles. He did not initially call for outlawing the market, but rather for its regulation by establishing a clearinghouse or exchange for the market, capital requirements, and strict margin requirements for all existing and future credit default swap contracts. Soros, *supra* note 87, at 15. However, more recently Soros has called for banning credit default swaps. *Soros Urges Ban on Credit default swaps*, UPI.com, June 13, 2009, http://www.upi.com/Business_News/2009/06/13/Soros-urges-ban-on-credit-default-swaps/UPI-20671244895874/ (quoting Soros as likening credit default swaps to "buying life insurance on someone else's life and owning a license to kill him").

[116] Joe Nocera, *A Financial Overhaul Plan, But Only a Hint of Roosevelt*, N.Y. TIMES, June 18, 2009, at A1, *available at* http://www.nytimes.com/2009/06/18/business/18nocera.html.

[117] For instance, when the Federal Reserve announced it would increase the size of its balance sheet by another $1.15 trillion to about $3 trillion the news triggered a plunge in bond yields and the dollar. Krishna Guha, *Fed Purchase Plan Stuns Investors*, FIN. TIMES, Mar. 19, 2009, at 1.

The need to extend margin and capital requirements to hedge funds should be apparent, but it is uncertain whether Congress and the president can muster the political will to impose regulation on such private centers of wealth, privilege, and power, which cross national borders.

The world is very different today from what it was in the 1940s. The financial marketplace is far more integrated and globalized. To protect the stability of our own financial system, we must consider multilateral ways to extend the economics of control beyond our borders, perhaps through financial transactions taxes on cross-border flows of currency and portfolio capital.[118] The task will be challenging, but in many ways it is the unfinished work of the Keynesian model and the Achilles heel of the system of global finance that Keynes helped to create just before his death.[119]

For Keynes and Lerner, central points of extending capital, margin, and reserve requirements were to tame investors' incentives to gamble while channeling credit and capital back into the public sector to be invested to meet the long-term needs of society. It was through great public sector projects that the foundations of a sustainable economy were to be achieved: full employment, more equitable distributions of wealth and income, and the maintenance of a truly free-enterprise competitive economic system.

Throughout the 1940s, when the Greatest Generation was not just winning a world war but reconstructing war-torn continents and creating an enormous middle class at home, the federal government spent and borrowed more than twice as much as it does today, as a percentage of GDP. But in the 1940s, the federal government borrowed at near-zero interest, and it borrowed mostly from domestic, rather than foreign, sources. What made this possible was a central bank that was strictly accountable to elected branches and that imposed selective credit controls to prevent inflation in asset markets and limit systematic financial risk. Today, we are in need of the same simple tools of regulation—speed bumps and traffic lights—to restore order to our markets and provide the resources needed to rebuild our economy.

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[118] *See generally* Timothy A. Canova, *Banking and Financial Reform at the Crossroads of the Neoliberal Contagion*, 14 Am. U. Int'l L. Rev. 1571, 1621 (1999); Canova, *supra* note 106, at 411–12.

[119] *See* James R. Crotty, *On Keynes and Capital Flight*, 21 J. Econ. Literature 59 (1983) (analyzing Keynes' proposal for an International Clearing Union and capital controls to empower nations to achieve full employment and currency stability).

Panel 1

Into the Bog: An Introduction to Dodd-Frank

Panel Presented by Allen Matkins

Speakers:

Dr. Roger Torneden, UCLA Extension:
Dodd-Frank: New Risks & Unintended Consequences

Steven Ramirez, Professor of Law, Loyola University Chicago School of Law
Dodd-Frank as Maginot Line

Jim Hawkins, Assistant Professor of Law, University of Houston Law Center
The Federal Government in the Fringe Economy

andré douglas pond cummings, Professor of Law, West Virginia University College of Law
The Delicate Dodd-Frank Dance

Peter H. Huang, Harold E. Kohn Chair Professor of Law, Temple University Beasley School of Law
How Behavioral Economics & Economic Theory Can Improve Financial Regulation

Moderator: Anthony T. (Tom) Caso, Chapman University School of Law

8:45am–10:30pm

Professor Anthony T. (Tom) Caso

2011 *Chapman Law Review* Symposium Speaker

Anthony T. (Tom) Caso earned his J.D. from University of the Pacific, McGeorge School of Law and M.B.A. from Golden Gate University. For nearly 30 years, Professor Caso held a variety of positions at Pacific Legal Foundation, most recently serving as Senior Vice President and Chief Counsel. Professor Caso's litigation experience includes successful litigation of cases at every level of the state and federal court system, including the California Supreme Court and the United States Supreme Court. Before coming to Chapman, Professor Caso was an Adjunct Professor of State Constitutional Law at McGeorge School of Law and an adjunct professor at the University of San Francisco, College of Professional Studies.

Dr. Roger Torneden

2011 *Chapman Law Review* Symposium Speaker

Certified Financial Planner™ with major time commitments focused on helping university students prepare for business careers. Seasoned classroom and on-line instructor with more than 5 years experience as an Adjunct Instructor with UCLA Extension (PFP Practicum and Insurance courses) as well as more than 5 years as Adjunct Professor with Webster University (classroom and on-line) teaching business, finance, accounting and marketing courses for their MBA Program. Lead speaker for Chapman University Law School's 2009 Economic Symposium in remembrance of the 80th anniversary of the Crash of 1929 (including a 2010 published article in the NeXus Law Review). Former Adjunct Assistant Professor with Baruch College in New York City (1980).

Former international executive with CEO and CFO experience in new business development, strategic and operations planning, worldwide marketing, resource allocation, policy development, and general management of complex businesses across multiple industries in the US, Europe and Asia; U.S. citizen with multi-year executive residency in Brussels, Osaka, and Sydney.

Dr. Roger Torneden graduated from New York University's Stern School with his doctorate in International Business. His career includes both executive leadership positions with AIG and JCPenney as well as six years leading businesses in Belgium and Japan. Roger addressed our October, 2009 Economic Symposium here and contributed an early 2010 article to the NeXus Law Journal. Looking back we recognize Roger as one of the earliest to forecast the substantial Federal Reserve "monetization" which is strongly supporting current U.S. Treasury security auctions. At that time, Roger also correctly foresaw both a weaker U.S. dollar and increasing long term interest rates.

The Dodd-Frank Act

New Risks and Unanticipated Consequences

Roger L. Tomeden, Ph.D., CFP®
UCLA Extension

January 28, 2011

CHAPMAN UNIVERSITY SCHOOL OF LAW

D-F Act: Risks & Unintended Consequences

1. Little or No Impact on U.S. Recovery

D-F Act: Risks & Unintended Consequences

1. Little or No Impact on U.S. Recovery
2. Derivative Threat Remains

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D-F Act: Risks & Unintended Consequences

1. Little or No Impact on U.S. Recovery
2. Derivative Threat Remains
3. Encourages Growth of "Too Big to Fail" Banks

D-F Act: Risks & Unintended Consequences

1. Little or No Impact on U.S. Recovery
2. Derivative Threat Remains
3. Encourages Growth of "Too Big to Fail" Banks
4. Trades Bank Risk for Clearinghouse Risk

D-F Act: Risks & Unintended Consequences

1. Little or No Impact on U.S. Recovery
2. Derivative Threat Remains
3. Encourages Growth of "Too Big to Fail" Banks
4. Trades Bank Risk for Clearinghouse Risk
5. Diminishes Rating Agency Credit Evaluations

D-F Act: Risks & Unintended Consequences

1. Little or No Impact on U.S. Recovery
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3. Encourages Growth of "Too Big to Fail" Banks
4. Trades Bank Risk for Clearinghouse Risk
5. Diminishes Rating Agency Credit Evaluations
6. More Responsibility for Overloaded Regulators

D-F Act: Risks & Unintended Consequences

7. Rulemaking: Too Much-Too Fast

D-F Act: Risks & Unintended Consequences

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8. Encourages Collaboration Between Executive Branch and Large Banks

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D-F Act: Risks & Unintended Consequences

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D-F Act: Risks & Unintended Consequences

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D-F Act: Risks & Unintended Consequences

7. Rulemaking: Too Much-Too Fast
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11. No Focus on Regulator Expertise

D-F Act: Risks & Unintended Consequences

7 Rulemaking: Too Much-Too Fast
8 Encourages Collaboration Between Executive Branch and Large Banks
9 Weak Response to Crisis Underpinnings
10 International "Arbitrage" of Act (Avoidance of U.S. Reg's)
11 No Focus on Regulator Expertise
12 Increase in Treasury & Fed Information and Consumer Protection Controls

D-F Act: Risks & Unintended Consequences

"Lawmakers should have taken the time to fully understand the root causes of the financial crisis before creating legislation"

-Harvey Pitt (former head of the SEC)

Dodd-Frank: New Risks & Unintended Consequences

A Working Paper Presented to:

The Annual Chapman Law Review Symposium
Chapman University School of Law

January 28, 2011

Presented by:

Roger L. Torneden, Ph.D., CFP®, CPCU
UCLA Extension

Introduction

Thank you for asking me to return after my presentation here in October, 2009, for The NeXus Law Review's "80th Anniversary of the Great *Crash* of 1929." [1]

Since I am not an attorney, my mission is to navigate the Dodd-Frank waves and currents with navigation tools borrowed from our business, economics and finance sectors. My perception of success today will be determined by highlighting strategic issues of Dodd-Frank and not by providing legal interpretations, potential conflicts of laws or assessments of future litigation potential with respect to the Act.

The first navigation point will be toward a definition of unintended consequences. This destination is only a few minutes away and from there we'll navigate by 12 islands in the so-called Bay of Dodd-Frank. Passing these islands will of necessity be a quick journey as we don't want to beach our ship and risk unintended consequences. My final navigation point will be the port of Dodd-Frank where today's legal experts will be your guides.

Unintended Consequences

Our economy is rooted in a classical theory of unintended consequences. According to Adam Smith, in his Wealth of Nations:

> *Every individual... neither intends to promote the public interest, nor knows how much he is promoting it... he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.*[2]

Smith's book was published in 1776. Our nation through recessions, financial panics and depressions held tightly to the core belief that individual freedom trumped control by government. We've had a rocky and often uncomfortable journey of nation building as severe economic downturns and panics have occurred about every 10 years on average for the past 230+ years. In brief, a most positive unintended consequence is the emergence of the U.S. as a world economic power based importantly on individuals pursuing their own dreams and goals.

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[1] http://www.chapman.edu/law/students/nexus/2009_Symposium.asp

[2] *The Wealth Of Nations*, Book IV, Chapter II, p. 456, para. 9.

All of us in our personal lives can cite many unintended consequences of our actions. However, let's keep our focus on the big picture. In 1936, the American sociologist Robert K. Merton identified a leading sources of unintended consequences; imperious immediacy of interest.[3] This term can refer to someone who wants the intended consequence of an action so much that he chooses to ignore the unintended effects. Recent history on not only Dodd-Frank but Obamacare strongly suggests that "imperious immediacy of interest" should be considered as an overall future risk factor.

Unlike the 1800's and most of the 1900's, the past decade or so has given us access to a substantial set of economic and financial tools, endless publically available data bases, analyses of well researched historical relationships and, importantly, availability of excel spreadsheets and related software. Despite our growing analytical capabilities, some government policymakers revert to policies that have known unintended consequences, such as price and wage controls.

Some policies have more subtle unanticipated consequences but they are nonetheless quite real and significant. As another example, Martin Feldstein, former head of the Council of Economic Advisors, argues that social security encourages lower U.S. savings rates as future social security checks are viewed as a savings replacement.[4] As a result, less savings are available in America to support new investments in plant and equipment.

We are in the "cat-bird" seat to mitigate the destructiveness of negative unintended consequences. Unfortunately, imperious immediacy of interest trumps our core capabilities, especially with respect to the Dodd-Frank Act.

Now, we are ready to sail past the upcoming 12 islands as a gateway to Dodd-Frank.

Dodd-Frank: Top 12 New Risks and Unintended Consequences (in no order of importance as all are critically important)

1. Dodd-Frank will have little, no, or even a negative impact on our expected economic recovery. The sheer magnitude of long term regulatory uncertainty generated by Dodd-Frank combined with the recent off-year election results will potentially side-track the Act. It's also possible that Dodd-Frank will be completely gutted over the next few years. Even if Dodd-Frank would be implemented today, it ignores major contributing factors to our financial system

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3 http://books.google.com/books?id=zPvcHuUMEMwC&pg=PA263&lpg=PA263&dq=robert+k.+merton+imperious+immediacy&source=bl&ots=x3UMQmeazT&sig=t6WQ9blsa2sW909d754j56wHNX0&hl=en&ei=W-YkTaeuBoSWsgPGvajDAQ&sa=X&oi=book_result&ct=result&resnum=2&ved=0CBcQ6AEwAQ#v=onepage&q&f=false

4 http://www.cato.org/pubs/ssps/ssp7.html

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crisis. For example, the "repo" was key to the bankruptcy of Lehman Brothers. A "repo" in the case of Lehman refers to a package of securities loaned toward the end of an accounting quarter from parent to subsidiary as a manipulation to create the appearance of cash on the parent company balance sheet. These short-term transactions allowed Lehman to manipulate its books and substantially contributed to its demise and added systemic risk to the nation's financial systems. These risks remain. By the way, this observation does not condemn repos as a financial transaction when they are conducted between third party buyers and sellers for legitimate purposes.

2. Dodd-Frank does not remove the derivatives threat that hangs over the world economies. It does present a rough future structure with a study committee status report due in another year or so. The large banks are engaged in actions that will effectively neuter Dodd-Frank and in any event will keep the derivatives risk in the realm of possible future bailouts. For example, U.S. banks are already calling for $42 Trillion of foreign exchange swaps to be exempt from Dodd-Frank. Dodd-Frank does provide for derivatives clearing houses. The value of derivatives, in total, is almost $600 Trillion.[5] However, the Dodd-Frank required clearinghouses for derivatives will only get a maximum of half of the derivatives with the other half to remain status quo (hidden from view and privately cleared...but private means cleared by the few large banks). Presently, the total derivative exposure is almost 200 times the amount of bank reserves so these issues remaining as *status quo* are huge by any standard. Consider that the top 5 U.S. banks control over 95% of the derivatives, are considered "too big to fail" and are key to the Federal Reserve itself.[6] An unintended consequence is to keep the systemic risks of derivatives alive and well...unfortunately.

3. Dodd-Frank will actually encourage the growth of the largest banks that are "too big to fail" and, therefore, actually increase future systemic risk. Banks on the "too big to fail list" will be able to borrow more cheaply than their smaller competitors with the existence of a "too big to fail" designation. The implied government guarantees for Fannie Mae and Freddie Mac had this effect for many years in terms of low borrowing cost even with these entities experienced large operating losses.

4. Dodd-Frank will trade the risk of bank bailouts for clearing house bailouts (the clearing houses may even become appendages of the large banks thereby re-combining the bank systemic risks). Additionally, Clearinghouse reserves under Dodd-Frank relate to only the one largest customer not the book of business to be cleared. Finally, Dodd-Frank gives the Federal Reserve authority to bail out clearing houses as they will be too big to fail.[7] The unintended consequence is that little may change in terms of the nation's bailout exposure which is counter to

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[5] http://www.bis.org/statistics/otcder/dt1920a.pdf

[6] http://justgetthere.us/blog/archives/Five-Major-US-Banks-Account-For-More-Than-95-Percent-of-Toxic-Derivatives.html

[7]David Skeel.. *The New Financial Deal* (John Wiley & Sons, 2010) pp.62, 66-73,75,162,167.

Dodd-Frank's stated mission. A bailout of a clearinghouse may also have less transparency and could be more *ad hoc* in nature than our bank bailouts.

5. Dodd-Frank will handicap the future effectiveness of rating agencies. Credit rating agencies will be accountable for their ratings with real dollars and cents liability if they're wrong. This sounds good but there are consequences. Recently, Ford pulled back a newly rated debt issue as the rating agency would not allow them to publish the rating for fear of liability.[8] A long term unintended consequence is that the market may see fewer rated bond issues which is the opposite of the intended consequence. Additionally, it can be noted that the rating agencies due to their past mistakes in rating securitized debt have teetered on the brink of bankruptcy. They faced their own extinction which itself is a severe punishment. In any event, the SEC would seem more ideal than Congress to construct rating agency regulatory models that encourage more and better ratings. Whoops! I apologize for getting off our course for a few seconds!

6. Dodd-Frank will focus more power into the very regulatory agencies that did in 2005-2006 properly assess the risks of our present economic recession/depression. They saw it but then side-stepped existing and readily available regulatory actions (including the FDIC, Federal Reserve, OCC, U.S. Treasury). The FDIC website and, specifically in their Summer of 2006 report shows some of these on-target assessments:[9]

- *"The tax deductible status of debt secured by homes made mortgage debt a more attractive financing alternative"...*(consumer debt became focused on home mortgages and HELOC's creating new risks and concentration).

- *"By 2005 almost 68% of home mortgage originations were securitized ...of total private-label MBS issuance, two-thirds comprised nonprime loans in 2005"...*(regulators noted the trends but largely remained on the side-lines)

- *"The OCC annual survey of credit underwriting practices at nationally chartered banks* (remarked that) *banks had relaxed underwriting standards for home equity and first mortgage loans...for the first time in the survey's 11 year history...by allowing lower minimum credit scores, reduced documentation...and simultaneous second-lien mortgages."* (No actions)

- *"A recent Fitch* (rating agency) *analysis warns that the payment shock associated with subprime...is strong even if rates do not rise...when rates do reset these loans...will make the monthly payment increases significantly greater...the ratings agency expects subprime...delinquency rates to increase, because those borrowers may not be able to keep up with payment increases, especially if the housing market softens"...*(again this is from the FDIC Outlook for Summer 2006 and is accessible on their website)

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[8] http://online.wsj.com/article/SB10001424052748703954804575381644138678302.html

[9] http://www.bestmindsinc.com/documents/FDIC.2Quar06.BestMinds.Highlight.pdf

- *"Lenders have targeted a wider spectrum of consumers, who may not fully understand the embedded risks but use the loans to close the affordability gap."*

Even before 2006, and back as far as 1997, the exposures of derivatives and the presence of a housing bubble was widely reported but Allen Greenspan, the nation's leading banker-regulator-money supply controller took no regulatory actions.[10]

7. The time compressed Dodd-Frank rulemaking will add risks of conflicts of rules among rule makers and will encourage future litigation to define or eliminate a number of these rules. Dodd-Frank is over 2,300 pages, will cost over $30 billion to implement, will require 44 new studies, and more than 243 new rule-makings.[11] As pointed by the Committee on Capital Markets Regulation, the known rulemakings under Dodd-Frank are 6 times the pace in recent years for the SEC, 7 times for the CFTC and about the same for the FDIC.with the SEC cutting in half the period from rule proposal to final rule.[12] Is this an example of imperious immediacy of interest? A website exists which updates the Dodd-Frank regulatory pages and final regulation/guidance pages, as of New Year's Day the totals were 628 pages and 352 pages respectively.[13] One wonders how many rule makers can even have time to read the Dodd-Frank bill plus the almost 1,000 more pages so far created in follow-up. Maybe this is just my own shortcoming.

8. Dodd-Frank adds a new risk increasing powers to the Executive Branch at the expense of our Judicial Branch. The Act encourages a new collaboration among the President, Secretary of Treasury, Head of the Federal Reserve and the largest U.S. financial institutions providing for a blending of administration ideologies and banking power to support administration policies. We need look no further than the histories of Fannie Mae and Freddie Mac to see Trillion Dollar exposures resulting from this extension of political power into the daily activities and priorities of financial institutions. Today, we know the Federal Reserve is owned by banks and they have received hundreds of billions of dollars at virtually a zero interest rate. These hundreds of billions of dollars are conveniently available to buy U.S. government securities thereby supporting the U.S. Treasury instead of focusing on lending to consumers and businesses. Dodd-Frank makes these government-bank relationships stronger with respect to the largest U.S. banks and this creates more risks for self-serving policy-making. The "Three Keys Turning" of Dodd-Frank makes a bank's future and the tenure of a bank's management subject to the opinions of a very small group while also side-stepping the nations' bankruptcy laws as they would otherwise apply to large banks in trouble. The decision to put a company into the resolution process instead of bankruptcy depends only on the agreement of the Secretary of

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[10] Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model, Timothy A. Canova. Harvard Law & Policy Review, Vol. 3.
[11] http://online.wsj.com/article/SB10001424052748704288204575363162664835780.html
[12] http://lawprofessors.typepad.com/files/2010.12.15_rulemaking_timeline_letter.pdf
[13] http://regreformtracker.aba.com/

Treasury, 2/3 of the Federal Reserve Board, and 2/3 of the FDIC Board. As an aside, the FDIC which has no experience in liquidating a "too big to fail bank" (Indy-Mac remains their largest takeover) not only gets the responsibility but gets to determine if and how creditors are paid. This lack of accountability to a judiciary is bound to create unanticipated consequences, new risks, and conflicts of interest.

9. The key elements of our current economic recession/depression were caused by "out of control securitization", low interest rates, and lack of enforcement of today's in-place regulations. Regulators today could encourage banks to re-build their mortgage qualification guidelines and to require a minimum down-payment percentage unless additional qualified collateral would be posted. Dodd-Frank takes a shot at securitization by requiring issuers to retain only 5% of each securitized issuance that is not prime credit to mitigate morale risks. Why not require a more meaningful percentage and apply it to all tranches of a collateralized credit pool? Our Federal Reserve maintains its control over interest rate albeit primarily short term rates. Dodd-Frank does provide for a Consumer Protection Agency which should impact bank borrowing guidelines. The intended consequence is favorable but having the Consumer Protection Agency inside the Federal Reserve relying on Fed funding for its existence has significant potential for unintended consequences.

10. Dodd-Frank will encourage country arbitrage of regulations. To the extent the U.S. is regulated with future derivative issuance and collateral requirements, the businesses will move to Europe, Asia and more flexible jurisdictions.

11. Dodd-Frank misses the opportunity to strengthen our regulators. For example, the Act is silent on the revolving door between large banks and regulators (importantly the Federal Reserve and the Treasury Department). Additionally, the Act has had at least an opportunity to focus on improving regulator capabilities, tools and expertise to better understand present day derivatives, mark to market, the roles of bank owned affiliates (including MARKIT Group[14] which gives derivatives pricing information), complex financial products, etc. The unanticipated consequence will be the continued ineffectiveness of regulators even though they may receive new powers.

12. Expanding the power of Treasury and the Fed in substantial and new counterbalances begs for unintended consequences. Dodd-Frank creates and locates an enormous new research facility (Office of Financial Research) in the Treasury Department. The unintended consequence is to give "knowledge as power" as another tool of political/administration influence. Additionally, the Consumer Financial Protection Bureau is located within the Federal Reserve and funding is only guaranteed through 2014. This is another potential conflict as the Federal Reserve is itself owned by banks.

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[14] http://www.markit.com/en/

Conclusion

As promised, we focused on a framework for discussing unintended consequences and selected key concerns with respect to the Dodd-Frank Act. We navigated by 12 islands but its understood that more islands appear and disappear depending on the tide going in or out and the route of your next Dodd-Frank voyage.

My time is up and I'd like to leave you with one final thought from Harvey Pitt, former SEC Chairman from 2001-2003:

"Lawmakers should have taken the time to fully understand the root causes of the financial crisis before creating legislation".[15]

Now, I'll join you and become a most interested passenger for the balance of the day.

Dr. Roger L. Torneden
January 28, 2011

[15] http://www.advisorone.com/article/harvey-pitt-assails-dodd-frank-indexing-conference

Professor Steven A. Ramirez

2011 *Chapman Law Review* Symposium Speaker

Professor Steven A. Ramirez is the Director of the Business and Corporate Governance Law Center at Loyola University Chicago. Previously he specialized in securities and banking and financial litigation and worked for the FDIC and SEC. He has published extensively in securities and corporate governance law, with a particular focus on law and macroeconomics. His book "Reimagining Capitalism" argues that the law's failure to control those holding concentrated economic power caused every element of the recent financial crisis and its continuing economic devastation. In response, he articulates a comprehensive legal means of tethering power to law by inveighing against privilege and disempowerment.

MAJOR PUBLICATIONS:

Law Review Articles

- *The Chaos of 12 U.S.C. Section 1821(k): Congressional Subsidizing of Negligent Bank Directors and Officers?*, 65 FORDHAM L. REV. 625 (1996).
- *The Misappropriation Theory of Insider Trading Under* United States v. O'Hagan: *Why Its Bark is Worse Than Its Bite*, 26 SEC. REG. L. J. 162 (1998) (with Christopher M. Gilbert).
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DODD-FRANK AS MAGINOT LINE

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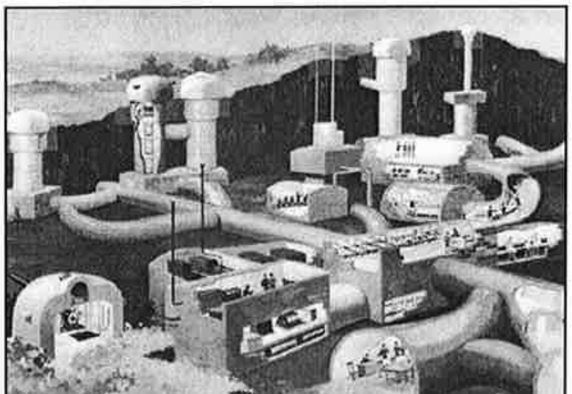

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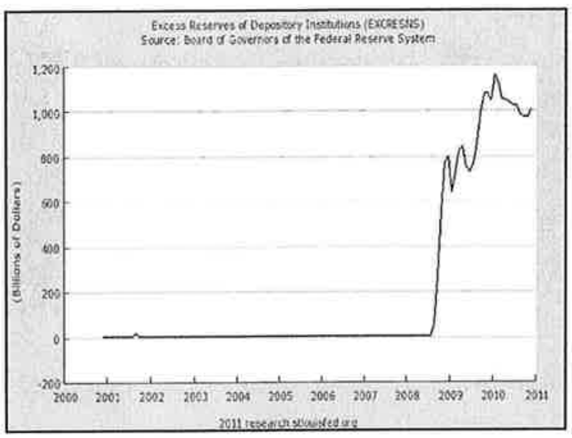
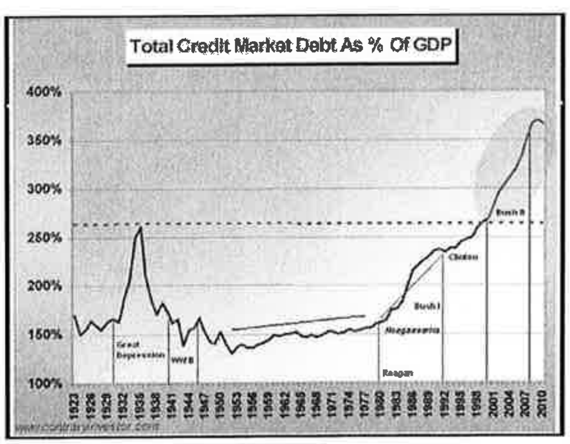
PROBLEMS:

- AIRPLANES FLY OVER FIXED FORTIFICATIONS
- TANKS DRIVE AROUND FIXED FORTIFICATIONS
- FIXED FORTIFICATIONS DRAW HUGE RESOURCES
- WWII WAS A WAR OF ENGINES NOT TRENCHES
- WEHRMACHT THROWS 1 MILLION TROOPS THRU ARDENNES AND TAKES PARIS IN 5 WEEKS

93


Balance on Current Account (BOPBCA)
Source: U.S. Department of Commerce: Bureau of Economic Analysis
(Billions of Dollars)
40
0
-40
-80
-120
-160
-200
-240
1960
1970
1980
1990
2000
2010
2020
2011 research.stlouisfed.org


Excess Reserves of Depository Institutions (EXCRESNS)
Source: Board of Governors of the Federal Reserve System
(Billions of Dollars)
1,200
1,000
800
600
400
200
0
-200
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2011 research.stlouisfed.org


Total Credit Market Debt As % Of GDP
400%
350%
300%
250%
200%
150%
100%

94

Problems:

- BANKS STILL HOLDING TOXIC ASSETS;
- RECKLESS LENDING INCLUDED RECKLESS MORTGAGE DOCUMENTATIO N;
- US GROSS DEBT STILL CATASTROPHICALLY HIGH AND LIKELY TO GO MUCH HIGHER;
- EUROPEAN DEBT CRISIS COULD ERUPT AT ANY GIVEN MOMENT;
- US STATES AND MUNICIPALITIES ARE STRETCHED TO LIMIT;
- NO POLITICAL WILL EXISTS FOR ANY SERIOUS TAX INCREASES;
- DODD-FRANK IS A PALLIATIVE.

The Good?

- Section 1403: "no person shall pay to a mortgage originator . . . compensation that varies based on the terms of the loan (other than the amount of the principal)." Outlaws steering.
- Section 1411 requires mortgage lenders to make a good faith determination that a mortgage loan can be repaid. Certain plain vanilla loans enjoy a safe-harbor from this provision. Section 1413 permits the victim of a predatory loan to raise a violation of section 1411 as a defense even against subsequent assignees, and even after the expiration of any statute of limitations. The amount of the defense includes costs and attorney fees. Outlaws predatory loans.
- Section 917 requires a study regarding financial literacy. Section 1021 requires the new Consumer Financial Protection Bureau to conduct financial education programs

More Good?

- Section 203: if a systemically risky megabank is insolvent then the Secretary of the Treasury (along with 2/3 votes of the Fed and the FDIC) may appoint the FDIC as receiver of the firm.
- Section 210: authorizes the sale of assets of the firm--meaning the FDIC can sell off all the operating divisions of the firm separately--i.e., break the firm up. This section also empowers the FDIC to takeover all the powers of senior managers--i.e., prior management is terminated

95

The Bad?

- Under section 716 banks are generally prohibited from using derivatives. But, there is an exception for "bona fide hedging and traditional bank activities." This exception apparently would include 80 percent of the derivatives market. The section does not even take effect until July 21, 2012 and no prohibition regarding bank derivative activities takes effect until July 21, 2014, which regulators may extend until July 21, 2015. Thus, all of the derivative trading that fueled the crisis will continue for at least 4 or 5 years, and most derivatives trading will be permissible for banks thereafter.

More Bad?

- Section 1101 paves the way for the Fed to bailout large banks so long as it does so pursuant to a program or facility that features "broad-based eligibility." Indeed, the Act directs the Fed and the Treasury to create emergency lending programs and facilities "as soon as practicable."
- Section 1105 of the Act directs the FDIC, in consultation with the Secretary of Treasury, to create a "widely available program to guarantee obligations of solvent insured depository institutions or solvent depository institution holding companies (including any affiliates thereof) during times of severe economic distress."

The Ugly:

- Does not address dollar reserve system;
- Does not address current account deficit and trade deficit;
- Does not address unbalanced "free trade;"
- Does nothing about lost jobs in America;
- Does not address cash hoarding by TBTF banks;
- Does not address the shadow banking system.
- USA thus destined to more debt, sluggish growth, and serial crises.

The Ugliest:

- Section 121: requires a 2/3 vote of the FSOC as well as certain trigger determinations by the Federal Reserve Board of Governors. Thus, no divestiture can proceed without the Fed.
- Mandates a determination that other mitigatory actions are "inadequate" for addressing threats to financial stability. The House version authorized the FSOC to "deem" other actions inadequate. Now, subject to review under an abuse of discretion standard while the House's language commits the decision to the discretion of the regulators. Divestiture now a last resort instead of leaving the issue solely up to the Fed.

Net effect:

- Congress effectively foreclosed another subprime crisis—which the market probably foreclosed in any event;
- Banks still face perverse incentives toward risk—heads they win, tails we pay. So they still have the same **motive** as before the crisis. TBTF lives!
- Banks can still play the derivatives casino. They have the **means** for generating more crises.
- The US still acts as consumer of last resort while wages stagnate—a recipe for more debt, a weaker dollar and more financial volatility. Thus more **opportunity** for recklessness.

The Stiglitz Verdict:

"It almost surely will happen again, because we didn't deal with the problem of too-big-to-fail banks. And we didn't really deal effectively with all the kinds of excessive risk-taking, all the problems of lack of transparency that were at the core of this crisis. We understand the issues better than we did three years ago, but the power of the banks, was too great. They're making $20 billion off of derivatives. So rather than lending, they're engaged in all of these kinds of gambling and excessive risk-taking and generating large profits, but it's not helping the American economy and it's putting at risk American taxpayers."

Professor Jim Hawkins

2011 *Chapman Law Review* Symposium Speaker

Jim Hawkins is an assistant professor at the University of Houston Law Center, where he teaches Contracts, Consumer Law, and Bankruptcy courses. He earned his J.D. from the University of Texas, where he graduated first in his class. Before becoming a professor, he practiced commercial litigation at Fulbright and Jaworski and clerked for the Honorable Jerry Smith on the Fifth Circuit Court of Appeals. His research focuses primarily on medical lending and fringe banking transactions.

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"The Consumer Financial Protection Agency," Teaching Consumer Law Conference, University of Houston Law Center (May 2010).

Invited Participant, "Creating a Research Agenda for Small Dollar Credit," US Treasury (March 4, 2010).

"Regulating on the Fringe," Faculty Workshop Series, University of Houston Law Center (March 2010).

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"When Your Car Dealer Goes Broke," Starting a Consumer Practice—Know the Law!, University of Houston Center for Consumer Law Continuing Legal Education Program (October 23, 2009).

andré douglas pond cummings

2011 *Chapman Law Review* Symposium Speaker

andré douglas pond cummings is a Professor of Law at the West Virginia University College of Law where he teaches Business Organizations, Securities Regulation, Civil Procedure, Sports Law, and Entertainment Law. Prior to joining the West Virginia University College of Law faculty, Professor cummings worked as a judicial law clerk for Associate Chief Justice Christine M. Durham of the Utah Supreme Court and for Chief Judge Joseph W. Hatchett of the United States Court of Appeals for the Eleventh Circuit. In addition, he worked at the Chicago, IL based law firm of Kirkland & Ellis LLP, focusing his practice on complex business transactions including mergers, acquisitions, divestitures and securities offerings of publicly traded corporations. Simultaneously, cummings represented clients in the sports and entertainment industries, including athletes in the National Football League, record labels, and a variety of authors, including Hollywood screenwriters and novelists.

cummings has written extensively on issues regarding investor protection, racial justice, and affirmative action, publishing in the *Utah Law Review*, *Indiana Law Journal*, *Iowa Law Review*, *Nebraska Law Review, Fordham Journal of Corporate Law, Harvard BlackLetter Law Review, Santa Clara Law Review, Louisville Law Review, Marquette Sports Law Review*, *Iowa Journal of Race, Gender and Justice* and *Thurgood Marshall Law Review* amongst others. cummings is currently completing work on a book entitled *Reversing Field: Examining Commercialization, Labor, Gender, and Race in 21st Century Sports Law* (West Virginia University Press) (with Anne Marie Lofaso). Dr. Cornel West has recently stated that cummings' scholarly "reputation goes far beyond West Virginia, to the nation, and is heard in every corner of the globe, wrestling with legacies of legal thinking on one hand and popular culture on the other." cummings has been recognized as Professor of the Year on three occasions since 2004, including the University Distinguished Professor Award by the West Virginia University Foundation. cummings has taught as a Visiting Professor of Law at the University of Iowa College of Law, the University of Utah S.J. Quinney College of Law, Syracuse University College of Law and Temple University Beasley School of Law – Tokyo Campus. cummings holds a J.D. from Howard University School of Law where he graduated *cum laude* and with high distinction.

Peter H. Huang

2011 *Chapman Law Review* Symposium Speaker

Peter H. Huang is the inaugural Harold E. Kohn Chair Professor of Law at Temple University's James Beasley Law School. He holds a J.D. from Stanford and a Ph.D. in applied mathematics from Harvard. He was a member of the School of Social Science at the Institute for Advanced Study during its psychology and economics theme academic year 2005-06. His major academic interests include securities and financial regulation, in addition to economics and psychology of rational decision-making and subjective well-being. He previously taught at the University of Minnesota Law School (where he was a tenured faculty member), Yale Law School, the University of Chicago Law School, the University of Pennsylvania Law School, the University of Virginia Law School, and the University of Southern California Law School. He has also taught in the economic departments of Stanford University, the University of California, Berkeley, and the University of California, Los Angeles, in addition to the finance department of Tulane University's business school. Before teaching, he was a staff economist in the Division of Consumer Protection of the Federal Trade Commission.

How Behavioral Economics & Economic Theory Can Improve Financial Regulation

Peter H. Huang
Temple Law School

Chapman Law Review Symposium: *From Wall Street to Main Street: The Future of Financial Regulation*

1

Outline

- General Equilibrium of Incomplete Markets
- Identity Economics
- Financial Judgment & Decision Making
- Gullibility & Trust
- Experiences & Memories

2

General Equilibrium (GE) Theory

- Arrow-Debreu GE Model
  - Formalizes Adam Smith's invisible hand
- Arrow Securities
  - Complete Set of Financial Markets
  - Correct Anticipations of Prices
- Properties of GE
  - Existence
  - Pareto Optimality

3

GEI Theory

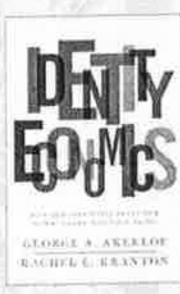
- Incomplete Security Markets
  - Fewer Securities than States of Nature
  - Not all possible income profiles across states can be achieved via securities markets
- Properties of GEI
  - Generic or Typical existence
  - Generic non-Pareto optimality
  - Generic not constrained Pareto optimal

GEI & Financial Innovation

- Degree of asset market incompleteness sufficiently > extent of consumer heterogeneity ⇒ financial innovation can be robustly:
- Pareto-improving
- Pareto-worsening


Identity Economics





Identity of CEOs Matter

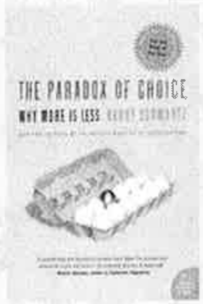
- Incentive-Based Compensation Pay is Problematic when there is
- Multiple Dimensions to Performance
- Unobservable Aspects of Performance
- Importance of Identification with Organization

Against Financial Literacy Education

- Dominant Model of U.S. Regulation for consumer credit, insurance, & investment products is Disclosure & Unfettered Choice
- Financial Literacy Education is a necessary corollary to disclosure model of regulation
- Seductive rhetoric of Empowered consumers
- But, Overconfidence
- Shame of Bad JDM

Choice & Happiness

Choice Overload & Stress



Bubbles & Gullibility

- Beautiful Illusions Attract Believers
- Comfortable & Comforting Illusions Keep Believers
- Collective Hallucinations or Illusions
- Illusions Can Be Persistent, Robust, & Strong
- Or Be Fragile, Temporary, & Weak
- Gullibility Index
- Information Viscosity
- Instead of Efficient Markets

Cognitive Theory of Trust

- Optimal Degree of Trust
  - Not Zero
  - Not Infinite
  - Positive
- Updating Trust
  - Impaired
  - Precluded

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Bounded Memory

- Feelings re: Disneyland Visit
  - Before: Planning Decider
  - During: Experiencing Visitor
  - After: Reminiscing Photographer

- "What's too painful to remember, we simply choose to forget"
- 5 minute college
- 1 minute law school

Financial JDM Experiences & Memories

- People Delay Financial JDM to Avoid Stress
- People Rush Financial JDM b/c it's unpleasant
- People Delay Leaving Bull Securities Markets to Avoid Individual Regret
- People Stay Out of Bear Securities Markets to Avoid Individual Anxiety
- People Forget About Financial JDM
- People Are Often Mindless about Financial JDM

Conclusions

- GEI Theory ⇒ Different Regulation of Derivatives than just More Transparency & Liquidity (Dodd-Frank Title VII)
- Identity Economics ⇒ More skepticism of Incentive-Based CEO Pay (Dodd-Frank § 951)
- Financial JDM ⇒ Mere Disclosure Not Enough (Dodd-Frank § 917)
- Gullibility & Trust ⇒ Index & Context
- Experiences & Memories ⇒ Improve Fin JDM

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Panel 2

Congress Punts; Administrative Agencies Receive; Welcome to a Decade of Rulemaking

Presented by the Chapman University Center for Global Law & Development

Speakers:

Rosalind Tyson, Regional Director, Los Angeles Regional Office
U.S. Securities and Exchange Commission
Dodd-Frank's Impact on SEC Regulation & Enforcement

Reza Dibadj, Professor, The University of San Francisco School of Law
Toward First Principles

Donna M. Nagy, C. Ben Dutton Professor of Law, Indiana University Mauer School of Law – Bloomington
Dodd-Frank's Impact on Securities Enforcement & Litigation

W.H. (Joe) Knight, Jr., Professor of Law, Seattle University School of Law
Fear of Flying – The Behavioral Psychology of Dodd-Frank

Mark A. Moore, Principal, Aldrich, Bonnefin & Moore, PLC
Dodd-Frank and the New Consumer Protection Bureau

Moderator: Professor Kurt Eggert, Chapman University School of Law

10:45am–12:30pm

Rosalind R. Tyson

2011 *Chapman Law Review* Symposium Speaker

Roslind Tyson is the Regional Director of the SEC's Los Angeles Regional Office, which has a staff of 170 in its enforcement and regulatory programs and is responsible for securities law enforcement in southern California, Nevada, Arizona and Hawaii.

Ms. Tyson joined the Los Angeles office as an enforcement staff attorney in 1982, following several years in private practice. She served as staff attorney and then Branch Chief of the Branch of Full Disclosure, reviewing initial public offering registrations of small business issuers. In 1988, Ms. Tyson became Assistant Regional Director and in 1993, Associate Regional Director. As Associate Regional Director until 2007, Ms. Tyson managed the broker-dealer, investment adviser and investment company inspection programs, as well as bankruptcy review.

Ms. Tyson graduated from Georgetown University's School of Languages and Linguistics, the University of Hawaii, and Stanford Law School. She is a member of the California bar.

Professor Reza Dibadj

2011 *Chapman Law Review* Symposium Speaker

Reza Dibadj is currently a Professor of Law and Dean's Circle Research Scholar at the University of San Francisco. He has also served as a Visiting Professor of Law at the University of California, Berkeley and the University of California, Hastings and began his academic career as an Assistant Professor at the University of Miami.

His research involves both corporate and securities area as well as administrative law and regulation. His writing focuses on two themes. The first involves the application of new tools, such as network theory, to legal analysis. The second is an exploration of different institutional choices the law has made. For instance, corporate and securities law often try to achieve similar goals, but through very different means; similarly for antitrust and regulation. For their part, corporate and administrative law each present distinct approaches to problems of governance and delegation. Which methods are preferable, and under what circumstances? These two themes converge in an attempt to propose new, welfare-enhancing, institutional arrangements for the relationship between government and business. The overarching question centers on how the modalities of government intervention can be improved to mediate the increasingly complex intersection of democracy and capitalism. Publications vary in method and scope: some cover broad themes, while others are narrowly focused; some are theoretical, others empirical. Much of the work is interdisciplinary, drawing primarily from law and economics.

Dibadj writes in three media: books, academic articles, and op-ed pieces. His recent book, Rescuing Regulation (SUNY Press) was released in hardcover in October 2006 and paperback in June 2007. His articles have appeared in over twenty academic journals, including the Antitrust Bulletin, Cardozo Law Review, University of Colorado Law Review, Ohio State Law Journal, San Diego Law Review, Stanford Journal of International Law, and Washington University Law Review. His op-ed pieces have been published in several newspapers, including the Washington Post, Financial Times, San Francisco Chronicle, and National Law Journal.

Summary of Professor Reza Dibadj's Presentation at the 2011 *Chapman Law Review* Symposium

The Dodd-Frank Act, while a positive step forward, exhibits more of an intricate reaction to our last financial crisis than a concise attempt to address fundamental flaws in how Wall Street is regulated. Averting the next disaster requires recognizing that financial crises rely upon four facilitators: dissemination of misleading information, abuse of regulatory gaps, exploitation of credulous consumers, and use of corporate size to privatize profits and socialize losses. Fascinatingly, along each of these dimensions the Act almost exclusively defers to further study. We are repeatedly told that some existing or newly-created agency or council should research private antifraud actions, aspects of the derivatives market, financial literacy among investors, or the size and complexity of financial institutions—to name just a few examples.

The question then becomes why sophisticated lawmakers would choose largely to defer these issues rather than confront them more simply and directly as the Glass-Steagall Act did. While there are benefits to statutory vagueness and delegation to agencies and courts, the main factor underlying voluminous legislation that ironically postpones the major questions lies in the political economy of twenty-first century Congressional action and the jostling among interest groups.

Professor Donna Nagy

2011 *Chapman Law Review* Symposium Speaker

Professor Donna Nagy joined the Indiana University Maurer School of Law in 2006 as the C. Ben Dutton Professor of Business Law. She began her teaching career in 1994 at the University of Cincinnati College of Law, where she served as Interim Dean from 2004-05 and as Associate Dean for Faculty Development from 2002-04. In Spring 2001, she was a Visiting Professor of Law at the University of Illinois College of Law, and was a Visiting Scholar at the University of Canterbury School of Law in Christchurch, New Zealand in Spring 2002.

Professor Nagy teaches and writes in the areas of securities litigation, securities regulation, and corporations. Her scholarship includes articles in the Cornell Law Review, the Notre Dame Law Review, and the Iowa Law Review as well as two co-authored books, one on the law of insider trading and a casebook on Securities Litigation and Enforcement. She is a frequent speaker on securities regulation and litigation topics at law schools and professional conferences. She served as Chair of the Section on Securities Regulation of the American Association of Law Schools (AALS) in 2004-05 and is an elected member of the American Law Institute. She is serving a third-year term as a member of the National Adjudicatory Council (NAC) of the Financial Industry Regulatory Authority (FINRA) and is as a Vice President and on the Board of Trustees of the SEC Historical Society.

Prior to teaching, Professor Nagy was an associate with Debevoise & Plimpton in Washington, D.C., specializing in securities enforcement and litigation

The Dodd-Frank
Wall Street Reform and Consumer Protection Act of 2010

Principal Provisions Relating to Securities Litigation and Enforcement

Professor Donna Nagy
C. Ben Dutton Professor of Law
Indiana University Maurer School of Law—Bloomington
dnagy@indiana.edu

Study and Rulemaking on Fiduciary Standard for Broker-Dealers (§913). The Act requires the SEC to conduct a study and authorizes the SEC to issue rules imposing on broker-dealers fiduciary duties when they provide "personalized investment advice about securities to a retail customer." The SEC may also enact rules requiring broker-dealers and investment advisers to "act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice" and to disclose "any material conflict of interest."

Securities arbitration (§921). The SEC now has the authority to issue rules that prohibit, or impose limitations or conditions on, mandatory pre-dispute arbitration provisions in customer agreements with brokerage firms and investment advisers.

Bounty provisions and whistleblower protections (§922). The Act adds a new Section 21F to the Exchange Act providing that where information conveyed by an individual leads to an SEC enforcement action resulting in a civil penalty of more than $1 million, the SEC *must* pay a bounty of between 10-30%. The SEC must also pay a bounty in certain instances where such information leads to enforcement action taken by the DOJ, another federal agency, an SRO, or a state attorney general. Existing protections available to whistleblowers (many of which were enacted as part of SOX) are further enhanced.

Collateral bars (§925). The Act allows the SEC to impose bar orders preventing securities law violaters from associating with *any* regulated entity (*e.g.*, in a broker-dealer disciplinary action under Exchange Act 15(b)(6)(A), the respondent's sanction can now prohibit future association with investment advisers and municipal securities dealers, in addition to broker-dealers).

Fair fund amendments (§929-B). The Act allows the SEC to add civil monetary sanctions imposed in enforcement actions to a "distribution fund" for the victims of the violation regardless of whether the SEC obtains disgorgement as part of that action.

Nationwide service of subpoenas (§929-E). Parties to SEC enforcement actions in federal district court will be able to serve subpoenas for documents and testimony at any place within the United States.

Formerly associated persons (§929-F). The Act clarifies that the SEC may bring enforcement action against and seek applicable remedies in cases where persons served in a regulated capacity at the time of the alleged violations (*e.g.*, former broker-dealers, investment advisers, officer and directors of SROs).

Enhanced application of antifraud provisions (§929-L). The Act amends Exchange Act Section 9(a), relating to market manipulation, and Exchange Act Section 10(a)(1), relating to short sales, to extend to *all* securities other than government securities. Prior to this change, these provisions applied only to exchange-listed securities.

Aiding and abetting liability in SEC actions (§929M-O): The Act expands Exchange Act 20(e) to impose aiding and abetting liability on persons who "recklessly" provide substantial assistance to persons who violate the Exchange Act (prior to this change, liability turned on a defendant's "knowing" assistance). The Act also adds new aiding and abetting provisions to the Securities Act, the Investment Company Act, and the Investment Advisers Act. Although Congress opted against amending the securities laws to provide for an express private right of action for aiding and abetting liability, the Act instructs the Government Accounting Office (GAO) to conduct a study on whether private plaintiffs should be accorded such an express right in the future.

Strengthening enforcement by the SEC (§929-P)

(a) Civil Penalties in administrative proceedings. The SEC now has the authority to impose civil monetary penalties in cease-and-desist proceedings brought against any person or entity. Prior to this change, only regulated persons and entities were subject to civil monetary sanctions in administrative proceedings.

(b) Extraterritorial reach of antifraud provisions. The Act specifies that the SEC and DOJ may bring actions in federal district court alleging a violation of Securities Act Section 17(a) or the antifraud provisions of the Exchange Act involving:

(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or

(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

(c) Control person liability. The Act clarifies that the "control person" liability provision in Exchange Act Section 20(a) extends to SEC enforcement actions as well as to litigation brought by private plaintiffs.

Deadlines for completing enforcement investigations and compliance inspections and examinations (§929U). Subject to exceptions for certain complex actions, after providing the subject of an investigation with a written Wells notice, the staff of the SEC has a deadline of 180 days to file an enforcement action against the investigated person. The same complex action exception and 180 day deadline extends to reports setting out findings and requests for corrective action in connection with compliance inspections and examination.

Corporate recovery of erroneously awarded compensation (§954). The Act substantially broadens the reach of the clawback provision added to the Exchange Act in SOX. The Act adds a new Section 10D to the Exchange Act which requires the SEC to direct the stock exchanges to institute new rules requiring listed companies to recover bonuses paid to *any* current or former executive officer where a financial restatement occurs due to the issuer's "material noncompliance" and the bonus was computed using erroneous data.

PCAOB oversight of broker-dealers (§982). The Act extends the Public Company Accounting Oversight Board's (PCAOB's) authority to auditors of registered broker-dealers. The SOX mandated PCAOB oversight for accounting firms that audit public companies; auditors of broker-dealers were required to register with the PCAOB but had not previously been subject to the PCAOB's broad inspection, investigation and enforcement authority.

Enhanced SEC funding (§991). Although Congress ultimately rejected a proposal for the SEC's self-funding, the Act authorizes the SEC to prepare its own budget which the President "shall" transmit to Congress "in unaltered form." The Act also pre-authorizes a series of increases in SEC funding over the next five years from $1.3 billion in 2011 to $2.25 billion in 2016 (thus nearly doubling the SEC's budget over that period).

Rulemaking, Studies, and Staff Expansion. The Act requires the SEC to promulgate a large number of new rules and conduct many special studies (the Davis, Polk law firm places the count at 95 rulemakings and 17 studies for the SEC). The Act also requires the SEC to create five new offices: an Office of the Investor Advocate (§915) (which will include an Investor Advisory Committee (§911) and an Ombudsman reporting to the Investor Advocate (§ 919D)); an Office of Credit Ratings (§932(p)); an Office of Municipal Securities (§979); an Office of Minority and Women Inclusion (§342); and an Office to administer and enforce the new whistleblower incentives and protections described above (§924(d)). The week after the Act was enacted, SEC Chairman Mary Schapiro shared with Congress the SEC's plan to add 800 new staff members – a sure sign that securities litigation and enforcement will be a booming area of legal practice for many years to come.

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Studies Pertaining to Possible New Self-Regulatory Organizations (SROs)

GAO study on Self-Regulatory Organization for Private Funds (§416) Requires the Comptroller General of the United States to conduct a study on the feasibility of forming a self-regulatory organization to oversee private funds.

SEC Study on Enhancing Investment Adviser Examinations (§914) Among other matters, this section requires the SEC to examine "the extent to which having Congress authorize the Commission to designate one or more self-regulatory organizations to augment the Commission's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers."

GAO Study on the Creation of an Independent Professional Analyst Organization (§939E) Requires the Comptroller General of the United States to conduct a study on the feasibility and merits of creating an independent professional analyst organization for rating analysts employed by nationally recognized rating organizations that would be responsible for establishing independence standards and a code of ethical conduct as well as for overseeing the profession of rating analysts.

SEC Study on Assigned Credit Ratings (§939F) Among other matters, this section requires the SEC to study "the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized rating organizations to determine the credit ratings of structured finance products."

Professor Joe Knight

2011 *Chapman Law Review* Symposium Speaker

From 2001 to 2007, Joe Knight served as Dean of the University of Washington School of Law. A strong advocate for educational innovation and academic excellence, Knight provided administrative leadership as the Law School built and moved into a new home, William H. Gates Hall (2003) and developed the financial resources to recruit over twenty new faculty members to the school.

Before coming to the UW in 2001, Knight was a professor at the University of Iowa College of Law. He also served as Vice Provost of the University from 1997-2000. An expert in commercial law, Knight has authored three books on the subject and taught courses in banking, contracts and commercial transactions. He has also taught seminars on international banking and critical race theory.

Knight grew up in Winston-Salem, N.C. and earned bachelor degrees in economics, speech, and political science from the University of North Carolina at Chapel Hill. He earned his juris doctorate degree from the Columbia University School of Law. At Columbia, he was a member of the Columbia Human Rights Law Review. Prior to becoming a faculty member, Knight worked in New York City as a labor lawyer and in Connecticut with a bank holding company.

He is an active member in several organizations, including the American Law Institute; the Law School Admissions Council; the Society of American Law Teachers; and both the American and National Bar Associations. He is currently serving a three-year term as a member of the Executive Committee of the Association of American Law Schools. Knight also serves as a member of the board of directors of State Farm Mutual Automobile Insurance Company where he chairs the Legal Affairs Committee of the board. He was recently elected to serve as a trustee of the National University System in La Jolla, California.

Mark A. Moore

2011 *Chapman Law Review* Symposium Speaker

Mr. Moore is a principal of Aldrich Bonnefin & Moore, PLC. He associated with the firm in May 1990 and became a shareholder in 1994. He specializes in banking operations, and he manages the Banking Operations Practice Group for the firm. He is the President and CEO of the law firm and Adjunct Professor of Law at Thomas Jefferson School of Law, where he teaches classes on Consumer Compliance.

Mr. Moore's practice focuses on banking operations and related fields. These include: deposit programs and payment services; checks and negotiable instruments; card-based deposit products; remote merchant and remote branch capture; positive pay; ACH and wire transfers; e-banking and cash management; information security; BSA/AML/OFAC. He works with bank and non-bank issuers and sellers of prepaid debit cards and other stored-value products. He also advises on outsourcing and vendor agreements.

Mr. Moore's publications include "Who Will Win: The Card Brands' 'Rails' or the Telecoms' 'Pipes'? (2010), "Mobile Payments: What Happens When the Card Disappears" (2009), "Customer Notice of Information Security Breaches" (2004) and "UETA and E-SIGN: An Overview with Attention to Current Issues" (2002). Mr. Moore has been a frequent speaker for the Federal Financial Institution Examination Council in Washington, D.C., the Bankers' Compliance Group, the California Bankers Association and other trade associations. Mr. Moore is a member of the California State Bar. He is a past Chair of the Business Law Section's Executive Committee (2005-2006) and a former member of its Cyberspace Committee, Financial Institutions Committee (Chair, 2001-2002) and Consumer Financial Services Committee (Chair, 2006-2008). Mr. Moore is also a member of the American Bar Association. He is a member of the California Bankers Association Legal Affairs Committee and chaired its Bank Counsel Seminar in 2006 and in 2007.

Mr. Moore received his law degree from The University of Chicago Law School in 1983. His undergraduate degree was awarded by the University of California, Irvine (magna cum laude) in 1975.

Areas of Practice

- Banking Operations

Published Works

- "Mobile Banking: What Happens When the Card Disappears", 2009
- "UETA and E-Sign: An Overview with Attention to Current Issues", 2002

The Consumer Financial Protection Bureau

Presentation by

Mark Moore, Esq.
Aldrich Bonnefin & Moore, PLC
Irvine, California

At the
Chapman Law Review 2011 Symposium
January 28, 2011

Please note that the information in this presentation is of a general nature and should not be used as the basis for legal analysis or the resolution of specific legal issues. Mr. Moore can be reached at mmoore@abmlawfirm.com, or at 944 474 1944.

1. The Power and Independence of the Director.

    a. The Director makes and adopts the Bureau's rules. Until a Director is in place, the Treasury Secretary serves. Currently, Timothy Geitner has delegated to Elizabeth Warren.

        i. This results in one person with unprecedented authority.

            1. The Director has a 5 year term. He or she can be removed, but only for good cause ("inefficiency, neglect of duty, or malfeasance in office").
            2. There is a process for the Oversight Council to "stay" (any voting member, acting alone, can stay a Bureau rule for 90 days) or "set aside" (2/3rds of the voting members -- 6 out of the 9 -- must act to "set aside").

        ii. The Director can delegate – not clear that delegation authority is limited to government employees. Can the Director delegate enforcement to a private law firm? It would seem so.

        iii. Ms. Warren is reported to favor the rulemaking process used by other agencies: notice, comment and adoption of final rules.

            1. The Administrative Procedures Act (APA) applies to Bureau.
            2. The Bureau is allowed to use the "good cause" exceptions, based on a finding (for example) that time constraints or other factors make public comment "impracticable."
            3. But many Executive Branch rules would not apply to the Bureau, since the Bureau is an "independent agency." Thus, no requirement to "justify " that costs are outweighed by benefits under Executive Order 12866.

    b. Congress does not control the purse strings.

        i. Funding is set at a percentage of Federal Reserve System operating expenses.
        ii. Estimated at $550 million for 2011. In theory, mandated transfers could exacerbate a loss year at the Federal Reserve (that is, there is no exception for years where the FRB is operating at a loss), but this would be an historical first.
        iii. The funding is not subject to Congressional review. If it is inadequate, Dodd-Frank authorizes appropriations of up to $200 million for fiscal years 2010 through 2014.

2. Legislative Mandates Given to the Bureau.

    a. The Bureau has authority to "implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive." Sec. 1021(a).

    b. The Bureau may prescribe rules:

        i. Applicable to a covered person or service provider,

        ii. Identifying as unlawful, unfair, deceptive, or abusive acts or practices,

        iii. In connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.

        iv. Rules under this section may include requirements for the purpose of preventing such acts or practices

3. The Bureau's Preventive (aka "Enforcement") Powers.

    a. The Bureau may take action to prevent a covered person from committing or engaging in an "unfair, deceptive or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service."

    b. Action includes ability to demand production of documents and to make criminal referrals. Sec. 1052. Also, cease and desist proceedings. Sec. 1053.

    c. The Bureau may prescribe rules to ensure that the features of any consumer financial product or service, both initially and over the term of the product or service, are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances.

4. What's Unfair? Under Section 1031, the Bureau has no authority to declare an act or practice to be unlawful as unfair, unless the Bureau has a reasonable basis to conclude that:

    a. The act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and

b. Such substantial injury is not outweighed by countervailing benefits to consumers or to competition.

c. The Bureau may consider established public policies as evidence to be considered with all other evidence, but these public policy considerations may not serve as a primary basis for such determination.

5. What's Deceptive?

   a. In contrast to "unfair" or "abusive," the Act does not define what is or is no "deceptive."

   b. Will a national standard be created?

   c. Will it "preempt" state law standards?

   d. Will the state law that has developed on "deceptive" practices now be a basis for action by a federal entity -- the Bureau? If so, is there a possible challenge over:

      i. Due process -- can Congress adopt a federal law that incorporates 50 state standards?
      ii. Due process -- what "choice of law" would apply when there are multi-state issues (for example, the bank is in one state and a credit card holder is in another, or in all 50)?

   e. State standards have moved away from the need for an "affirmative" misrepresentation to support a cause of action under "UDAP" statutes and under common law tort theories of "deceptive" acts or practices.

6. What's Abusive? Under Section 103, the Bureau has no authority to declare an act or practice abusive unless the act or practice:

   a. Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or

   b. Takes unreasonable advantage of—

      i. a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
      ii. the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
      iii. the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

7. Information Gathering: Under Dodd-Frank, consumers have rights, upon request, to obtain information from a covered person concerning the consumer financial product or

service that the consumer obtained from them, including information relating to any transaction, series of transactions, or to the account including costs, charges and usage data.

8. Dispute Resolution: The Bureau must (in consultation with the appropriate Federal regulatory agencies) establish reasonable procedures to provide a timely response to consumers, in writing where appropriate, to complaints against, or inquiries concerning, a covered person.

9. Impact on Community Banks.

    a. Bureau jurisdiction over "banks" is limited to institutions with $10 billion or more in assets.

    b. "Unfair or deceptive" as a finding is, however, expected to "trickle down."

        i. So supervisory agencies are expected to impose the same rules on smaller banks.
        ii. Likewise, litigation is expected to impose the same rules on smaller banks.

    c. There is no inflation adjustment mechanism.

10. Industry Concerns.

    a. Will rulemaking based on larger institutions result in problems for the smaller banks?

    b. Will independent funding for the Bureau lead to problems (too much regulation or too many solutions)?

    c. How can the Bureau avoid substantive regulation of prices and terms/conditions?

Panel 3

The Return of the Rating Agencies: Rerun or Redemption?

Presented by the Chapman University Student Bar Association

Speakers:

Claire Hill, Professor, Solly Robins Distinguished Research Fellow and Director, Institute for Law & Rationality, University of Minnesota Law School
The Limits of Dodd-Frank's Rating Agency Reform

Kurt Eggert, Professor of Law, Chapman University School of Law
Cleaning Up After the Rating Agencies Failed

Cassandra Jones Havard, Professor of Law
University of Baltimore School of Law
Got Transparency?

Moderator: Professor Timothy A. Canova, Betty Hutton Williams Professor of International Economic Law, Chapman University School of Law

2:00pm–3:15pm

Professor Claire Hill

2011 *Chapman Law Review* Symposium Speaker

Claire Hill teaches at the University of Minnesota Law School and heads its Institute for Law and Rationality. She is the 2009-11 Solly Robins Distinguished Research Fellow, and was the 2008-9 Vance K. Opperman Research Scholar and the 2007-8 Julius E. Davis Professor. She previously taught at Chicago-Kent College of Law, George Mason School of Law and Georgetown University Law Center, where she was a Sloan Visiting Professor. Professor Hill teaches corporate law, mergers and acquisitions, contracts, and seminars in law and economics. She has published numerous articles on capital structure, corporate governance, structured finance, rating agencies, secured debt, contract theory, law and language, and behavioral economics. Two of her articles were selected for inclusion in the Securities Law Review, an annual edited volume of noteworthy scholarship in the field. One of her articles won the David Watson Memorial award. Her work has been featured on various business blogs; she has been interviewed on the subject of rating agencies on television and radio.

Publications

Book Chapters

- The Promise and Limits of Financial Engineering in Emerging Markets, in *Financial Innovations and the Welfare of Nations: How Cross-Border Transfers of Financial Innovations Nurture Emerging Capital Markets* (Laurent L. Jacque & Paul M. Vaaler, eds., Kluwer Academic Publishers, 2001)

Journal Articles

- Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability, 33 *Seattle University Law Review* 1173 (2010) (with Richard W. Painter)
- Concepts, Categories, and Compliance in the Regulatory State, 94 *Minnesota Law Review* 1151 (2010) (with Kristin Hickman)
- What Cognitive Psychologists Should Find Interesting about Tax, 17 *Psychonomic Bulletin & Review* 180 (2010)
- Who Were the Villains in the Subprime Crisis, and Why It Matters, 4 *Entrepreneurial Business Law Journal* 323 (2010) (Symposium on The Credit Crash of 2008: Regulation within Economic Crisis)
- Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?, 71 *University of Pittsburgh Law Review* 585 (2010) (Symposium on the Past, Present, and Future of the SEC)
- Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts, 34 *Delaware Journal of Corporate Law* 191 (2009)
- Executive Compensation and the Optimal Penumbra of Delaware Corporate Law, 4 *Virginia Law & Business Review* 333 (2009) (with Brett McDonnell)
- Rationality in an Unjust World: A Research Agenda, 35 *Queen's Law Journal* 185 (2009) (Symposium on Emerging Paradigms of Rationality)
- Why Did Anyone Listen to the Rating Agencies after Enron?, 4 *Journal of Business & Technology Law* 283 (2009)

- Commentary: The Trajectory of Complex Business Contracting in Latin America, 83 *Chicago-Kent Law Review* 179 (2008) (Symposium on Law and Economic Development in Latin America: A Comparative Approach to Legal Reform)
- Negative Dimensions of Identity: A Research Agenda for Law and Public Policy, 9 *Minnesota Journal of Law, Science & Technology* 643 (2008) (Symposium on Self and Other: Cognitive Perspectives on Trust, Empathy and the Self) (with Avner Ben-Ner)
- Reducing the Negative Consequences of Identity: A Potential Role for the Nonprofit Sector in the Era of Globalization, 79 *Annals of Public and Cooperative Economics* 579 (2008) (with Avner Ben-Ner)
- The Myth of Discovery, 9 *Minnesota Journal of Law, Science & Technology* 743 (2008) (Symposium on Self and Other: Cognitive Perspectives on Trust, Empathy and the Self)
- The Rationality of Preference Construction (and the Irrationality of Rational Choice) 9 *Minnesota Journal of Law, Science & Technology* 689 (2008) (Symposium on Self and Other: Cognitive Perspectives on Trust, Empathy and the Self)
- *Disney*, Good Faith, and Structural Bias, 32 *Journal of Corporation Law* 833 (2007) (with Brett McDonnell)
- *Stone v. Ritter* and the Expanding Duty of Loyalty, 76 *Fordham Law Review* 1769 (2007), reprinted in *Corporate Governance: Directors' Duties* (K. Janardhanacharyulu, ed., Amicus Books, an imprint of Icfai University Press) (with Brett McDonnell)
- Anti-Anti-Anti-Paternalism, 2 *New York University Journal of Law & Liberty* 444 (2007) (Symposium on Legal Paternalism)
- Creating Failures in the Market for Tax Planning, 26 *Virginia Tax Review* 943 (2007) (with Philip A. Curry & Francesco Parisi)
- Tax Lawyers are People Too, 26 *Virginia Tax Review* 1065 (2007) (commentary on Victor Fleischer, Options Backdating, Tax Shelters, and Corporate Culture, 26 *Virginia Tax Review* 1031 (2007)), reprinted in *Monthly Digest of Tax Articles* (2007)
- The Law and Economics of Identity, 33 *Queen's Law Journal* 389 (2007)
- A Cognitive Theory of Trust, 84 *Washington University Law Review* 1717 (2006) (with Erin Ann O'Hara)
- Beyond Mistakes: The Next Wave of Behavioural Law and Economics, 29 *Queen's Law Journal* 563 (2004)
- How Do German Contracts Do as Much with Fewer Words?, 79 *Chicago-Kent Law Review* 889 (2004); also published in *Ordinary Language and Legal Language* (Barbara Pozzo, ed., Giuffrè, 2005) (conference papers presented at the 2003 Conference of Comparative Law and Language, co-sponsored by the Associazione italiana di diritto comparato, the American Society of Comparative Law, and Milan University Faculty of Law) (with Christopher King)
- Regulating the Rating Agencies, 82 *Washington University Law Quarterly* 43 (2004), reprinted in 36 *Securities Law Review* 313 (2005)
- Rating Agencies Behaving Badly: The Case of Enron, 35 *Connecticut Law Review* 1145 (2003) (Symposium on Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron)

- A Comment on Language and Norms in Complex Business Contracting, 77 *Chicago-Kent Law Review* 29 (2002) (Symposium: Theory Informs Business Practice) (symposium issue editor)
- Comment on Adler & Triantis: The Aftermath of *North LaSalle Street*, 70 *University of Cincinnati Law Review* 1297 (2002) (Fifteenth Annual Corporate Law Symposium: Corporate Bankruptcy in the New Millennium)
- Is Secured Debt Efficient?, 80 *Texas Law Review* 1117 (2002)
- The Future of Synthetic Securitization: A Comment on Bell & Dawson, 12 *Duke Journal of Comparative and International Law* 563 (2002) (Symposium on International Securitization and Structured Finance)
- Whole Business Securitization in Emerging Markets, 12 *Duke Journal of Comparative and International Law* 521 (2002) (Symposium on International Securitization and Structured Finance)
- Why Contracts are Written in "Legalese," 77 *Chicago-Kent Law Review* 59 (2002) (Symposium: Theory Informs Business Practice) (symposium issue editor)
- How Investors React to Political Risk, 8 *Duke Journal of Comparative and International Law* 283 (1998) (Symposium on International Issues in Cross-Border Securitization and Structured Finance)
- Latin American Securitization: The Case of the Disappearing Political Risk, 38 *Virginia Journal of International Law* 293 (1998)
- Securitization: A Financing Strategy for Emerging Markets, 11 *Journal of Applied Corporate Finance* 55 (1998)
- Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics, 22 *Delaware Journal of Corporate Law* 141 (1997), reprinted in 30 *Securities Law Review* 89 (1998)
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The Limits of Dodd-Frank's Rating Agency Reform

Claire A. Hill
University of Minnesota

Chapman Law Review Symposium: *From Wall Street to Main Street: The Future of Financial Regulation.*

History, pre-Enron

- Law (and practice) 'requires' ratings, from standard, government-approved raters (NRSROs)
- There are effectively* only 3 government approved raters, 2 having most of the market (Moody's; S&P)
  - Occasionally they make huge mistakes
  - Calls for more regulation
    - When urgency fades, nothing much happens

* Not really 3, but details are messy and unhelpful. For some time pre-Enron, and continuing post-Enron, Standard & Poor's and Moody's share the vast bulk of the market – a partner duopoly. Fitch makes big inroads in structured finance. Various other agencies are bought by or merged into these over time.

Reasons for the huge mistakes

- Complacency because of lack of competition
- Conflicts of interest?

Aims of reform

- First, Quality
- Second, Price
- Third, competition
  - For competitors
  - For quality and price

Possible Mechanisms

- Increase quality "directly"
  - Oversight
  - liability
- Decrease price
  - By increasing competition
- Increase competition
  - "Allow" competitors
  - Increase quality and decrease price

Post-Enron Reform, Credit Rating Agency Reform Act of 2006

- Addressed competition directly
  - Previous regime: SEC gave hugely important NRSRO designation at its discretion
  - **New regime: default is SEC approval if requirements met**

Post-Enron Reform, Credit Rating Agency Reform Act of 2006

- Other issues addressed
  - (Limited) Oversight
  - Conflict procedures
  - SEC and Comptroller General produce and give reports

Result of Post-Enron Reform

- More competition "allowed"
  - Old habits are mostly sticky, BUT---
    - Expressive force/passage of time pushes more to Fitch...
      - Disaster!

What do we do now?

- Improve quality of rating agency product?
- Get people no longer to rely on agencies?
- Promote more, real, competition?

- *Dodd Frank mostly tries to do first two things*

Dodd Frank

- Improve quality of ratings
- Decrease reliance
- No real focus on increasing competition (or decreasing prices)
  - *Legislation meant to address ratings quality*

Limits of Dodd Frank

- Increasing quality is desirable but how useful will new laws be?
- How well will new law decrease reliance?

Punch Line

- Reasons to suspect answer is 'not nearly as well as we might hope'
- Better approach was clever 'attack' on client bias inherent in issuer-pays model
  - May be cause for optimism after law-required report produced

Professor Kurt Eggert

2011 *Chapman Law Review* Symposium Speaker

Professor Kurt Eggert is a Professor of Law at Chapman University School of Law. His scholarly research has focused on mortgage and lending issues, predatory lending, consumer protection and securitization, among other topics, and he has been writing about the dangers of mortgage securitization since 2002. Professor Eggert was a three year member of the Federal Reserve Board's Consumer Advisory Council, where for two years he chaired the subcommittee on Consumer Credit. He recently testified to the federal Financial Crisis Inquiry Commission on the causes of the financial crisis and has testified to Congress and California's state legislature multiple times on mortgage and lending issues. In December, 2010, he testified to the Senate Banking Committee on the causes of the foreclosure crisis.

Beyond "Skin in the Game"

The Structural Flaws in Private-Label Mortgage Securitization That Caused the Mortgage Meltdown

Kurt Eggert

Professor of Law

Chapman University School of Law

Prepared for the Financial Crisis Inquiry Commission for its Hearing entitled "The Impact of the Financial Crisis at the Ground Level – Greater Sacramento, California."

Sacramento, California

September 23, 2010

INTRODUCTION AND SUMMARY

The Financial Crisis Inquiry Commission is holding its hearings during a crucial moment, when the country is slowly recovering from what has been called the "Great Recession," a severe economic downturn that was triggered in part because of the boom and then collapse of the subprime and non-prime mortgage market and the high numbers of mortgage defaults and foreclosures that the boom and bust left in their wake.[1] At the same time, Congress and federal regulators, along with the financial industry, are attempting to revive private-label mortgage securitization by establishing new rules of the road to govern that securitization.[2] The new Dodd-Frank bill takes basic steps to remake mortgage securitization and requires regulators to fill out the full set of rules with new regulations.

To create those new rules of the road, it is crucial to establish what went wrong under the previous system so that when private-label mortgage securitization recovers, we do not find ourselves heading for yet another crash. In my testimony, I will try to identify what I consider the primary causes of the subprime and non-prime mortgage boom and bust and what led to the high foreclosure and default rates.[3] In addition, given the location and purpose of these hearings, I will also describe why some California

[1] "Subprime" generally refers to loans that carry higher interest rates and fees than the prime loans guaranteed by Fannie Mae and Freddie Mac. "Non-prime loans" are those that do not conform to the standards for agency loans guaranteed by Fannie and Freddie. "Non-prime" is a more inclusive term than subprime in that it includes not only subprime loans but also "Alt-A" loans, loans that may have near prime interest rates for borrowers with good credit, but have non-traditional characteristics, such as interest only or payment-option terms or reduced documentation.
[2] Private-label securitization is that done outside the auspices of government-sponsored entities (GSEs) such as Fannie and Freddie.
[3] This testimony is largely a distillation and update of my 2009 article The Great Collapse: How Securitization Caused the Subprime Meltdown (May 2009). Connecticut Law Review, Vol. 41, No. 4, 2009. SSRN: http://ssrn.com/abstract=1434691

communities were especially hard-hit by the subprime boom and bust and the resulting foreclosures.

Those analyzing the subprime crash and the accompanying defaults and foreclosures have converged on two main story lines to explain the flaws of securitization. The first is the idea that the "originate to distribute" model, where lenders originate loans intending immediately to sell or securitize them, misaligns the incentives of loan originators because by quickly assigning their loans, they no longer suffer from the results of loan defaults. Without ongoing "skin in the game," the theory goes, lenders have little motivation to engage in careful underwriting to ensure their loans will not default.[4] The second dominant story line is that securitization's problem was one of transparency: investors could not determine the risks of the securities created from subprime and non-prime loans, given the complexity of the resulting securities and the inadequate disclosures investors were given. Much of the proposed new regulation of private-label securitization is designed to solve these two problems.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 reflects these twin emphases. Its securitization reforms focus primarily on increased disclosure to investors and risk retention by originators and securitizers. Federal regulators who have already been moving forward with their own securitization reforms also focus on disclosure and risk retention. The Security and Exchange Commission's proposed rules regarding securitization, which would revise Regulation AB and other

[4] "Skin in the game" is the idea that investors can better trust the decisions of managers or others who stand personally to lose from bad decisions. Warren Buffett has been widely credited with coining the phrase "skin in the game." See, e.g. http://www.worldaffairsjournal.org/new/blogs/rieff/Skin_in_the_Game. However, Buffett has indirectly denied that he coined the phrase and its usage seems significantly to predate Buffett himself. See Safire, William. 2006. "Language: Who's got a skin in the game?" *The New York Times,* September 17. http://www.nytimes.com/2006/09/17/opinion/17iht-edsafire.2839605.html

rules related to securitization, would also impose risk retention and much more disclosure, not only of the loans in the pool but also of the waterfall structure that determines which tranches receive money and when. The FDIC has also proposed new conditions for an FDIC-insured issuer to benefit from the FDIC's securitization "safe harbor" rule. Use of that safe harbor shields an asset-backed securities issuer from the FDIC's power following an issuer's insolvency to recover assets that have been securitized. FDIC's proposed rule includes risk retention and disclosure requirements, as well as other measures, for such safe harbor.

While the lack of "skin in the game" and of transparency are significant flaws in how private-label mortgage securitization has been conducted, it is important to recognize that they are not the only flaws, and that other aspects of securitization played a major factor in the subprime boom and bust.[5] Private-label mortgage securitization has been structured so that it encourages, at each stage of the origination and securitization of mortgages, market participants to push risk tolerance to its limits. It encourages brokers and lenders to make the largest and riskiest loans borrowers will sign and that can be securitized. Securitization rewards investment houses creating the riskiest loan pool that the rating agency would bless with high ratings, and then gives financial incentives to rating agencies to find some way to give high ratings to a large percentage of securities backed by the resulting risky loans.

Another flaw in private-label securitization is that its use has made it possible and lucrative for loan originators especially but also investment houses to bargain down the due diligence efforts of other securitization participants. Lenders have put great pressure

[5] In this paper, my critique of securitization is limited to the private-label securitization of residential mortgage loans as it existed before the subprime collapse. Other forms of securitization, such as credit card securitization, are structured differently and so have different structural characteristics.

on appraisers to overstate the value of houses to justify loans and on investment houses to reduce their due diligence in examining loans in order to securitize them. Investment houses and others securitizers could shop among rating agencies to find the rating agency that would produce the best rating for securities while demanding the fewest potentially costly credit enhancements designed to protect investors from excessive loan defaults.

Securitization of non-prime loans also destabilizes the financial markets by being susceptible to an investor-driven boom and bust cycle. Notably, the recent subprime collapse was the second one that subprime securitization has experienced. The first subprime collapse occurred in the late 1990s and was largely driven by economic issues outside of the subprime market. This boom and bust cycle for mono-line subprime lenders encourages risk taking by those lenders because they can recognize that if securitization dries up, they may well be put out of business through no fault of their own. Therefore, during boom years subprime lenders have the economic incentive to make as many loans as they can, good or bad, as long as the loans can be securitized. Subprime lenders have little reason to be concerned about the long term reputational effect of making bad loans if they may soon be out of business regardless of the quality (or lack thereof) of the loans they make.

While the "originate to distribute" model explains that securitization undermined loan underwriting, it is important to recognize exactly how that underwriting was undermined. Securitization causes originators to focus on "hard" objective underwriting, underwriting that can be demonstrated and verified through the use of specific data points, such as the borrowers' FICO scores, loan-to-value ratios, debt-to-income ratios, income and assets (Eggert, 2002). In focusing on these objective attributes, lenders intending to securitize their loans have less cause to engage in "soft" underwriting, which examines borrowers' credit-worthiness more subjectively, looking for evidence of borrowers' ability and willingness to repay outside of the data points valued by securitization (Eggert, 2009). Analysis by economists indicates that much of the decline in underwriting after 2000 can be explained to the decline in "soft" underwriting.

In addition to creating the conditions for the making of risky and default-prone subprime and other non-prime loans, securitization amplified the effect of those defaults beyond the mere losses that the defaults themselves would otherwise have caused. If financial institutions had held individual loans, their losses would have been significant, but would have been more transparent to counterparties, investors, regulators and even the financial institutions themselves. Mortgage losses were amplified by counterparty risk, when other companies withheld credit because they could not accurately estimate the amount of subprime risk counterparties held. Had regulators realized the risk that federally-regulated financial institutions held, they should have demanded measures to counter or account for that risk. When the subprime collapse happened, no one knew which institutions were concealing subprime time-bombs on their books, and this lack of transparency of risk led to a severe credit crunch.

The tail end of securitization, the fact that loans are managed by servicers on behalf of the trusts that own loan pools, rather than by an individual owner, also contributes to the increased foreclosure rate, as servicers are more likely to foreclose and less likely to engage in meaningful loan modifications, than portfolio loan owners would be. In this way, securitization also amplifies the effects of loan defaults.

In the following testimony, I will first address why California has suffered so greatly from the subprime boom and bust. Then I will address each of these factors in greater detail. Those creating new rules of the road for private-label securitization should recognize the many factors that played a role in the subprime boom and bust, and not just focus on "skin in the game" and transparency.

CALIFORNIA AND THE SUBPRIME MARKET

One troubling question for Californians is why California communities were among the worst affected nationally by the subprime boom and bust and so have suffered the most from the foreclosure and property value declines that result. A Forbes article from earlier this year identified Merced, California as the housing market in which median home prices dropped the most in the entire nation since the second quarter of 2006, falling an astonishing 62% from their high of about $337,000 (Levy, 2010). In 2008, Mountain House, California, a planned city sixty miles east of San Francisco, was identified as the most "underwater" community in the country, with almost 90% of its home securing mortgages for more than the house was worth already by 2008 (Streitfeld, 2008).

The subprime boom and accompanying rise in property values was concentrated in the so-called "Sand States": California, Nevada, Arizona, and Florida (Tracy, 2010). These states were ripe for housing booms for several reasons. They were subjects of higher than average immigration from other states, with Nevada, Arizona and Florida all recently in the top four "magnet states" with the highest percentage of current state residents born in another state (Cohn and Morin, 2008). Arizona and Nevada were the fastest growing states from 2004 – 2007, with Florida not far behind, while in California, communities that would later be hit by subprime foreclosures, such as Riverside and San Bernardino, were also rapidly adding population (Olesiuk and Kalser, 2009). These states were magnet states because of their job growth, and they, as well as California exurbs, were ripe for development because of empty land and low building costs.

In California, the cities hardest hit by subprime loans were right outside of large population center: those in Riverside and San Bernardino counties for Los Angeles and communities like Fresno, Merced or Mountain Home near San Francisco (Mayer and Pence, 2008). These "exurbs" grew rapidly to accommodate would-be homeowners who could not afford houses in the cities. Once a housing boom started in these communities, the use of subprime loans pushed that boom into a bubble. Rapidly rising prices justified and covered up increasingly risky loans, as lenders required less and less money down based on anticipated valuation increases. Rising housing prices covered up a multitude of sins, and homeowners who got into trouble could typically sell their houses and pay off their loans, often reaping a profit. Cities with housing bubbles, such as Phoenix and Las Vegas, had greater percentages of loans that were subprime than expensive markets like Boston and San Francisco (8 and 12 percent in Phoenix compared to 3 and 4 percent for San Francisco and Boston, in 2005, for example) (Mayer, 2010).

California's anti-predatory lending law did little to fend off abusive practices in the subprime market, as it contained only weak protection for residential borrowers. In 2001, California in 2001 enacted AB 489,[6] a bill purportedly designed to deter predatory lending. However, this law had numerous weaknesses. First of all, the protections only covered loans under $250,000, an amount raised in 2006 to Fannie Mae's limit for a

[6] The bill AB 489 is embodied in Division 1.6 of the California Financial Code, Sections 4970 to 4979.8.

conforming single-family first mortgage. The law did little to restrict brokers from steering borrowers into higher priced loans, and explicitly exempted from liability assignees who are holders in due course. In other words, even when California's law was violated, investors in the resulting mortgage-backed securities were by and large immune from suit by the borrower.

To make matters worse, California's weak state law was held to preempt local law that might have provided homeowners with more protection from abusive lending. In the case, Am. Fin. Servs. Ass'n v. City of Oakland,[7] the California Supreme Court held that California's weak state law preempted local ordinances, including Oakland's much stronger local ordinance which would have covered more loans, mandated borrower counseling for high-cost loans, and provided liability to assignees of predatory loans, including those that had been securitized. Assignee liability is designed to force the secondary market to police originators in order to avoid liability for abusive lending (Eggert, 2002). California borrowers were left relatively unprotected as a result of the weak state law and its preemption of stronger local ordinances.

FACTORS IN THE SUBPRIME COLLAPSE:

1. The "Originate to Distribute" Model

Much has been made of the "Originate to Distribute" model of subprime lending. In 2002, I argued that subprime securitization weakens underwriting because lenders would be less concerned about whether loans would default, given that they planned quickly to sell them, and would only do the sort of automated, objective underwriting the results of which can be communicated to the secondary market (Eggert, 2002). It seems

[7] Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813, 828–29 (Cal. 2005).

clear that new regulations mandated by the Dodd-Frank bill and being considered by the SEC and the FDIC are designed to reduce the ills caused by the "originate to distribute" model. The law and likely regulations will fairly soon require originators to retain some "skin in the game" by holding 5 percent or so of the subprime securities backed by their loans, though the exact details will be determined by various federal regulators. However, it would be a mistake to place too much confidence in the effect of such efforts. First of all, many subprime originators had so much "skin in the game" in terms of requirements that they repurchase early defaults or loans that violated their representations and warranties that they quickly went out of business once the loans went bad and they were asked to repurchase them. While their creditors would benefit if the monoline subprime originators had held more assets when they went bankrupt, the problem seems to have been one much larger than a mere 5 percent retention requirement would have solved.

Also, how the retention requirement should be structured is difficult to determine. If originators are required to retain the first loss position, they might well bank on the retained assets having so little value because of nearly inevitable losses that they should not affect the lenders' behavior, especially that of abusive lenders with high default rates. The worse the lender, the less effect holding a 5 percent first loss position would have on that lender's behavior. On the other hand, if originators were required to hold 5 percent scattered vertically among all of the tranches of a securitization, then they would face much lower losses even if there were significant default rates.

Nor is merely increasing the retention percentage without its own share of difficulty. If originators retain too great a percentage of securities in loans they originate, they lose much of the advantages of securitization, as they would have less access to capital. Furthermore, originators who continue to service the loans they make would find themselves with a growing conflict of interest with the other investors, as the originators' interest in how the loan is serviced increases.

Instead of accomplishing risk retention solely through forcing originators to hold mortgage-backed securities, it may be better to have them retain some risk by forcing them to hold loans in their portfolio for a period of time, say a year, before securitizing them. The FDIC had proposed such a one-year seasoning requirement but in its latest Notice of Proposed Rulemaking replaced the seasoning requirement with that of a "a 5% reserve fund for RMBS in order to cover potential put backs during the first year of the securitization." (FDIC, 2010). Requiring seasoning would have some clear advantages over simply requiring retention of securities. First of all, seasoning would not lead to a conflict of interest between originators and investors, as the lenders would hold their own loans. Secondly, it would force lenders to bear all of the risk of early default, and would prevent them from securitizing a large number of bad loans and then declaring bankruptcy when the loans quickly go bad. Also, it would reduce the boom and bust cycle of subprime loans, as lenders who rapidly ramp up their subprime operations would have to hold the resulting loans for a year rather than quickly transferring them and immediately relending the money.

2. Lack of Transparency

Critics have accurately condemned the lack of transparency that private-label mortgage-backed securitization, as it was structured, provided. Such securitization has created two kinds of opacity. First of all, investors were not given good information about the risks contained in the securities they were purchasing. Secondly, by concealing those risks in securities with complex, opaque structures, the risks of which were again sliced and diced among CDOs, credit default swaps, insurance, repurchase agreements and other hedge attempts, securitization made opaque the subprime risk held by many different financial institutions.

For private-label securitizations, investors should have been given current loan-level detail for every security offering, so that they could see what they were buying, albeit with measures in place to protect borrower privacy. The value of mortgage-backed securities depends almost completely on the loans themselves, but investors were rarely given loan-level information. By failing to give investors loan level data, Wall Street firms were able to continue to securitize non-prime loans despite the deterioration of underwriting for those loans and their increased risk of default.[8] Worse yet, the prospectuses and accompanying supplement often made claims about the underwriting used for loan pools, but did not disclose how many of the loans included in the pools were made as exceptions to the underwriting standards. Instead, the offering materials reported mere boilerplate language that exceptions might make up "substantial" or "significant" portions of the pool (Bajaj and Anderson, 2008). The number and character of exceptions, which ran as high as 50 to 80 percent of some loan pools, would have an enormous effect on the quality of the loan pool and should have been disclosed (Bajaj and Anderson, 2008).

Investors often were not notified of the changing nature of the mortgages that

[8] According to Randall S. Kroszner, Governor of the Federal Reserve, "The paucity and inaccessibility of data about the underlying home loans was, in my opinion, one of the reasons that private-label MBS was able to expand so rapidly in 2005 and 2006 despite a deterioration in underwriting and prospective credit performance." (Kroszner, 2008).

were being securitized. For example, while investors might have been told of the number of no or low documentation loans, they often were not informed that such loans were being marketed to a different kind of borrower, wage earners who should have easily been able to document their income (Adelson and Jacob, 2007) Wage earners who can easily document their income but affirmatively choose not to are significantly more risky borrowers than non-wage earners that lenders choose for reduced loan documentation because of the borrowers' low credit risk (Dungey, 2007). However, this change in the type of borrower using low documentation loan was not adequately disclosed.

Investment houses also should have disclosed the results of their due diligence efforts in determining whether the loans fit the purported qualifications of the pool. In this due diligence process, some portion of the pools would be examined, often by a third party, to see if the mortgages met the criteria for the pool. What percentage failed in this examination was important information for investors, as it would tell them about the actual, as opposed to claimed, underwriting by the lender. Instead of disclosing the due diligence reports to rating agencies and investors, however, it appears that some Wall Street firms may have been using those reports primarily to increase their own profits. According to recent reports, some Wall Street firms used due diligence reports showing a large number of problem loans in order to negotiate a lower price with the originator, then securitized the problem loans anyway without disclosing the problems to investors (Mortgenson 2010). Such behavior, if proven, stands due diligence on its head, and turns if from a mechanism to protect investors from problem loans to a mechanism for investment houses to benefit from problem loans at the expense of investors who unknowingly end up with the bad loans.

3. Pushing Risk to Its Limits

One hazard of securitization is that it encourages each market participant to push risk tolerances to their limits in an effort to maximize profits. For example, during the subprime boom, mortgage brokers could increase their income by closing as many loans as possible, convincing borrowers to take the largest loans they would qualify for, and inducing borrowers accept interest rates higher than what their credit records justified, all of which increased the risk of defaults. Brokers' commission was often based on loan amount and the number of loans, and so if they could upsell the amount of loan and close as many loans as possible, they could maximize their earnings. This motivated brokers to learn the limits of lenders' underwriting standards, often automated, and to push those limits as far as possible. Worse yet, yield spread premiums, additional payment to brokers when borrowers accepted interest rates higher than their credit could have justified, further rewarded brokers who could lure borrowers into taking loans with higher interest rates, leading to even riskier loans (Gordon, 2009).

As a result of these broker incentives, loans originated through a mortgage broker have experienced significantly higher delinquency rates (more than 50% higher, according to one study) than loans originated directly by a bank (Jiang, Nelson, and Vytlacil, 2009). Jiang, et. al. conclude that brokers not only "apply looser lending standards" but are also "less diligent in verifying borrower information" than banks originating their own loans, with the likely result being increased information falsification for loans originated by brokers.

While brokers were testing the underwriting limits of originators, originators were also testing the secondary market to see what loans it would accept, and used the information they gleaned to weaken their underwriting if they could sell more loans by doing so. While offering materials for subprime-backed securities touted subprime lenders' underwriting standards to investors, it appears that for at least some non-prime lenders, the primary if not sole underwriting question was whether the loan could be securitized. In securities litigation by the Securities and Exchange Commission against Angelo Mozilo, of Countrywide Financial Corp., at one time the nation's biggest residential mortgage lender, the SEC has argued that "the evidence is clear that by as early as July, 2005, Countrywide's primary 'underwriting standard' was not the borrower's ability to repay the loan, but rather whether it could sell the loan into the secondary market, where Defendants apparently hoped the performance of the loan would then become the purchaser's problem." (SEC Brief, 2010). If so, Countrywide was succumbing to the siren call of securitization.

When loans were being securitized, again risk tolerance was pushed to the limits. Because highly rated securities are, all else being equal, more valuable than those lower rated, and because credit enhancements, like over-collateralization of loans or default insurance designed to protect investors from the risk of default, can be expensive, securitizers profit when rating agencies give the maximum high rating for the resulting securities while demanding the cheapest credit enhancements. Wall Street firms and other securitizers were rewarded for assembling the worst loans with least expensive credit enhancements that would receive the desired credit ratings. They pushed rating agencies to weaken their rating quality.

Rather than mortgage-backed securities at each rating level with risk tolerances across the whole band of risk tolerances for that level, the securitizers were encouraged to create securities always just barely justifying the given rating level (Eggert, 2009, Brunnermeier, 2009). In other words, when mortgage or CDO securitization produced investment grade securities, it produced the riskiest investment grade securities that the rating agencies would permit. This pushing of risk to its edge of tolerance has made the entire system more fragile. Much like an eco-system with little bio-diversity is more vulnerable to environmental change, so too a mortgage finance system based on pools of mortgages all pushed to the limit of risk tolerance is more vulnerable to a financial shock.

4. Bargaining Down Due Diligence

Securitization atomized the mortgage process, breaking it apart and assigning its various functions to different business entities (Jacobides, 2001). Instead of a lender originating, holding and collecting payments for its own loans, a mortgage broker dealt directly with the borrower, a lender originated the loan, an investment house bundled it for securitization, a rating agency blessed the resulting securities with its ratings, and a servicer collected the mortgage payments with perhaps another servicer stepping in to foreclose. This atomization not only gave market participants incentives that conflicted with those of investors, with originators, investment houses and even rating agencies rewarded for quantity of loans over quality, but also gave those interested in quantity over quality the ability to bargain down the due diligence and quality control of other market participants.

Home appraisers widely complained of lender pressure to inflate the value they assigned to houses for lenders. Lenders that hold their own loans desire accurate appraisals to protect themselves with an equity cushion should the borrower default. For lenders that securitize, however, home appraisals represented not a protective mechanism to reduce loan losses but rather a pesky hurdle to overcome in order to make and sell the loan. Artificially inflating the appraised values makes loans more valuable by decreasing their loan-to-value ratios and can also justify higher loan amounts. Banks too often let their loan officers or underwriters manage the hiring of appraisers, which allowed their loan officers to pressure appraisers to come up with an appraisal high enough to justify the desired loan (Taylor, 2004) Appraisers that refused to meet appraisal targets could expect to lose business as a result (N.Y. Comm'n of Investigation, 2008). Other appraisers apparently did "play ball" with lenders and brokers, and a review of a small sample of loans from 2006 that suffered early default showed that more than half had appraisal problems, such as inaccurate appraisals, conflicting information, or items "outside of typically accepted parameters" (Fitch Ratings, 2007).

During the boom years, subprime loan securities were in such high demand and subprime loans hence so valued that subprime originators could demand that investment houses engage in less due diligence and could resist having to buy back all of the shoddy loans that the diminished due diligence uncovered. While Wall Street firms might have ordered twenty-five to forty percent of loans to be reviewed before they were securitized shortly after 2000, by 2006, this percentage had fallen to, typically, 10 percent (Reckard, 2008). Large subprime originators had so much leverage that they could bargain down this due diligence, insisting that Wall Street firms engage in far less due diligence for loans that would be securitized than financial firms would conduct for loans they intended to hold in portfolio (Muolo and Padilla, 2008).

Similarly, Wall Street firms could shop among rating agencies to obtain the most favorable ratings given the quality of loans, relying on the rating agencies' conflict of interest created by the fact that they were paid by the securities issuers they were supposed to judge rather than the investors they were supposed to protect (Raiter, 2008). One internal rating agency memo noted, "The real problem is not that the market . . . underweights ratings quality but rather that, in some sectors, it actually penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating."[9] Rating agencies appear to have responded to Wall Street pressure by downgrading the quality of their ratings, especially when doing so would allow them to secure sole rating authority over a security offering. Benmelech and Dluglosz (2009) find that where only one agency rated a set of securities, those ratings were more likely to be downgraded. Becker and Milbourne (2008) find that, at least for corporate ratings, competition between rating agencies is accompanied by a decrease in rating quality. Ashcraft, Pinkham-Goldsmith, and Vickery (2010) also find correlation between rating quality and number of rating agencies who rated a deal, but more importantly conclude that there was a significant erosion in the quality of credit ratings at the peak of the subprime boom and that securities backed by high risk loans or low documentation loans have been consistently overrated.

5. Subprime's Boom and Bust Cycle

One of the dangers of securitizing subprime loans is that it links those loans directly to the capital markets, which for subprime lending is a relatively unstable funding supply, one that has crashed twice already in the young life of subprime

[9] This memo is from a confidential presentation to Moody's Board of Directors, and was made public for a hearing *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. On Oversight and Gov't Reform*, 110th Cong. (2008). http://oversight.house.gov/documents/20081022111050.pdf

securitization. The securitization of subprime loans started first in the late 1980s, but did not gain much volume until the mid-1990s (Gittelsohn, 2007). The first subprime crash occurred in 1998, when the combination of the Russian debt crisis and the collapse of the private hedge fund Long-Term Capital Management (LTCM) caused investors to jettison subprime securities in their rush to the safety of U.S. Treasury securities. Subprime lenders suffered a double blow as they received a lower price for loans they had in the pipeline at the same time that their cost of funds increased (Sabry and Schopflocher, 2007). The stock values of subprime lenders plummeted, some to zero, and fallen subprime lenders that had depended on securitization included some of the biggest names in subprime (Muolo and Padilla, 2008. White, 2006). While subprime lenders had suffered some greater than expected default rates and had played accounting games, the first subprime collapse seems to have been for reasons largely external to the subprime market (Danis and Pennington-Cross, 2005).

Realizing that they are tied to such an unstable money supply would naturally lead subprime lenders to become greater risk-takers. If a subprime lender had scrupulously maintained its underwriting standards throughout the subprime boom, it still would in all likelihood have found itself unable to stay in business, cut off from its funding source when subprime crashed, as subprime securitization has essentially disappeared. The lender would have obtained no benefit for forgoing making even default-prone loans that could be securitized, as there would be no long-term reputational benefit for good underwriting once the lender is out of business. As federal regulators and the financial market attempt to restart private-label mortgage underwriting, they must not only convince investors that the loans will be well-underwritten, they must also convince subprime lenders that there are benefits for good underwriting and that lenders should not just engage in a race to the bottom before the market collapses again.

6. Securitization and "Hard" vs. "Soft" Mortgage Underwriting

Between 2002 and 2006, underwriting standards became significantly degraded. For example, the median loan to value ratio of new subprime loans increased from 90 percent to 100 percent from 2003 to 2005 (Mayer, Pence, and Sherlund, 2009). There has been significant academic discussion about how much this underwriting decline led to the increased foreclosure and default rate, and how much was due to declining housing prices, but it appears likely that both played a role. Gerardi, Shapiro and Willen (2009) argue that declining housing prices led to the rapid increase in foreclosures, though concede that underwriting standards did decline, creating a set of borrowers "particularly vulnerable to the decline in prices." Others note the great role increasingly shoddy underwriting played in the increase in defaults and foreclosures (for example Dell'Ariccia, Igan and Laeven, 2008, and Mayer, Pence, and Sherlund, 2009), though they too note the relevance also of declining housing prices.

Even to the extent that declining housing prices led to the rise in defaults, securitization still seems to have played a role in the housing price bubble, the popping of which led to those housing price declines. Some have blamed the bubble on the federal government's monetary policies. The national government of the United States and Canada however had similar expansionist monetary policy in the last decade, yet housing prices in Canada did not exhibit the boom and bust seen in the United States, and Canada's mortgage delinquency rate has been much lower than that of the United States (MacGee, 2009). MacGee (2009) concludes that the larger subprime market and more lax underwriting standards in the United States were critical factors in the housing bubble and bust, rather than overall monetary policies.

In discussing declining underwriting standards, it is important to recognize the multiple dimensions of underwriting. Some underwriting is based on hard, objective data which can be determined with little direct knowledge of the borrower and fairly easily communicated to the secondary market. Automated underwriting systems, and their use of data points such as loan to value ratios, borrower income and assets, and FICO scores use "hard" mortgage underwriting both on the lender level and by the secondary market to evaluate loans for securitization (Anderson, et. al., 2008). "Soft" mortgage underwriting is based on more personal, subjective information, such as direct knowledge of the borrower, the borrower's explanation for credit mishaps or for anticipated earnings, or the neighborhood wherein the house is located (Rajan, Seru and Vig, 2010).

Each form of underwriting has its strengths and weaknesses, with hard mortgage underwriting faster and cheaper, and less subject to favoritism or red-lining, while soft mortgage underwriting is better at reacting to new and different mortgage conditions with common sense, rather than relying on a statistical analysis mired in the past (Browning, 2007, Rajan, et. al. 2010). Ideally, lenders would employ both hard and soft mortgage underwriting, so that the strengths of each would make up for the weakness of the other. One of the great challenges to restarting subprime securitization will be to reestablish automated underwriting, given that past subprime default data will have been under a completely different regulatory regime and those designing automated underwriting systems will initially have little useful current data on which to base their programs.

Securitization led to the decline, if not often the virtual elimination, of soft mortgage underwriting for loans designed to be securitized. Originators had no incentive to gather "soft" information that could not be communicated to the Wall Street firms, rating agencies and investors that would determine which loans would be securitized. Demyanyk and Van Hemert (2008) conclude that "during the dramatic growth of the subprime (securitized) mortgage market, the quality of the market deteriorated dramatically" and that the loan quality declined, even when adjusted for changes in "borrower characteristics (such as the credit score, a level of indebtedness, an ability to provide documentation), loan characteristics (such as a product type, an amortization term, a loan amount, an mortgage interest rate), and macroeconomic conditions (such as house price appreciation, level of neighborhood income and change in unemployment)." Anderson, Capozza, and Van Order (2008) found a two-stage decline in underwriting standards, with hard mortgage underwriting standards declining during the 1990s, possibly as investors gained confidence in the securitization of subprime loans, and a second decline after 2004 that was not as readily apparent to the secondary market. Rajan, Seru and Vig (2010) also find a decline in soft mortgage underwriting, noting that as securitization increases, the rates of subprime loans for borrowers with similar hard credit criteria converge, indicating that lenders focus more exclusively on hard information.

7. How Securitization Amplifies Default Risk

Securitization perniciously amplified the damage caused by non-prime defaults beyond the mere losses the defaults would have caused if they had been held by financial institutions as whole loans. Some financial institutions have regulatory requirements that treat investment grade securities very differently from non-investment grade securities. Financial institutions, either through regulation or by agreement, may have requirements concerning investment grade securities "hard coded" into them. If they hold too many securities that are downgraded below investment grade, they may have to raise significant additional capital, may have their counterparty status threatened or their liquidity questioned, and may even be considered "troubled" (Berg, 2009). If the investment grade mortgage-backed securities have all been "rated at the edge" by rating agencies eager to maximize their rating business, the securities may be too prone to being downgraded, thus unduly threatening the institution that holds them.

Securitization reduced financial transparency for investors and regulators attempting to determine the subprime risk held by various financial institutions. Instead of holding whole loans so that their risk was fairly obvious, financial institutions held subprime risk that had been sliced apart and reassembled in such complex and multitudinous transactions that even the financial institutions themselves had difficulty in determining what their own exposure was. For example, Citigroup recently settled claims that it had wildly underestimated its subprime exposure, claiming in mid-October, 2007, that it had "only" $13 billion in subprime exposure, only to admit in early November, 2007 that its "direct exposure" for subprime was about $55 billion, which included "'super-senior' tranches of collateralized debt obligations and financial guarantees known as liquidity puts that allowed customers to sell debt securities back to Citigroup if credit markets froze," according to the SEC (Westbrook and Keoun, 2010).

Had Citigroup's federal regulators realized the extent of its subprime exposure, they might well have demanded that it take steps to reduce that exposure or to allocate additional capital reserves because of the risk. Investors might have pulled out or threatened to pull out of Citigroup's stock, giving it further encouragement to reduce its subprime risk. Because that exposure was relatively hidden, though, regulators and investors did not have adequate opportunity to rein in Citigroup's risky behavior.

This lack of transparency contributed greatly to the global liquidity crisis that followed the subprime meltdown and accompanying increase in mortgage defaults. Securitization has led to an "opaque web of interconnected obligations," significantly increasing counterparty risk, in that financial institutions have difficulty determining the stability of their counterparties (Brunnermeier, 2009).

Securitization also amplifies the risk of foreclosure by making it harder for borrowers to obtain appropriate loan modifications. Securitized loans are exhibiting higher foreclosure rates than unsecuritized loans, not only because of the effect securitization had on underwriting, but also due to the fact that third-party servicers act on behalf of investors to collect mortgage payments, monitor defaults and also foreclose. Securitization makes it more difficult for borrowers to resolve problem loans, due to such factors as "tranche warfare" whereby a servicer is concerned that a loan modification may benefit one tranche of a mortgage deal above others, leaving the servicer open to claims of favoritism and breach of the fiduciary duty to treat all classes fairly (Eggert, 2002). Servicers' self-interest may also encourage excessive foreclosures, as servicers may benefit more from the foreclosure than they would from a loan modification (Eggert, 2007). In this way, securitization also amplifies the effects of loan defaults by causing more loan defaults to turn into loan foreclosures.

Economists currently do not all agree that securitization increases foreclosures by limiting effective loan modifications or other workouts. However, those who argue that loans serviced by third parties have higher foreclosure rates than those held in portfolio appear to be gaining the upper hand. Adelino, Gerardi, and Willen (2009) discounted the idea that securitization made effective loan modification more difficult, and asserted instead that servicers are failing to engage in widespread loan modifications merely because such modifications would not make economic sense. Instead, according to their analysis, investors may often benefit if servicers either passively wait to see if borrowers find some other way to cure the loan or if servicers foreclose, and so avoid the high risk of re-default after modification. However, a recent paper by Piskorski, Seru and Vig (2010) has concluded that securitization causes a "foreclosure bias," noting, "Controlling for contract terms and regional conditions, we find that seriously delinquent loans that are held by the bank (henceforth called 'portfolio' loans) have lower foreclosure rates than comparable securitized loans (between 3% (13%) to 7% (32%) in absolute (relative) terms)." Piskorski, et. al. also note that governmental agency reports on loan modifications also validate the idea that securitized loans exhibit a "foreclosure bias," and state, "OCC and OTS Mortgage Metrics Reports (2009b) point out that the re-default rate for renegotiated loans serviced by third parties was significantly higher than the re-default rate for loans held in the servicers' own portfolios (for example, 70% higher after six months).

It is unlikely that those holding loans in their own portfolios are regularly failing to foreclose when foreclosing would be in their own best interests. Hence, because loans held by third party servicers have a foreclosure bias as compared to loans held in portfolio, it appears likely that servicers are foreclosing on some loans even when it is in the interest of the investors not to do so. Foreclosures can cause great damage, not only to the homeowner, but also to neighboring property values and the community (Eggert, 2009). By causing more troubled loans to be foreclosed rather than resolved, securitization amplifies the damage of problem loans.

CONCLUSION

Governmental regulators and the financial industry are now in the process of attempting to re-write the rules of the road regarding private-label mortgage-backed securitization. The Dodd-Frank bill contains a broad outline of some improvements, but leaves many of the specific changes to regulations created by a variety of federal regulators. As those regulators and the financial industry work to put private-label securitization back together, it is important to recognize that the flaws of the previous system go far beyond the lack of both "skin in the game" by originators and transparency for investors. Some in the financial industry are advocating for minimizing the changes to the system, as if adding a dash of disclosure and risk retention were all that was needed for a safe and vibrant system of private-label securitization. However, the structural problems of private-label mortgage securitization go far beyond mere "skin in the game" and transparency. Those who would seek to prevent another crash need to make bold, rather than merely cosmetic, changes. By addressing all of the problems of mortgage securitization, we can maximize our chances to avoid another mortgage crisis caused in large part by securitization.

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Professor Cassandra Jones Harvard

2011 *Chapman Law Review* Symposium Speaker

Cassandra Jones Havard earned a B.A., *with highest honors*, from Bennett College and the J.D. from the University of Pennsylvania, where she was Editor-in- Chief of the *Black Law Journal*. She joined the faculty of the University of Baltimore School of Law in 2005 after teaching and receiving tenure at Temple University School of Law, serving as an attorney for the Federal Deposit Insurance Corporation, the Department of Justice (Tax Division) and clerking for the Hon A. Leon Higginbotham, Jr., of the United States Court of Appeals for the Third Circuit.

Professor Jones Havard's scholarship examines the intersection of law, economic subordination and access to credit. She has written thoughtful critiques of the Community Reinvestment Act; on credit barriers faced by black farmers and small businesses; and on sub-prime and predatory lending. She has also written on the regulation of financial institutions and their holding companies.

Professor Jones Havard is active in the Association of American Law Schools, having served as chair of both the Section on Financial Institutions and of the Audit and Association Investment Policy Committee. She is also an active member of the Business Law Section of the American Bar Association, formerly serving on the Diversity Committee and chair of the CLEO Fellows Sub-Committee.

At Baltimore, she teaches courses in banking, corporate and commercial law.

Panel 4

Who's the Boss? Re-writing the Rules of Corporate Governance

Presented by LexisNexis

Speakers:

Iman Anabtawi, Professor of Law, UCLA School of Law
Dodd-Frank, Corporate Governance and Systemic Risk

Z. Jill Barclift, Associate Professor of Law, Hamline University School of Law
Governance in the Public Corporation of the Future: The Battle for Control of Corporate Governance

Stefan J. Padfield, Associate Professor of Law, The University of Akron School of Law
The Dodd-Frank Corporation: More Than a Nexus of Contracts

Gary Aguirre, The Aguirre Law Firm
The Dodd-Frank Bounty for Whistleblowers: A New Arrow in the SEC's Quiver or Career Suicide for the Whistleblower?

Moderator: Keith P. Bishop, Partner, Allen Matkins, Adjunct Professor, Chapman University School of Law, Former California Commissioner of Corporations

3:30pm–5:00pm

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Keith P. Bishop

2011 *Chapman Law Review* Symposium Moderator

Keith P. Bishop is a partner in Allen Matkins' Corporate and Securities practice group, and works out of the Orange County office. He represents clients in a wide range of corporate transactions, including public and private securities offerings of debt and equity, mergers and acquisitions, proxy contests and tender offers, corporate governance matters and federal and state securities laws (including the Sarbanes-Oxley Act of 2002), investment adviser, financial services regulation, and California administrative law. He regularly advises clients on compliance, licensing, regulatory and civil enforcement issues. He has advised clients in connection with several internal corporate investigations, including investigations of stock option backdating. Keith previously served in the positions of Commissioner of Corporations California and Interim Savings & Loan Commissioner for the State of California. He also served as Deputy Secretary and General Counsel to the California Business, Transportation & Housing Agency. He was also appointed as a member of the California Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions.

Keith is a past co-chair of the Corporations Committee of the Business Law Section of the California State Bar and a past member of the Executive Committee of the Business Law Section. He has also served as Chairman of the Business and Corporate Law Section of the Orange County Bar Association and a member of the Administration of Justice Committee of the Orange County Bar Association. Keith is currently the California liaison to the Committee on the State Regulation of Securities of the Business Law Section of the American Bar Association.

Keith has written numerous articles on corporate and securities laws and is the author of a treatise on the corporate law of Nevada, "Nevada Law of Corporations and Business Organizations." He is a practice consultant to "Marsh & Volk, Practice under the California Securities Laws". He is also a frequent speaker on securities and corporate law topics and for the last several years has been an adjunct professor of law at Chapman University Law School where he teaches classes in corporate governance and sales transactions.

Professor Iman Anabtawi

2011 *Chapman Law Review* Symposium Speaker

Iman Anabtawi teaches in the Corporate Law Specialization with an emphasis on teaching transactional skills in courses such as Mergers and Acquisitions Transaction Planning and Business Associations.

At Oxford University, Professor Anabtawi was a Marshall Scholar, receiving an M.A. (in philosophy, politics, and economics). At Stanford Law School, she was articles editor of the Stanford Law Review, won the Hilmer Oehlmann, Jr. First Year Writing Award, and received the John M. Olin Prize in Law and Economics. She clerked for the Honorable Laurence H. Silberman of the U.S. Court of Appeals for the D.C. Circuit, and then Justice Sandra Day O'Connor of the U.S. Supreme Court. She then spent eight years with the firm of O'Melveny & Myers where she practiced both tax and corporate law. During this time, she specialized in mergers and acquisitions, joint ventures and strategic alliances, funds and acquisition vehicles, and financial products, as well as general corporate representation.

Professor Anabtawi has written and published numerous articles in corporate law.

Professor Jill Z. Barclift

2011 *Chapman Law Review* Symposium Speaker

Professor Barclift brings more than 15 years of corporate law experience to Hamline University School of Law. After graduating from Columbia University School of Law in 1983, she worked as an attorney with a large Midwest financial services firm. Professor Barclift came to Minnesota in 1996 to head the law department of a bank spin-off of a large retailer. Prior to teaching at Hamline University School of Law she was executive vice president, secretary and general counsel of a financial services firm in Minneapolis. Her practice areas included corporate law, governance, corporate disclosures, and negotiation of corporate purchase and sale of assets.

Publications

*Too Big to Fail, Too Big Not to Know: Financial Firms and Corporate Social Responsibility,*25 St. John's J. civil Rights and Economic Development _ (forthcoming 2010).

*Scheme Liability and Common Law Fraud under State Law: Holding Corporate Officers and their Co-Conspirators Accountable to Shareholders,*26 T.M. COOLEY L. REV. (forthcoming fall 2009).

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Senior Corporate Officers and the Duty of Candor: Do the CEO and the CFO Have a Duty to Inform, 41 VALP. U. L. REV. 269 (2007).

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From Wall Street To Main Street: The Future of Financial Regulation Chapman Law Review Symposium

[illegible]
Associate Professor of Law
[illegible] School of Law
[illegible] Governance of the Public Corporation of the Future – The [illegible] Corporate Governance,
[illegible] 2011

Corporate Governance Provisions
- Proxy Access – "say on pay"
- Executive Compensation – "claw backs"
- Disclosures on Hedging
- Independent Compensation Committee
- Disclosures on CEO and Chairman Positions

Dodd-FranK Act & Corporate Governance

2010 SEC Rulemaking
- Disclosures on compensation policies and risk management
- Disclosures on experience, qualifications of directors
- Disclosures on board diversity
- Disclosures on the board's role in oversight of risk management
- Disclosures on combined or separated chairman and CEO
- Disclosures on director compensation
- Disclosures on compensation consultants
- Quicker shareholder voting results

Dodd-Frank Act & Corporate Governance

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- Federal and State truce on governance
- New disclosures move closer to the line – but do not cross
- New rules and corporate governance

Dodd-Frank Act & Corporate Governance

- "Group Think" and the social nature of boards
- Failure of state fiduciary law to adequately address

Delaware examples:

- Beam v. Stewart
- In re Oracle Corp Derivative Litigation

Dodd-Frank Act & Corporate Governance

- Benefit to shareholders under state corporate law
- Future of federal and state complimentary governance rules
- State law must be responsive

Dodd-Frank Act & Corporate Governance

Professor Stefan J. Padfield

2011 *Chapman Law Review* Symposium Speaker

Stefan J. Padfield is an Associate Professor of Law at The University of Akron School of Law. His areas of expertise include corporate and securities law. Professor Padfield received his B.A. from Brown University, and J.D. from the University of Kansas School of Law. Prior to joining the Akron Law faculty, Professor Padfield clerked for The Hon. John R. Gibson of the U.S. Court of Appeals for the Eighth Circuit, and The Hon. William E. Smith of the U.S. District Court in Providence, R.I. Professor Padfield also worked as a corporate attorney for Cravath, Swaine & Moore, LLP, in New York City.

The University of Akron

School of Law

The Dodd-Frank Corporation: More Than a Nexus of Contracts?

Presented by
Prof. Stefan J. Padfield
at the
Chapman Law Review Symposium:
From Wall Street to Main Street
Jan. 28, 2011

INTRODUCTION

- An Overview of Theories of the Corporation
- Why Corporate Theory Still Matters
- How Dodd-Frank Impacts Corporate Theory
- Implications
- Conclusion

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An Overview of Theories of the Corporation

- Question 1: "What is a corporation?"
- Question 2: "What way of thinking about corporations leads to their most efficient regulation?"

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An Overview of Theories of the Corporation

- Prof. Hamilton lists 5 theories of the corporation in his "Black Letter Series" outline for students (West, p.119):
  - 1. Entity Theory
  - 2. Concession Theory
  - 3. Contract Theory
  - 4. Nexus of Contracts
  - 5. Process Theories

Competing Themes of Corporate Theory

- "entity" v. "aggregation of individuals"
- "artificial creation of state law" v. "natural product of private initiative"
- "public" v. "private"
  - David Millon, Theories of the Corporation, 1990 Duke L.J. 201, 201.

Corporate Theory in a Nutshell: Concession vs. Contract

- *"Not all theorists use the language of contract and concession, with several preferring 'property' and 'entity,' but the contract and property theories are roughly the same, as are the concession and entity theories."*
  - Liam Seamus O'Melinn, Neither Contract nor Concession: The Public Personality of the Corporation, 74 Geo. Wash. L. Rev. 201, 201 (2006) (discussing "*the two preeminent theories of the corporation--contract and concession*") (emphasis added).

NOTE: "Concession Theory" Broadly Defined

- Cf. *"[Concession] theory had its origins in the early history of the corporation, when corporations were, in fact, created by special charter. The theory has no relevance today, when corporations are freely formed by making a simple filing under general corporation laws."*
  - Butler & Ribstein, The Corporation and the Constitution ix (AEI).

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Why Corporate Theory Still Matters: Does It?

- *"As a matter of intellectual interest, the debate over the contractual nature of the firm is over."*
- *"This is not to say that the contractarian view has pre-empted the field . . . but . . . the debate has been played out."*
- *"Contractarians and noncontractarians no longer have much of interest to say to one another."*
  - Prof. Stephen Bainbridge, Corporation Law and Economics 31 (Foundation).

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Why Corporate Theory Still Matters: Does It? (cont.)

- "Historically, the political implications of the natural/artificial and entity/aggregate distinctions have been ambiguous, meaning different things at different times."
  - David Millon, Theories of the Corporation, 1990 Duke L.J. 201, 202 (1990).

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Why Corporate Theory Still Matters: *Citizens United*

- The majority relied on a view of the corporation as fundamentally an *"association of citizens."*
- Where the majority saw an association of citizens, the dissent saw state-created entities that *"have been 'effectively delegated responsibility for ensuring society's economic welfare.'"*
  - CU, 130 S. Ct. at 971 (Stevens, J., dissenting).

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Why Corporate Theory Still Matters: *Citizens United* (cont.)

- But see: *"Nothing in this analysis turns on whether the corporation is conceptualized as a grantee of a state concession, a nexus of explicit and implicit contracts, a mediated hierarchy of stakeholders, or any other recognized model."*
  - CU, 130 S. Ct. at 971, n.72 (Stevens, J., dissenting).

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How Dodd-Frank Impacts Corporate Theory: The Reality of Government's Power to Regulate Corporations

- 1. "say on pay"
- 2. increased compensation committee regulation & exec comp disclosure
- 3. expanded clawbacks
- 4. "proxy access"
- 5. *Too Big To Fail?*

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How Dodd-Frank Impacts Corporate Theory: The Reality of Government's Power to Regulate Corporations

- *"[T]heories of corporate law [must] be disputed when they … fail to comport with realities of corporate law."*
  - Eric W. Orts, The Complexity and Legitimacy of Corporate Law, 50 Wash. & Lee L.Rev. 1565, 1614 (1993).

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How Dodd-Frank Impacts Corporate Theory: The Reality of Government's Power to Regulate Corporations

- Cf. Butler & Ribstein, The Corporation and the Constitution ix (AEI).
  - *"[T]his argument is simply a statement about current law, not a normative argument about what the law ought to be."*

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How Dodd-Frank Impacts Corporate Theory: The Predictive Power of Theory

- Cf. C. CARR, THE GENERAL PRINCIPLES OF THE LAW OF CORPORATIONS 165-73 (1905) (*describing the concession theory of corporate powers as a response to fears about threats of corporate power to the sovereignty of the King*).

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How Dodd-Frank Impacts Corporate Theory: The Predictive Power of Theory

- Cf. *"I found a flaw in the model that I perceived is the critical functioning structure that defines how the world works. That's precisely the reason I was shocked. . . . I still do not fully understand why it happened . . . ."*
  - Alan Greenspan on the failure of his deregulatory ideology (Oct. 23, 2008).

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IMPLICATIONS: *AT&T v. FCC*

- QUESTION PRESENTED: *Does the Freedom of Information Act's protection for "personal privacy" protect the "privacy" of corporate entities?*

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IMPLICATIONS: Proxy Access, etc.

- Larry Ribstein has suggested that *Citizens United* is relevant to attempts to regulate the speech of corporations in the context of both proxy access and global warming disclosures.
  - http://truthonthemarket.com/2010/12/28/the-securities-laws-and-the-first-amendment/
  - http://busmovie.typepad.com/ideoblog/2010/01/the-sec-global-warming-and-the-first-amendment.html

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CONCLUSION

- The Dodd-Frank Act, together with the events that it arose out of, may provide an additional argument for those who seek to challenge the dominance of the nexus-of-contracts theory of the firm because it:
  - (1) provides yet another example of the actual authority of government to regulate corporations, and
  - (2) it validates one of the primary predictions of concession theory.

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THE END – THANK YOU!

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Gary Aguirre

2011 *Chapman Law Review* Symposium Speaker

Mr. Aguirre is a trial attorney whose practice focuses on securities litigation with offices in San Diego and Los Angeles. He is a former Senior Counsel with the SEC's Enforcement Division in Washington. While at the SEC, Mr. Aguirre led the investigation of Pequot Capital Management which eventually resulted in the largest SEC recovery against a hedge fund for insider trading. He is a frequent guest commentator on SEC Enforcement developments on TV and radio. He has published articles on securities law in both academic and professional journals. He has a BS from UC Berkeley, an MFA from the UCLA School of Theater and Film, an LL.B from Boalt Hall, and an LL.M from Georgetown on securities regulation.

Gary Aguirre

The Dodd-Frank Bounty for Whistleblowers: A New Arrow in the SEC's Quiver or Career Suicide for the Whistleblower?

Chapman Law Review Symposium

Jan., 11, 2011

SEC: Difficult to Prove Institutional Insider Trading

"We certainly see institutional-type accounts that have come into the market with extraordinarily good timing on a repeat basis…but to **get the evidence** to prove a violation of the statute under which we allege insider trading **is difficult**."

Joe Cella, Head of SEC's Office of Market Surveillance.

Gretchen Morgenson, *Whispers of Mergers Set Off Bouts of Suspicious Trading*, N.Y. Times, Aug. 26, 2006

SEC: Difficult to Prove Institutional Market Manipulation

"Since the almost overnight collapse of Bear Stearns earlier this year, top-level Wall Street executives have been pleading with regulators to investigate what they see as efforts by short sellers to plant false information and profit from it…**The issue is a notoriously challenging one for the S.E.C.**"

Stephanie Clifford and Jenny Anderson, *S.E.C. Warns Wall Street: Stop Spreading the False Rumors*, N.Y. Times, July 14, 2008

SEC: Difficult to Prove Ponzi Schemes

"SEC IG David Kotz asked the enforcement staff how it could possibly have failed to prosecute someone who was believed by so many others to be running a fraud. The staff told him that senior SEC management did not favor the pursuit of Ponzi schemes and other frauds that were **difficult to investigate and time-consuming to prosecute**."

The SEC's Impeccable Timing, The Wall Street Journal Apr. 20, 2010

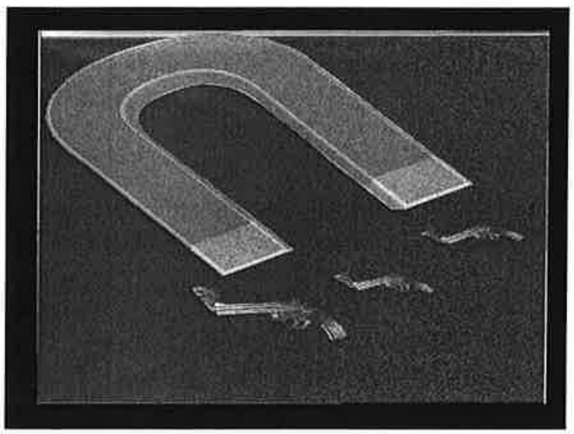
Why can't the SEC make the big case?

"There are no smoking guns .... Evidence is almost entirely circumstantial. The investigation of the case and the proof presented to the fact-finder is a matter of putting together pieces of a puzzle."

Thomas C. Newkirk, Associate Director, Division of Enforcement, Sep. 19, 1998

The SEC's Clarion Call: We Need This:

So Congress Created the First Ever …



Dodd Frank's Smoking Gun Magnet

21F (b)(1) "In any covered judicial or administrative action, … the Commission, ***under regulations prescribed by the Commission*** … shall pay an award or awards to … whistleblowers who voluntarily provided original information to the Commission that led to the successful enforcement of the covered judicial or administrative action … in an aggregate amount equal to" not less 10% or more than 30% of funds collected.

Appellate review of denial of the claim, but not amount.

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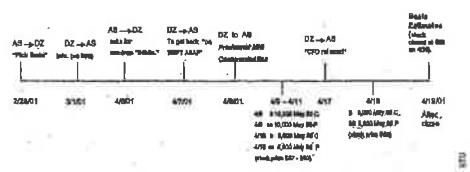
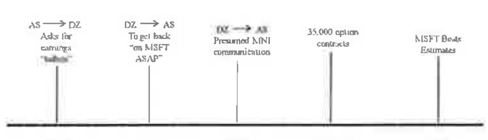
A Case Study of a Whistleblower's:



P. 628 to S. HRG. 109–898, Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity

SEC: Privileged and Confidential



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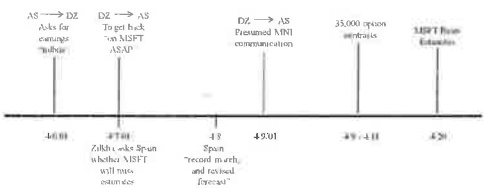
From: Mark Spain
Sent: Sunday, April 8, 2001, 11:08 AM
To: David Zilkha
Subject RE: Any visibility on the recent quarter?

March was the best march of record. Made up the shortfall in us sub. w2k pro major contributor. on track for revised forecast (MYR)

----Original Message--------

From: David Zilkha
Sent: Saturday, April 07, 2001 11:37 PM
To: Mark Spain
Subject: Any visibility on the recent quarter?

Hey there,
Have you heard whether we will miss estimates? Any other info?
David



"After a scathing 2007 report by the Senate criticized the SEC's handling of Aguirre's Pequot investigation, and after **Aguirre dredged up the smoking gun e-mails and passed them along to the Senate, the FBI and the SEC in late 2008, the SEC reopened the case in January 2009."**

Liz Moyer, *Scales of Justice Look Skewed for Rajaratnam, Samberg*, May 27, 2010, Forbes

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Gregory Zuckerman and Kara Scannell, ***Pequot Capital, a Top Fund, to Close as Firm Faces Probe,*** The Wall Street Journal May 29, 2009

Gretchen Morgenson, ***Pequot Capital and Its Chief Agree To Settle S.E.C. Suit for $28 Million,*** N.Y. Times May 28, 2010

"Mr. Samberg and Pequot will return $18 million in profits and interest and pay $10 million in penalties."

Gretchen Morgenson, ***S.E.C. Pays Settlement to Staff Lawyer It Fired***, N.Y. Times June 30, 2010

"The settlement appears to be the largest disclosed by the Merit Systems Protection Board, the federal agency that oversees such cases."

Reuters, *Whistle-Blowers Awarded $1 Million In Pequot Case,* N.Y. Times, July 24, 2010

"A couple has been awarded **$1 million** for information that led to an insider trading settlement against Pequot Capital Management ... The $1 million award is a **record for a whistle-blower** who provided information in connection with an insider trading case, the agency added."

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21F(2) (A) CONFIDENTIALITY.—

Except [for narrow exceptions] the Commission and any officer or employee of the Commission shall not disclose any information, including information provided by a whistleblower to the Commission, ***which could reasonably be expected to reveal the identity of*** ..."

Subsection 21F(h)(2)(A) of the Securities Exchange Act of 1934.

"We expect that in appropriate cases, ... our staff will, upon receiving a whistleblower complaint, contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back."

Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934.

Robert Khuzami, SEC Director of Enforcement PLI 42nd Annual Institute on Securities Regulation Nov. 12, 2010.

"I am sure that it will be not uncommon, in the appropriate case, to contact the company and indicate that we have received this and have them undertake at least the same kind of initial review that they would currently do or hopefully that they would have done even if it had never come to our attention and it had stayed within the company."

Preet Bharara, U.S. Attorney for SDNY, PLI 42nd Annual Institute on Securities Regulation, Nov. 12, 2010.

"My expectation is that the Department of Justice will treat the whistleblowers… who are attempting to do something wrong, in other words, make things up about the company or lie to the SEC in order to get, to rip the rewards of the financial incentives that has been set … that you may see … the occasional criminal case with respect to a whistleblower who does not have the truth in mind."

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