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AFTER THE MELTDOWN

Daniel J. Morrissey*

We will not go back to the days of reckless behavior and unchecked excess that was at the heart of this crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses.

—President Barack Obama1

The window of opportunity for reform will not be open for long . . .

—Princeton Economist Hyun Song Shin2

I. INTRODUCTION: THE MELTDOWN

A. How it Happened

One year after the financial markets collapsed, President Obama served notice on Wall Street that society would no longer tolerate the corrupt business practices that had almost destroyed the world’s economy.3 In “an era of rapacious capitalists and heedless self-indulgence,”4 an “ingenious elite”5 set up a credit regime based on improvident

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3. One commentator gave this apt summation of the effects of the meltdown:

During the next year, the recession that, in Bernanke’s words, inevitability follows a financial panic drove unemployment to 9.7 per cent. The economic crisis, the worst since the Depression, destroyed household and retirement savings, pensions, insurance funds, and endowments. Eighty-nine banks have failed this year . . . . General Motors and Chrysler filed for bankruptcy protection, along with nearly a hundred and fifty other public companies—an increase of more than a hundred per cent from the previous year. By March of 2009, nearly nineteen hundred hedge funds had gone out of business.

James B. Stewart, Eight Days: The Battle to Save the American Financial System, New Yorker 59, 79 (Sept. 21, 2009). Two good books about the meltdown by financial journalists are Andrew Ross Sorkin, Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System from Crisis—and Themselves (Viking 2009) and John Cassidy, How Markets Fail: The Logic of Economic Calamities (Farrar, Straus & Giroux 2009).

4. Frank Rich, The Rabbit Ragu Democrats, 159 N.Y. Times 8WK (Oct. 4, 2009) (quoting James Stewart). In like fashion, one commentator called it “an era in which many private-sector financial leaders showed themselves to be unremittingly reckless, greedy or incompetent—or all three[,]” Paul M. Barrett, I, Banker, 159 N.Y. Times 12 (Nov. 1, 2009) (reviewing Last Man Standing by Duff McDonald).


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loans to homeowners\textsuperscript{6} that came to dominate the global financial markets. Almost all the participants in that speculative system were at least willfully ignorant\textsuperscript{7} that many of those borrowers could not afford their shaky mortgages.\textsuperscript{8} When the inflated real estate

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As a huge crowd of fans marched through lower Manhattan in a ticker-tape parade to celebrate the Yankees' World Series championship in November 2009, it "erupted in rhythmic, echoing chants of 'Wall Street sucks! Wall Street sucks!' " as it passed through the financial district. Bob Herbert, \textit{A Word, Mr. President}, 159 N.Y. Times A35 (Nov. 10, 2009).

6. \textit{See generally} Nick Paumgarten, \textit{The Death of Kings: Notes from a Meltdown}, New Yorker 41, 42 (May 18, 2009). Along those lines, a Nobel prize-winning economist has written this about his colleagues who supported this precarious financial system:

Few economists saw our current crisis coming, but this predictive failure was the least of the field's problems. More important was the profession's blindness to the very possibility of catastrophic failures in a market economy. During the golden years, financial economists came to believe that markets were inherently stable—indeed, that stocks and other assets were always priced just right. There was nothing in the prevailing models suggesting the possibility of the kind of collapse that happened last year.

Paul Krugman, \textit{How Did Economists Get It So Wrong?} 158 N.Y. Times A36 (Sept. 6, 2009).

The folly of such short-sightedness has been impressively corroborated by Nassim Nicholas Taleb in his classic, \textit{The Black Swan}, which explains how humans can deceive themselves into believing they have invented fool-proof theories on matters like securities valuations. Nassim Nicholas Taleb, \textit{The Black Swan: The Impact of the Highly Improbable} xix (Random House 2007).

\textit{The New York Times} has made this observation about the leading role played by the investment bank, Goldman Sachs: in this decade, "[i]t is widely and correctly understood that Wall Street, with Goldman as a leader and with regulators in thrall, helped to inflate and profited from a credit bubble that burst and cost tens of millions of Americans their jobs, incomes, savings and home equity." \textit{Goldman's Non-Apology}, Editorial, 159 N.Y. Times WK9 (Nov. 22, 2009).

7. A telling comment by Charles Prince, CEO of Citigroup, reveals how top financiers were aware of the improvident nature of these investments. Prince has conceded that he knew his firm's participation in the subprime credit market could have disastrous consequences. He nevertheless continued dealing in those securities, saying, "When the music stops, in terms of liquidity, things will be complicated, . . . [b]ut as long as the music is playing, you've got to get up and dance." Cassidy, \textit{supra} n. 2, at 32.

As a leading economist summed up the debacle, "[h]ere you had all these people who were supposed to be sophisticated investors, and it turns out they were buying billions of dollars worth of debt where they didn't even understand what they owned . . . ." Peter S. Goodman, \textit{The Free Market: A False Idol After All?} 157 N.Y. Times WK4 (Dec. 30, 2007).

One commentator gave a succinct description of this reckless system of financial folly.

It's rational for a mortgage company to loan $500,000 to a borrower who can't pay back the money if the lender can immediately sell the loan to a Wall Street investment bank. It's also rational for the investment bank to bundle a bunch of risky home loans and resell them—for a tidy profit, of course—to hedge funds as a bond. Such bonds, known as mortgage-backed securities, were attractive to hedge funds and other investors because they paid relatively high interest. Sure, the bonds were risky (remember that the home buyers never really should have qualified as borrowers in the first place), but many investors bought a form of insurance against the bonds' defaulting. The sellers of this insurance, called credit default swaps, assumed they'd be able to collect premiums and never have to pay out very much because real estate prices would keep rising forever—so those original dubious borrowers would be able to refinance their unrealistic loans. Everyone felt especially rational about all of this because prestigious credit-rating agencies issued triple-A stamps of approval for the exotic, high-interest securities. Never mind that the rating agencies were paid—i.e., bought off—by the very investment banks peddling the mortgage-backed securities.

Paul M. Barrett, \textit{Rational Irrationality}, 159 N.Y. Times 18 (Nov. 15, 2009) (reviewing \textit{Too Big to Fail and How Markets Fail}).

8. Michael Lewis provides this graphic description of the worst of these loans:

They'd be in what Wall Street people were now calling the sand states: Arizona, California, Florida, Nevada. The loans would have been made by one of the more dubious mortgage lenders; Long Beach Financial, wholly owned by Washington Mutual, was a great example. Long Beach Financial was moving money out the door as fast as it could, few questions asked, in loans built to self-destroy. It specialized in asking homeowners with bad credit and no proof of income to put no money down and defer interest payments for as long as possible. In Bakersfield, California, a Mexican strawberry picker with an income of $14,000 and no English was lent every penny he
values supporting those loans collapsed, they took down long-established financial firms that had dealt recklessly in myriad derivative forms of those debts.9

Enormous frauds were committed on investors in the sale of those securities,10 but it wasn’t just the holders of the obligations who suffered. The entire economy was thrown into a tail-spin causing wide-spread unemployment.11 Jay Light, Dean of Harvard Business School, described the scene one month later: “What we have witnessed is a stunning and sobering failure of financial safeguards, of financial markets, of

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9. The debacle reached its climax in mid-September 2008 when the global finance suffered a near-fatal heart attack. In the space of two days Merrill Lynch fell into the arms of Bank of America[,] Lehman went bust and American International Group[,] a mighty insurer, buckled under suicidal derivative bets and had to be bailed out. Lehman’s demise marked the onset of the worst financial crisis and global recession since the 1930s. "Rearranging the Towers of Gold," Economist 75, 75 (Sept. 12, 2009).

10. Among the most culpable here were credit rating agencies that certified these financial instruments as having high investment grades. An email exchange between two analysts at one of those firms said it all. One wrote, “[T]hat deal is ridiculous . . . We should not be rating it.” ‘We rate every deal,’ came the response. ‘It could be structured by cows and we would rate it.’ ” Gretchen Morgenson, "They’re Shocked, Shocked, About the Mess," 158 N.Y. Times BU1 (Oct. 26, 2008). Another analyst wrote this in an email about securities backed by subprime mortgages: “Let’s hope we are all wealthy and retired by the time this house of cards falters.” Michael M. Grynaubn, "Study Finds Flawed Practices at Ratings Firms," 157 N.Y. Times C1 (July 9, 2008).

An SEC study found that a major issue in these corrupt ratings was the “issuer pays” conflict where the entity seeking the rating pays for it. Summary Report of Issues Identified in the Commission Staff’s Examination of Select Credit Rating Agencies, SEC Rpt. 23-24 (SEC July 2008) (available at http://www.sec.gov/news/studies/2008/crarexamination070808.pdf).


11. As one commentator reported on the anniversary of the meltdown, “[i]t was only a year ago that the world economy was enveloped in a financial panic of such dimensions that, if one believes Federal Reserve Chairman Ben Bernanke, it threatened to produce a calamity as bad as the Great Depression.” David Wessel, Government’s Trial and Error Helped Stem Financial Panic, Wall St. J. A1 (Sept. 14, 2009).

Another observer gave this one-year perspective: “[m]eanwhile, the economy is still in a deep recession, with unemployment at nearly ten per cent.” Stewart, supra n. 3, at §1.
financial institutions and mostly of leadership at many levels." \(^{12}\)

And in the depths of this debacle came revelations of the most egregious of these frauds, Bernard Madoff's decades-long ponzi scheme that bilked billions from well-healed investors. \(^{13}\) Yet, as one commentator has aptly put it, "Madoff is in some ways a distraction, cover for the quiet crooks [because] he embodies many of the meltdown's traits—the illusion of expertise, the belief in getting something for nothing, the mirage and subsequent evaporation of wealth." \(^{14}\)

B. The Grave Economic Damage

A report issued by the Treasury Department in June 2009 gave this appraisal of the country's grim situation: "Over the past two years we have faced the most severe financial crisis since the Great Depression. Americans across the nation are struggling with unemployment, failing businesses, falling home prices and declining savings." \(^{15}\) The Bush and Obama administrations responded with unprecedented government intervention in the economy which included nationalization of the auto industry and sweeping control of much of the country's financial industry. \(^{16}\)

In the fall of 2009 it looked like the economy was going to survive, but only because of hugely expensive bail-outs, stimulus packages, and monetary measures enacted or supported by the federal government. The amount of these payments was staggering. As one commentator described these government actions to bailout the economy, "Bank of America and Citigroup together got $90 billion in TARP funds and $420 billion in guarantees. Stabilizing A.I.G. cost taxpayers $180 billion. To combat the crisis, the size of the Fed's balance sheet—$850 billion before the Lehman collapse—grew to $2 trillion." \(^{17}\)

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14. Paumgarten, supra n. 6, at 43.

Those insights were echoed by Harry Markopolos, the financial analyst who made repeated, well-documented complaints to the SEC about Madoff's operations. In Congressional testimony, Markopolos gave this description of the meltdown:

An entire criminal class consisting of corrupt real estate agents, property appraisers, mortgage lenders, ratings agencies, and Wall Street investment banks openly colluded to originate, package and sell toxic debt securities to pension funds, individuals and other unsuspecting victims . . . . Bernard Madoff is merely the poster child for what went so horribly wrong with our financial system.


Along the same lines, Nobel Prize winning economist Paul Krugman summed up these practices by hedge funds and other large pools of investment capital, which he called "the Madoff economy."

Consider the hypothetical example of a money manager who leverages up his clients' money with lots of debt, then invests the bulked-up total in high-yielding but risky assets, such as dubious mortgage-backed securities. For a while—say, as long as a housing bubble continues to inflate—he (it's almost always a he) will make big profits and receive big bonuses. Paul Krugman, The Madoff Economy, 158 N.Y. Times A45 (Dec. 19, 2008).

17. Stewart, supra n. 3, at 79.
In a wry observation, Gao Ziquing, the president of the China Investment Corporation, said he saw all this as “socialism with American characteristics.” All of those borrowings, of course, have imposed a tremendous burden on future generations. The 2009 federal budget deficit was an unprecedented $1.6 trillion. In addition, “[t]he national debt rose by more than a third over a one-year period, far more than it ever did at any time since World War II.”

Citing persistently high unemployment figures, many economists now see only a long, painful road to recovery. The news from Dubai at the end of November 2009 that it could not not repay $59 billion provided even more fallout from the meltdown’s “credit crunch.” As one commentator observed, the Dubai default “reminds us that we are far from finished with a ferocious deleveraging process that began last year.”

C. A Decade of Disgraceful Business Dealings

The economic collapse is thus the result of not just speculative excesses but also egregious wrong-doing. In that regard it is only the most recent in a series of serious misconduct by our business leaders, what my friend and former colleague Professor Tom Arnold has called the “scandals du jour” of corporate America. At the beginning of the decade, right after the bursting of the Dot-com bubble, we had a spate of accounting frauds like Enron.

In their wake, Congress passed the stringent Sarbanes-Oxley legislation

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For the engrossing story of the actions of the Federal Reserve Bank and its chairman, Ben Bernanke, during this crisis, see David Wessel, In FED We Trust: Ben Bernanke’s War on the Great Panic (Crown Bus. 2009).

18. Stephens, supra n. 16.


20. Floyd Norris, A Rich Uncle is Picking up the Borrowing Slack, 159 N.Y. Times B3 (Sept. 26, 2009).

The staggering federal deficit has produced anxiety in the financial markets, leading White House and Congressional Democrats to consider the creation of a bipartisan commission to push tax increases and spending cuts. Jackie Calmes & Carl Hulse, Top Democrats Are Pushing for New Strategies on Federal Deficit, 159 N.Y. Times 26 (Nov. 1, 2009).

21. Figures released by the Bureau of Labor Statistics in early October 2009 showed that, during the 12 month period ending in March 2009, the American economy lost 5.6 million jobs, 824,000 more than the 4.8 million previously reported. In no downturn since World War II have so many jobs vanished. Floyd Norris, The Job News Gets Worse, 159 N.Y. Times WK3 (Oct. 4, 2009).


Even as news came that the economy expanded in the 3rd quarter of 2009 officially ending the recession, a leading observer made this comment: “But the recovery is expected to be slow and painful, as companies shed jobs and credit remains tight.” Conor Dougherty, Economy Snaps Long Slump, Wall St. J. A1 (Oct. 30, 2009).

23. Christopher Davidson, an expert in Gulf politics, as quoted in The Chatter, 159 N.Y. Times BU2 (Nov. 29, 2009).


Other business reporters expressed much the same fears with these remarks: “As Dubai, that one-time wonderland in the desert, struggles to pay its bills, a troubling question hangs over the financial world: Is this latest financial crisis an isolated event, or a harbinger of still more debt shocks?” Graham Bowley & Catherine Rampell, A Burden without Borders, 159 N.Y. Times B1 (Dec. 1, 2009).


requiring more meaningful oversight by corporate management and providing for stricter sanctions for their wrongdoing.27 Those laws, however, did little to deter the type of business conduct that brought about our economic calamity or shore up the “rotten timber”28 supporting our financial system.

The disgraceful conduct continued with news of deceitful actions by stock analysts along with abusive market timing and late trading by mutual fund managers.29 More recent revelations about the pervasive practice of options backdating by already lushly-compensated corporate executives have further eroded public trust in those who manage society’s resources.30

D. A Meaningful Response

In response to this distressing state of affairs, this Article will first describe the regulatory and law enforcement failure that brought about our current economic calamity. It will then discuss the reforms to our system of financial regulation that have been proposed to remedy them. As welcome as most of them are, they are not enough. The Article will therefore suggest how they may be strengthened to assure that another meltdown will not occur.

A financial collapse of epic proportion has exposed great deficiencies in our system of economic regulation. It must be modernized so that the investment community will be held accountable for its destructive practices. This piece will conclude with a hope that these new laws and policies, along with a re-invigorated Securities and Exchange Commission (SEC), will restore a sense of integrity to our capital markets.

II. THE INADEQUACY OF GOVERNMENT PROTECTIONS

A. The SEC’s Pre-Madoff Failures

One of the distressing conclusions to be drawn from this economic debacle is that the government failed to safeguard the integrity of our financial institutions. The SEC, the agency charged with administering and enforcing federal securities laws,31 was once highly respected for aggressively protecting investors and maintaining honesty in our capital markets.32 The last decade, however, has been a different story.33

27. Among other things, the Sarbanes-Oxley legislation created an accounting oversight board for public companies, promulgated strict standards for auditor independence, enhanced financial disclosure requirements, and stiffened penalties for white collar crime. For a good summary of that legislation and its impact on corporate America, see Joris M Hogan, The Enron Legacy: Corporate Governance for a New Era, 31 Secs. Reg. L. J. 142 (2003).
28. See Broughton, supra n. 5.
29. For the author’s comments on those matters, see Daniel J. Morrissey, After the Ball is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals, 83 Neb. L. Rev. 732, 737 (2005).
32. On the occasion of its 60th anniversary in the mid-1990s, Professor David Ratner, a former SEC chairman, summed up the generally favorable perception of the SEC with these remarks:

https://digitalcommons.law.utulsa.edu/tlr/vol45/iss3/2
Elliot Spitzer, the Attorney General of New York, did the most to expose the numerous fraudulent practices by investment bank firms and securities analysts during the stock market bubble of the late 1990s, far outstripping the efforts of the SEC. Similarly, the Commission fumbled a whistle blower’s complaint in 2003 about mutual fund abuses that were ultimately brought to light by New York and Massachusetts...

No agency is perfect, and the SEC has had its ups and downs over the years. But it is a testament to the prescience of the people who drafted the securities laws back in the early 1930s, and to the quality of the people who have served as Commissioners and staff members over the years, that it has adapted to change without the need for basic amendment of its governing statutes, that it has been free of major scandals, and that it has been an important force for higher ethical standards in an industry which relies heavily on public confidence. The SEC is one important reason why the securities industry is in so much better shape than other financial service industries, and why U.S. securities markets are the best securities markets in the world.


Even while enduring ignominy for its inept handling of the Madoff matter and other recent corporate scandals, the SEC’s earlier, fine reputation has been cited by knowledgeable observers. As one of the Commission’s leading historians, Joel Seligman, wrote recently, “[t]hrough most of its history, the Commission has been the so-called ‘cop on Wall Street,’ whose uncompromising enforcement program has had a major impact on deterring fraud.” Joel Seligman, *We Need a Strong SEC*, Forbes (Dec. 12, 2008) (available at http://www.forbes.com/2008/12/18/sec-banking-regulation-oped-cx_js_1218seligman.html).

The Commission’s past achievements are frequently being contrasted with its current sorry state. U.S. Senator Jack Reed made these pointed remarks in an oversight hearing: “I want to close by saying that while the SEC is currently suffering from a very tarnished reputation, one that it deserves based on its failures in recent years, the agency historically has been a symbol of strength and toughness in the markets for decades, thanks in large part to its dedicated staff.” Sen. Comm. on Banking, Hous., & Urban Affairs, *Opening Statement of Senator Jack Reed* (Sept. 10, 2009) (available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Home) [hereinafter Reed].

Even more telling were these comments of former SEC Commissioner Isaac Hunt about the SEC: “It’s not a 21st century institution; they’re all living on their past glory, which was great, but it’s gone.” Daniel Wagner & Pete Yost, *Here’s Why SEC Failed to Investigate Madoff*, http://articles.sfgate.com/2008-12-22/news/17132769_1_madoff-case-bernard-madoff-sec-s-problems (Dec. 22, 2008).


33. One commentator aptly summed up the SEC’s failures with these remarks:

In recent years, the SEC did not provide the regulation and control that might have prevented the worst results of the speculative binge of the first decade of the twenty-first century. Its failures were of two kinds. First, succumbing to the deregulatory climate that pervaded the government since the 1980s, the SEC dismantled crucial parts of the regulation established to protect investors and the markets. Second, the SEC failed to detect and stop widespread abuses by securities firms, costing investors billions of dollars.

Norman S. Poser, *Why the SEC Failed: Regulators Against Regulation*, 3 Brook. J. Corp. Fin. & Com. L. 289, 290 (2009). These high profile failures by the SEC have led another knowledgeable observer, Spokane securities lawyer Doug Siddoway, to comment that the stock market would be better regulated by the Nevada Gaming Commission.


35. As one commentator put it, “[i]t does not appear that the SEC took any action in the research analyst scandal until the NYAG’s [New York Attorney General’s] sensational announcement prompted it to act. For at least two years, the largest broker-dealer firms made a practice of betraying their customers by publishing tainted research reports, apparently without the SEC noticing.” Poser, supra n. 33, at 312 (footnote omitted).

As another author generally described the SEC’s laggard efforts, “[t]he Securities and Exchange Commission was weathering hard times at the start of the twenty-first century. Spitzer’s relentless crusade against securities fraud exposed the agency as a passive and somewhat feckless regulator. Critics were complaining that the Bush administration’s pro-business policies were emasculating the once revered industry watchdog.” Andrew Kirtzman, *Betrayal: The Life and Lies of Bernie Madoff* 184 (Harper 2009).
At that time, the Commission was also slow in moving in on the gigantic accounting frauds of the Enron era, perhaps in part because its chairman during the early Bush years was Harvey Pitt, someone who seemed to discourage aggressive enforcement action. As one commentator of that time said about the SEC’s lackadaisical spirit: “[i]n recent years the Securities and Exchange Commission lost its watchdog soul to the interests it was created to regulate and is currently in search of it ...”

In the middle of this decade, the Commission’s reputation was also tarnished by allegations that its investigation of insider trading at Pequot Capital Management was compromised by influence exercised by the powerful Wall Street figure John Mack. The SEC was further “drained and demoralized [during] the Bush administration” by the appointment of Congressman Christopher Cox, a conservative Republican, as its chairman in 2005.

The “notoriously ineffectual” Cox was not even asked to join an early morning meeting of other federal officials in March 2008 that decided the fate of the struggling financial firm Bear Sterns even though the SEC was its chief regulator. As David Wessel, economics editor of the <i>Wall Street Journal</i>, put it: “[T]op officials at both the Fed and the Treasury had decided the S.E.C and its chairman weren’t up to the job of coping with the collapse of an investment bank[].”

In addition, the SEC’s general ineffectiveness was compounded by its lack of resources. In December 2007, one well-respected commentator wrote: “[i]t’s no secret that the Securities and Exchange Commission is terrifically understaffed and wildly underfunded compared with the populous and wealthy Wall Street world it is supposed to police.” Shortly thereafter, three former SEC chairmen echoed those sentiments with this statement: “The problem with the S.E.C. today is that it lacks the money, manpower and tools it needs to do its job.”

The most specific evidence on the Commission’s lack of resources, however, came

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36. Wagner & Yost, <i>supra</i> n. 32. As another author described the SEC’s inept response to that situation, Subsequent investigations by the NYAG and the SEC revealed that several hedge funds and other investors, assisted by brokerage firms, and, in some cases, by mutual fund companies, had engaged in late trading and market timing for years. Nevertheless, despite the fact that the SEC made regular examinations of mutual fund companies during the period in question, it never brought an enforcement action against any broker-dealer, mutual fund company, hedge fund, or any other investor based on either of these practices before the NYAG’s announcement in September, 2003.

37. <i>See e.g.</i> Michael Duffy & Karen Tumulty, <i>Is Pitt’s SEC a Toothless Watchdog</i>, Time 25 (Jul. 8, 2002).


39. Wagner & Yost, <i>supra</i> n. 32.

40. The observation is by Paul M. Barrett, an assistant managing editor of Business Week in Paul M. Barrett, <i>While Regulators Slept</i>, 158 N. Y. Times Bk. Rev. 10 (Aug. 9, 2009) (reviewing David Wessel’s <i>In FED We Trust</i>).

41. The quote is from Paul M. Barrett, noting that even Republican presidential candidate John McCain called for Cox to be fired. <i>Id</i>. For a summary of a General Accounting Office report on Cox’s poor stewardship at the SEC, see Jesse Westbrook & David Scheer, <i>Cox’s SEC Hindered Probes, Slowed Cases, Shrank Fines</i>, <i>GAO Says</i>, http://www.bloomberg.com/apps/news?pid=20601087&sid=aPus5CBJhQ# (May 6, 2009).

42. Barrett, <i>supra</i> n. 40.


from various SEC attorneys themselves in statements made during the agency’s investigation of its inept investigations of Madoff. One said, “we had to buy our own legal pads. We had to buy our own pens. It got to the point we didn’t have paper for the printers.” Another lamented, “In 2005, and maybe before 2005, they shut down our money for training.” The staff attorney went on:

I think the fact that . . . any of us didn’t know more[ ] related more to a lack of training . . . that we didn’t have broker-dealer resources that we could go to . . . . We asked for additional options help, and it wasn’t there to be had.

It wasn’t just the Commission’s incompetence, however, that undermined the stability of our financial markets. Recklessly imprudent actions initiated by the SEC itself also contributed to the meltdown, as when it relaxed the net capital rules that required investment banks to maintain certain reserves. That allowed financial firms to increase their leveraging, making them much more vulnerable to economic downturns. In lieu of such regulation, the Commission invited the banks to voluntarily disclose their investments. However, that program was so ineffective at revealing the true financial situation of those firms that just days before Bear Sterns’ collapse, Chairman Cox assured the public that it was “well-capitalized and fully liquid.”

B. The Madoff Debacle

The once highly-respected agency, however, was decisively shamed and discredited in late 2008 with the shocking revelation that Bernard Madoff, a leader on Wall Street, had been running a decades-long ponzi scheme that bilked investors out of tens of billions of dollars. A detailed study by the Commission’s own Office of Investigations laid out almost two decades of red flags, dropped leads, and unresolved inquiries involving Madoff. Senator Richard Shelby gave this summary of the report’s incredible findings:

[T]he IG [Inspector General] found that the [SEC’s] Office of Compliance Inspections and Examinations and the Division of Enforcement were made aware at least six times that there might be something wrong at Madoff’s firm. Potentially fruitful leads were not

46. Id. at 365.
47. Id. at 366.
49. For instance, before it collapsed, Bear Sterns had an astounding debt/equity ratio of 33 to 1. Id. at A23.
51. See Ratner, supra n. 32.
52. It appears that Madoff’s fraudulent operation may have been going on as early as the 1960s. An SEC investigation of a small New York accounting firm in 1992 indicated that it had been raising money for Madoff for thirty years. Peter Burrows, The SEC’s Madoff Misery, Bus. Week 24–25 (Jan. 12, 2009).
54. SEC, supra n. 45.
pursued while significant staff resources were devoted to running down clearly unproductive avenues. Investigations were unfocused, understaffed, and improperly documented.55

Madoff himself appeared to scoff at the SEC’s incompetence. In describing how he handled the Commission’s investigations, Madoff told executives at one of his feeder funds, “It’s a fishing expedition. . . . They ask you a zillion . . . questions and we look at them and sometimes we laugh and we say are you guys writing a book?”56 Madoff also related how he played on the inexperience of the Commission’s staffers and their desire to leave it for more lucrative positions, saying to his associates about the SEC, “Nobody wants to stay there forever.”57

Harry Markopolos, a financial analyst who had been making credible complaints about Madoff to the SEC since 2000,58 gave these remarks to a Congressional committee after the SEC published the findings of its internal investigation: “To all Americans who are thinking that the level of incompetence, inexperience and laziness depicted in the full 477-page report just can’t be true, sadly, I can assure you it is all true.”59 Markopolos continued his testimony with this telling comment:

[n]o doubt it would have been far better for the agency if it turned out that Mr. Madoff had bribed one or more of the SEC staff to waylay investigations of his criminal enterprise. Catching an SEC employee or employees who were paid to look the other way would have resulted in far less embarrassment and turmoil for this agency.60

SEC officials, operating under the new leadership of an Obama-appointed Chairman, candidly acknowledged the accuracy of the critical investigative report, admitting that it had uncovered serious shortcomings in the expertise, training, and supervision of the Commission’s staff.61 Responding to its findings in testimony to Congress, they stated, “[e]ven before the report was issued, the agency already had begun instituting extensive reforms, including vastly expanding our training programs, hiring staff with new skill sets, streamlining management . . . .” Among other things, the SEC officers went on to say, “it is clear that addressing key problems identified by

56. Moyer, supra n. 53.
57. Id.; see also infra n. 68 and accompanying text.
58. In relating a bizarre incident where Markopolos tried to indirectly furnish information about Madoff’s scheme to New York Attorney General Elliot Spitzer in 2002, one author describes Markopolos as “an eccentric mathematician with a paranoid streak[.]” Kirtzman, supra n. 35, at 184.
60. Id. at 8.
the IG’s Report will also ultimately require additional resources.”63

Markopolos himself praised the IG’s investigation as a “breath of fresh air . . . a comprehensive and transparent report about what transpired during the Madoff crime spree . . . .”64 He also gave the Commission a back-handed compliment for its reform efforts with these skeptical remarks that may reflect sentiments shared widely by public officials and concerned citizens:

Before Madoff turned himself in, the SEC staff didn’t seem to care about anything other than showing up and collecting their paychecks. Nowadays it does seem that the agency is operating with a speed and vigor which it hasn’t exhibited in many years. I would rate the SEC in its current state as still being non-functional but at least they are trying to get better and they are trying at an enviable pace.65

Markapolos, however, gave Congress further reasons why attempts to shape up the SEC may be problematic with comments like these: “Right now there is no accountability in government”66 and “the problem is that the SEC pays peanuts and then wonders how it ended up with so many monkeys.”67 The latter quip reflects the sad fact that compensation paid to lawyers and other financial service professionals in the private sector far outstrips government salaries.68 Those remarks echoed comments made by Madoff himself in an unguarded moment where he boasted about exploiting the inexperience and lack of commitment of Commission staffers which resulted from that disparity.69

C. The Example of Options Backdating

Another current case-in-point that illustrates the inadequacy of the SEC’s enforcement efforts is the options backdating scandal. That was a particularly pernicious form of corporate kleptomania involving the manipulation of rights given to executives to purchase shares of their companies’ stock.70 Typically, the exercise price of those options was set at the time they were issued to correspond to what the shares were then trading for.71 A number of dishonest corporate officials, however, clandestinely moved their grant dates back to times when the stock was selling for a lower price. They were thus able to fraudulently increase their gain when they ultimately exercised their options and purchased the stock.72

This deceitful practice was first brought to public light in 2005 by a professor of finance, Erik Lie, in a study he published of almost six thousand options granted to

63.  Id. at 3.
64.  Markopolos, supra n. 14, at 10.
65.  Id. at 13.
66.  Id. at 17.
67.  Id. at 25.
68.  Well-respected commentators have feared that the SEC’s staff has been too easy on Wall Street because so many of them were planning to leave the agency to take high paying jobs with its firms. Michael Lewis & David Einhorn, Op-Ed, The End of the Financial World as We Know It, 158 N.Y. Times WK9 (Jan. 4, 2009).
69.  See supra n. 57 and accompanying text.
70.  For the author’s take on that scandal, see Morrissey, supra n. 30.
72.  Id.; see also Adam Lashinsky, Options Gone Wild! Fortune 86 (July 10, 2006).
corporate executives. His findings were swiftly corroborated in an investigation by the Wall Street Journal. Professor Lie estimated that this subtle form of corporate theft went on at almost 30% of companies whose shares were listed on major stock exchanges.

Top executives at some of our country’s largest corporations thus appeared to have taken huge amounts of unauthorized compensation. Yet the SEC’s pursuit of this blatant stealing was so lackadaisical that the Commission was criticized by members of a Congressional oversight committee for its slow pace. That reprimand came in March 2007, when many of the SEC’s investigations were approaching bars to prosecution that would be imposed by the statute of limitations.

As of October 2009, the SEC has brought 54 enforcement actions for options backdating, but a number of those involve charges against officials of the same company. In addition, a recent study by researchers at the University of Houston has found that options were backdated at more than 500 public companies—only one-third of whom have been investigated or caught.

Even when the SEC has secured sanctions against wrong-doers, they have appeared inadequate. For instance, credible evidence existed that this practice was going on at Apple Computer and involved the company’s founder, Steven Jobs. The SEC, however, only pursued the company’s former General Counsel and Chief Financial Officer. The General Counsel was not criminally prosecuted, although she did disgorge $1.5 million in illegal gain she realized from backdated options and paid a $200,000 fine. The CFO got off even lighter, with only a $150,000 fine. In addition, the Commission did not use its power to bar him from again serving as an officer of a public company, as seemed appropriate there.

Nor has the Justice Department been more successful in securing criminal convictions. In one high profile case, Gregory Reyes, the CEO of Brocade Communications Systems, Inc., was found guilty of options-backdating, but his conviction was reversed and a new trial ordered in August 2009 for prosecutorial misconduct. Even though Reyes made the list of “Top 10 Crooked CEOs,” he has

not been the only alleged back-dater to escape prosecution after charges were filed.

The SEC also dropped its case against the former general counsel of McAfee, Kent Roberts, in March 2009. Roberts had already been acquitted in a federal criminal prosecution in October 2008 because, according to one prominent securities lawyer, "the government—in the broadest sense of the word—had its day in court and couldn’t convince a jury." Shortly thereafter the SEC also announced it would take no enforcement action against another alleged options back-dater it had been investigating, the former CFO of Pixar Animations, Ann Mather.

D. The Bank of America Embarrassment

The SEC’s high-profile woes continued in September 2009 in a case where it tried to prosecute major wrongdoing that occurred during the meltdown. There Jed Rakoff, a U.S. District Judge in the Southern District of New York, refused to accept a settlement that the SEC had made with Bank of America arising from false statements in proxy materials that the bank used to solicit shareholder approval for its takeover of Merrill Lynch. The Judge criticized the Commission for inadequate enforcement of the securities laws because it was willing to settle the case by only securing a fine from the company and not pursuing its officers and lawyers who appeared to be the true wrongdoers. In response to the SEC’s argument that it could not go after the company’s executives because they acted on advice of counsel, the judge said, "If that is the case, why are the penalties then not sought from the lawyers?"

III. The Proposed Reforms

A. Regulatory Restoration

The economy’s collapse, unprecedented in recent memory, undercut the laissez-faire propositions that had been the sustaining principles not only of the Bush administration policy, but also of recent global development. As one knowledgeable commentator put it, "[t]he crisis has restored the legitimacy of the state: bankers have been dethroned, Alan Greenspan defrocked and economists exposed. Regulation is no longer a term of abuse."

As a result, in the fall of 2009 a number of initiatives were moving through Congress and being proposed by executive authorities. They were all designed to strengthen regulation of the financial sector and promised needed reform. One must

84. Id.
87. Id.
88. Stephens, supra n. 16.
89. See infra nn. 97–154 and accompanying text.

Senator Chris Dodd, chairman of the Senate Banking Committee, introduced a 1,136 page bill in early
ask, however, if they are “too little, too late.” Many were already being weakened during the legislative process due to intense lobbying from interests most in need of such governmental discipline. And if enacted they would all take effect well after the meltdown had taken its devastating effect on the economy.

B. The Treasury White Paper

The Obama administration, led by Treasury Secretary Timothy Geithner, issued a white paper in June 2009 calling for far-reaching reforms. Its stated goal was to “promote robust supervision and regulation of financial firms.” The Treasury’s plan would provide a number of desirable checks on our financial system. Among other things, it would authorize the SEC to regulate credit rating agencies and credit default swaps (CDS's), two purported safeguards for investors who purchased collateralized debt obligations (CDO's) based on shaky mortgages.

In reality, however, the assurance the credit ratings and the CDS's claimed to offer those investors often turned out to be illusory. Many times the credit ratings gave opinions of value on CDO's that were blatantly fraudulent while the precarious structures of the CDS's did much to hasten the near collapse of our economy.

The Treasury proposal would also create two new federal panels. They would be charged with making sure that a calamitous situation like the one brought about by wild speculation would never occur again. The first, the Financial Services Oversight Council, would be tasked with identifying excessive risk-taking in the markets and safeguarding the public from it. The second, The Consumer Financial Protection Agency, would have the responsibility of making sure that mortgage and credit card borrowers get fair treatment.

C. The Oversight Council and Too-Big-to-Fail

In early October 2009, Federal Reserve Chairman Ben Bernanke told Congress that the Oversight Council would be led by Treasury. He thus envisioned the Fed not as a “super-regulator” of the financial system, but only as one member of that group that would police its operation. The Council would gather expertise, he said, from several regulatory agencies to identify and assess risks that might jeopardize the health of markets and other financial institutions.

Later in the month, Treasury Secretary Timothy Geithner informed a Congressional panel that the Council would be empowered to make sure banks did not

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90. Dept. of the Treas., supra n. 15.
91. Id. at 19.
92. Id. at 45-46; see also infra nn. 117-122 and accompanying text.
93. See supra n. 10 and accompanying text; see also infra n. 116 and accompanying text.
94. See infra nn. 117-122 and accompanying text.
95. Dept. of the Treas., supra n. 15, at 20.
96. Id. at 55.
become “too big to fail.”98 That authority would be exercised to head off a repeat of the enormous taxpayer funded bailouts occasioned by the large liabilities of those leading financial institutions that came due during the meltdown.99 One noted commentator has put the case for authority well:

It is perverse, of course, to reward big banks’ mistakes with bailouts financed by beleaguered taxpayers. But the too-big-to-fail doctrine benefits the banks in other ways as well: the implication that an institution will not be allowed to fail gives it significant cost advantages over smaller, perhaps more responsible competitors.100

A prime example of such a firm currently existing through federal largesse is Citigroup, a huge bank with 200 million customer accounts in more than 100 countries. As a result of the meltdown, Citigroup has written down tens of billions of dollars worth of mortgages101 and is struggling with major problems arising from its credit card loans. To survive, it has taken $45 billion from the federal government’s Troubled Assets Relief Program and accepted $300 billion more in support from the Federal Deposit Insurance Corporation.102

As of fall 2009, however, the structure that such an overseeing council would take and the powers that it would have were very much unsettled. Parallel legislation proposed in the Senate contemplated quite a different arrangement from that offered by the House and the Obama administration.103 According to some observers, those competing plans had “the potential to disrupt progress of the financial-regulation overhaul, one of the legislative priorities of the administration.”104

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100. Legislation to create a Financial Services Oversight Council was sponsored by Congressman Barney Frank (D. Mass). The Council would include the Treasury Department, the Federal Deposit Insurance Corporation, the Federal Reserve, the Securities and Exchange Commission, and certain bank regulators. The proposed powers of the Council were described as follows:
   The Council would . . . be responsible for identifying companies and financial activities that pose a systemic threat to the markets and subject those institutions to greater oversight, capital standards and other regulations.
   These institutions would need to set up a plan to identify how they would be dismantled, through asset sales and other means, if they were to become insolvent. The statute also seeks to have The Fed set limits on a systemic institution’s concentration in a particular activity.
   However, one observer, reflecting on the deregulatory fervor of the last several decades, raised this caveat about such an all encompassing supervisory body for our financial system. “What if some future administration were to install as the chairman of the Federal Reserve—or as chief of whatever agency is made into the One Big Regulator—a man who really doesn’t believe in the regulatory mission?” Thomas Frank, The Real Danger of One Big Regulator, Wall St. J. A19 (Nov. 11, 2009).
102. Citigroup’s former CEO Charles O. Prince has conceded that he knew his firm’s purchases of those debts that came from the subprime credit market could have disastrous consequences. He nevertheless continued dealing in them. See supra n. 7.
103. Andrew Martin & Gretchen Morgenson, Can Citigroup Carry Its Own Weight? N.Y. Times Sun. Bus. 1 (Nov. 1, 2009). Citigroup is “the queen of the zombie dance” according to Charles Whalen, editor of the Institutional Risk Analyst, because it is hoping to find some way to maximize its revenue that will allow it to survive. Id. at 6.
D. The Consumer Finance Protection Agency

In early October, President Obama came out strongly for the creation of a new consumer finance agency that would protect the public from abusive lending practices in areas like mortgages, credit cards, and pay-day loans. In essence, this legislation would safeguard borrowers from loans with terms they can’t understand. With populist fervor, the president railed against lobbyists for various business interests who claimed that the new agency would hurt small businesses that extended credit. The president called those charges clearly false and noted that such distortions reflected how “business has been done in Washington for a very long time.”

In late October, the House Financial Services Committee voted its approval of the new agency despite vigorous opposition by the banking industry. Many nevertheless see the bill as unsatisfactory in its present state because it would give federal rules in the area pre-emptive power over actions taken by state officials to protect their consumers. The fear is that such a provision would be used to restrict needed enforcement and regulatory actions by local authorities. The bill also carves out dangerous exemptions for various auto and insurance products and prohibits the agency from giving needed review to the actions of smaller banks.

E. Regulating Derivatives

A derivative is a financial instrument that gets its value from another security. A simple example is an option to buy a particular stock. The worth of that investment opportunity depends on the value of the underlying shares that it gives its holder a right to purchase.

More complicated derivatives lay at the heart of the financial meltdown.

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106. Paul Krugman, Reform or Bust, N.Y. Times A21 (Sept. 21, 2009).
111. Id.
112. A derivative is “[a] security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset.” Investopedia, Derivate: What Does “Derivative” Mean? http://www.investopedia.com/terms/d/derivative.asp (last accessed Mar. 27, 2010).
113. A stock option is “[a] privilege, sold by one party to another, that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed-upon price within a certain period or on a specific date.” Investopedia, Stock Option: What Does “Stock Option” Mean? http://www.investopedia.com/terms/s/stockoption.asp (last accessed Mar. 27, 2010).
commentator put it,

"It is difficult for civilians to understand a derivative contract, or any range of closely related instruments such as credit default swaps. These are all products that were designed initially to transfer or hedge risk—to purchase some insurance against the prospect of a price going down, when your main bet was that the price would go up."115

The credit collapse in September 2008 arose because lenders lost faith in the value of mortgage-backed securities known as CDO's.116 Their values were supposed to be insured by CDS's117 which generally committed their obligors to make good on any loss suffered by holders of CDO's.

CDS's are thus sophisticated bets on the potential defaults of speculative debtors.118 Rightly managed, they can be used to control risk.119 At the time of the meltdown there were over $40 trillion of those obligations outstanding, however, and they were created and traded over-the-counter, that is, in individualized transactions.120

As such they were neither standardized nor publicly reported.121 In addition, they involved numerous participants in a convoluted chain of potential liability from unknown counterparties of their co-parties.

Even worse, many of these CDS's had become highly speculative arrangements where some of the major obligors lacked the resources to make good their assurances. The most notorious of those was the large insurance company AIG that the federal government had to continually shore up with tax-payer-funded bail-outs so that its counterparties would not collapse.122

To make sure such a calamity will not recur, two House committees have reported bills that would require a number of these derivatives to be traded on exchanges in standardized form with their details reported for public scrutiny.123 Issuers of CDS's would also have to provide reserves so that they would, like a regular insurance

115. John Lanchester, Melting into Air, New Yorker 80, 83 (Nov. 10, 2008).
116. The SEC has defined an asset backed security, in part, as follows:

Asset backed security means a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases.
120. Gretchen Morgenson, Don't Let Exceptions Kill the Rule, N.Y. Times BU1, BU7 (Oct. 18, 2009).
121. Under the Commodities Futures Modernization Act of 2000, it was made illegal to regulate CDS's.
122. Morgenson, supra n. 120, at BU7.
company, have the where-with-all to stand behind their commitments. However both bills have been rightly called "weak and unlikely to prevent another fiasco." Major players in swaps like big banks are not eager to have their deals exposed in exchange trading where the identities of the parties and the price of their obligations would be open for public scrutiny. This year the financial service industry has spent $220 million in lobbying and some of that seems to have paid off in a major exemption that the bills have for "end-user" trades which would not have to be done on exchanges. Those arrangements are supposed to involve useful hedges that companies like airlines and oil companies engineer to offset their commercial risks. Skeptics, however, see a possible abuse of that by general speculators like hedge funds and private equity companies that might structure their swap trading to claim this "end-user" exemption. In addition, nothing currently emerging from Congress would give federal authorities the ability to ban outright dangerous derivative products and abusive practices here.

F. Taking On Excessive Compensation

The meltdown also brought the issue of excessive compensation, both in the financial sector and the corporate world generally, front and center to public consciousness. From 1929 to 1998, profits in banking averaged 1.2% of the national economy, but by 2005 they had risen to 3.3%. Presumably financiers earn their pay by assisting in the efficient allocation capital, but in the bubble economy of the last decade that got all out of whack. Hedge fund managers grabbed exorbitant fees from their investors and banks took all kinds of compensation that was hidden from their

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125. The State of Financial Reform, supra n. 110.
126. Morgenson, supra n. 120. The venerable investment banking firm JPMorgan appears to have taken a leading role, here "stonewalling derivative reform in order to protect the outsized margins the business generates." Barrett, supra n. 7.
127. Labaton, supra n. 105.
128. Morgenson, supra n. 120, at BU7.
131. Lloyd Blankfein, CEO of the Investment Bank Goldman Sachs, tried to make that point in a recent interview saying, "[w]e help companies to grow by helping them to raise capital . . . . Companies that grow create wealth. This, in turn, allows people to have jobs that create more growth and more wealth. It's a virtuous cycle. We have a social purpose." Maureen Dowd, Virtuous Bankers? Really?! N.Y. Times A31 (Nov. 11, 2009). Blankfein, however, went on to say that his firm was "doing God's work[,]" which touched off public outrage given his firm's anticipated profits and huge bonuses. Geraldine Fabrikant, In Charity Tax Filing, a Glimpse of Goldman, N.Y. Times B1 (Nov. 12, 2009). In response to public outrage from his statements, however, Blankfein issued this apology several days later announcing that his firm would spend $500 million to help small businesses recover from the recession. "We participated in things that were clearly wrong and have reason to regret . . . ." Graham Bowley, People Power, N.Y. Times WK1 (Nov. 22, 2009). On whether investment bankers like Mr. Blankfein have been doing "God's work," a putative authority on that subject, Pope Benedict XVI, weighed in recently with these comments: "Today's international economic scene, marked by grave deviations and failures, requires a profoundly new way of understanding business enterprise . . . . Financiers must rediscover the genuinely ethical foundation of their activity, so as not to abuse the sophisticated instruments which can serve to betray the interests of savers." Encyclical ltr. from Benedict XVI, Caritas in Veritate § 40, § 65 (July 7, 2009). By contrast, another form of Christianity, the "Prosperity Gospel," may have made a significant contribution to the meltdown by encouraging excessive risk-taking by its followers. See Rosin, supra n. 8.
Likewise, the pay of top corporate executives in the last decade far exceeded what had been the norm in earlier times. In 1965 a CEO made twenty-four times as much as the average worker, but by 2007 that had increased by more than 10 fold to a multiple of two hundred and seventy-five. Such enormous disparity in the allocation of wealth is evidence of a fundamentally unfair society.

Even more unjustly, there often seemed no grounds for this stratospheric compensation. For instance, according to a report by New York Attorney General Andrew Cuomo, in 2008 Citigroup and Merrill Lynch, which had together lost $55 billion in 2008 and had received the same amount in federal bailouts, nevertheless paid out $9 billion in bonuses. Public ire towards those inequities reached a fever pitch shortly after the meltdown when it was disclosed that AIG officials were paid $165 million in bonuses after the government had rescued it with $175 billion in bail-out funds.

In addition, the four largest investment banks in New York earned a record $22.5 billion during the first nine months of 2009. As stocks rebounded, much of those gains came from the trading the firms did in securities because they were able to borrow money for almost no interest and put it to work in the surging market. Six of the country’s top bank holding companies also put aside an astounding $112 billion for bonuses and salaries reputedly earned during the first three quarters of 2009.

Summing up this outrageous state of corporate and financial compensation, Nobel prizewinning economist Paul Krugman wrote: “In a nutshell, bank executives are lavishly rewarded if they deliver big short-term profits—but aren’t correspondingly punished if they suffer even bigger losses.” For instance, investment bankers who sold risky mortgage-backed securities were paid immediately for the volume of business they generated even though their houses suffered substantial losses when those investments proved worthless.

With what the Wall Street Journal called a “one-two punch,” the federal

132. Norris, supra n. 130, at BU7.
134. Zachery Kouwe, Wall Street on Track for Record in Profits, N.Y. Times B8 (Nov. 18, 2009).
135. Krugman, supra n. 106.

138. This author made his views known on that point in the heady days immediately preceding the meltdown. See Daniel J. Morrissey, American Catholics in the New Gilded Age, America 22 (Jan. 7, 2008).
government appeared to take decisive action on this matter in late October 2009. First, the country’s so-called pay czar, 141 Kenneth Feinberg, ruled that the compensation paid to the 25 most highly paid executives at banks getting bailout funds would be capped at $500,000 while the group’s total pay level would be 50% lower than the year before. 142

When asked if he hoped his rulings would more broadly change the practices of executive pay, Mr. Feinberg replied, “I hope so.” 143 Skeptics, however, noted that Feinberg’s action does not affect banks which had given back their bailout money. They could thus hire away top performers for lush compensation from those firms that still remain wards of the government.144

Of perhaps more lasting impact was the simultaneous announcement by the Federal Reserve Bank, awaking from its “Greenspan-era slumber,”145 that it would review bankers’ compensation as part of its routine regulatory process.146 The new initiative was designed specifically to deter excessive speculation by financial firms. According to Fed Chairman Ben Bernanke, the new rules would tie compensation to long term performance and not create “undue risk for the firm or the financial system.”147 The emerging Fed guidelines will apparently scrutinize remuneration plans over periods of performance and assess whether they also take into account losses incurred because of actions by bank employees.148

Along the same lines, in July the House of Representatives passed the so-called “Say on Pay” legislation as part of a “Compensation Fairness Bill.”149 It would allow shareholders to cast advisory votes on corporate compensation.150 A reform measure with a more potent promise for change, however, may soon be promulgated by the SEC. This new rule would allow shareholders to have their nominees for directors included without cost in proxy materials as rivals to the candidates put forth by incumbent management.151 Stockholders fed up with virtual looting of their firms by overpaid executives could then have a chance to “throw the bums out.”152

Such lavish and excessive compensation also implicates violations of fiduciary duties that directors who authorize such remuneration owe their shareholders. The leading jurisdiction of Delaware has been reluctant to review these decisions, acceding to

142. Lucchetti et al., supra n. 140.
143. Nocera, supra n. 141. One reporter aptly put the impact of Feinberg’s actions into the broader context of social justice with these remarks: “For Mr. Feinberg, the process of cutting pay underscored the widening divide between Wall Street and the rest of America, where even a fraction of a banker’s pay seems like riches to many people.” Louise Story, Pay Czar Doubts Cuts Will Make Bankers Leave, N.Y. Times B8 (Oct. 23, 2009).
144. See generally Nocera, supra n. 141.
145. The descriptive comment is from Paul Krugman, supra n. 106, at A21.
147. Hilsenrath, supra n. 139, at A4.
148. Id.
149. The bill now appears as the Compensation Fairness Act of 2009, Sen. 651, 111th Cong. § 1 (Mar. 23, 2009). It has also has been incorporated into the Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 1 (Dec. 2, 2009).
150. Owen, supra n. 133, at 62.
152. That apt description is by Nell Minnow, co-founder of the Corporate Library, an organization dedicated to reforming corporate compensation. Nocera, supra n. 141, at B8.
the board’s business judgment.\textsuperscript{153} Given the gross inequities currently endemic in schemes of executive remunerations, one can rightly question, however, whether this judicial deference can continue. As one leading academic said recently about the perverse incentives offered by the current business culture, “[e]xecutive bonuses—especially in the form of stock and option grants—represent the most prominent form of legal corruption that has been undermining our large corporations and bringing down the global economy.”\textsuperscript{154}

IV. \textsc{Never Again}

A. Assumption of Responsibility by Leading Figures

Lack of adequate regulation for the financial industry has cost our country dearly. In the wake of the meltdown even a humbled Alan Greenspan confessed to Congress, “[t]hose of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief.”\textsuperscript{155} The Maestro, who for decades had opposed the regulation of derivatives,\textsuperscript{156} was forced to concede the inadequacy of his laissez-faire theories. “This modern risk-management paradigm,” he admitted, “collapsed in the summer of last year.”\textsuperscript{157}

Greenspan’s remorseful comments were echoed by his successor, Fed Chairman Ben Bernanke, in testimony given before the Senate as he sought approval for a second term. “There were mistakes made all around,” he said. “I did not anticipate a crisis of this magnitude and this severity.” Bernanke went on. “We should have required [banks to hold] more capital, more liquidity . . . . We should have required more risk-management controls.” He also admitted that the Fed was “slow on some aspects of consumer protection.”\textsuperscript{158}

That repentance by the two Fed chairmen was in line with similar comments by other leading architects of the improvident arrangements that brought about the meltdown. Charles Prince, CEO of Citigroup, has famously admitted he knew the dangers of those investment practices but continued to pursue them in cavalier fashion because, “as long as the music is playing, you’ve got to get up and dance.”\textsuperscript{159} And after initially defending the actions of his firm as “God’s work,” Lloyd Blankfein, the CEO of Goldman Sachs, has reversed his position and issued a public apology by saying, “[w]e participated in things that were clearly wrong and have reason to regret.”\textsuperscript{160}

B. The Urgent Need for Reform

For centuries it has been apparent that unrestrained free enterprise, particularly as

\textsuperscript{153} See \textit{In re Walt Disney Co.}, 906 A. 2d 27 (Del. 2006).
\textsuperscript{156} See Greenspan, \textit{supra} n. 119.
\textsuperscript{157} Andrews, \textit{supra} n. 155, at B6.
\textsuperscript{159} See \textit{supra} n. 7.
\textsuperscript{160} See \textit{supra} n. 131 and accompanying text.
it is practiced with regard to financial instruments, has the potential to bring great ruin to the social fabric of our country.\textsuperscript{161} No one perhaps ever put that better than the solidly pro-business president Herbert Hoover who famously observed, "\{t\}he trouble with capitalism is capitalists. They're too damn greedy."\textsuperscript{162} The government must therefore have the tools to safeguard the economy. And public officials must use them to make sure that business and finance operate in the public interest.

Yet, as a noted economic historian observed, "[I]t is impossible to anticipate every form of corruption that might develop in a constantly evolving free-market economy. . . the law will always lag well behind the ideas . . . that people, driven by self-interest, will develop for quickly exploiting new opportunities as they appear."\textsuperscript{163} Keeping that caveat in mind, here are certain prescriptions that public officials must enact and pursue to make sure another financial meltdown and a resulting great recession never happen again.

1. An Oversight Council with Teeth

The proposed oversight council is much needed to protect the economy against speculative excesses that could result in the devastating burst of another fiscal bubble.\textsuperscript{164} Its mission should be to promote secure markets and prudent financial and business conduct. One of its principal concerns must be to prevent excessive debt. In whatever form this supervisory body ultimately takes, the Federal Reserve should therefore have a signal role because of its responsibility over monetary policy.\textsuperscript{165}

Most importantly the council should have real power to stop speculative excesses and a leadership committed to taking such action when necessary. Even Alan Greenspan once warned against such "irrational exuberance" in the markets. Now that the economy has felt the painful effects of such practices, unfounded bull markets must be halted before they inevitability turn bearish and result in another crippling recession.

No single agency currently possesses the information or authority to oversee the entire economy, nor does any authority have the mandate to watch out for great upheavals that may occur when significant financial sectors become troubled. As the Treasury’s white paper aptly noted, our present system regulates the economy in piecemeal fashion with "separate regulatory agencies across segregated functional lines . . . such as banking insurance, securities and futures."\textsuperscript{166} This proposed oversight council should have such plenary power to safeguard our macroeconomic stability. As a result, policy makers should never again have to face the dilemma of "too-big-to-fail scenarios" with their Hobson’s choices of costly bailouts or devastating economic collapses.

\textsuperscript{161} A fine contemporary history of the impact of finance, for good and ill, on the modern world is Niall Ferguson, \textit{The Ascent of Money: A Financial History of the World} (Penguin Press 2008).


\textsuperscript{163} \textit{Id.} at 222.

\textsuperscript{164} \textit{See supra} n. 3--9 and accompanying text.

\textsuperscript{165} Along those lines, Federal Reserve officials appear to now be rethinking the "do-nothing" policy they have followed in past decades "when they saw bubbles building in prices of stocks, houses or other assets." Jon Hilsenrath, \textit{Fed Debates New Role: Bubble Fighter}, Wall St. J. A1 (Dec. 2, 2009).

\textsuperscript{166} Dept. of the Treas., \textit{supra} n. 15, at 4.
2. A Powerful Consumer Finance Agency that Does Not Preempt Local Protections

Abusive and reckless lending lay at the heart of our current financial crisis. In addition to having a destructive effect on the overall economy, such predatory practices have brought hardship to countless citizens.\textsuperscript{167} It is therefore high time for a strong federal consumer finance protection agency.

Potential borrowers must be protected from enticing deals that they can neither understand nor afford, whether by way of mortgages, credit cards, or notoriously oppressive pay-day loans. Auto and insurance loans which can be just as unfair should also be brought under this regulatory scheme. And state and local officials who are closest to the people affected by these harmful arrangements must retain the power to police and prosecute such wrongdoers.

3. The Registration of Derivatives as Securities

The current legislation standardizing financial derivatives and requiring them to be traded on exchanges is a good start, but it does not go far enough. There should be substantive regulation of these instruments as well. CDO's are securities, but they were almost all sold without SEC registration under exemptions to those important requirements that have been unduly expanded during the last several decades.\textsuperscript{168}

Even worse, the Commodities Futures Modernization Act of 2000\textsuperscript{169} amended the federal securities laws to provide that CDS's are not securities.\textsuperscript{170} But for that ill-advised legislation, such arrangements would obviously be regulated under those statutes as investment contracts whose purchasers expect profit solely from the efforts of others, specifically the bankers who package, sell, and manage those arrangements. The public interest mandates repeal of that improvident action so that there may be full public disclosure of these risky arrangements.\textsuperscript{171}

4. Beefing Up Investor Remedies, Particularly against Credit Rating Agencies

Perhaps the most meaningful action to prevent another meltdown would be to strengthen investor remedies for fraudulent and improvident financial activity. Even though a discussion of that is beyond the scope of this article, an important legislative initiative would be to reverse a string of Supreme Court cases that have weakened

\textsuperscript{167} See supra n. 8 and accompanying text.
\textsuperscript{171} As one authority noted even before the credit collapse of 2008, [t]he market for credit default swaps is quite opaque. . . . Thickening the informational fog still further is the frequency with which one of the original parties sells its stake to someone else without notifying the other party. "Record-keeping, documentation and other practices have been so sloppy," as a recent article put it, "that no firm could be sure how much risk it was taking or with whom it had a deal."

Partnow, supra n.114, at 1036 (footnote omitted).
shareholder rights.\textsuperscript{172} Another would be to fortify the class action lawsuit, the legal instrument that allows disparate stockholders to aggregate their claims for corporate wrong-doing.\textsuperscript{173}

Unsubstantiated favorable ratings of CDO’s were among the most egregious causes of investor losses during the meltdown. To deter that abusive conduct and provide redress from such wrongdoers, investors should be given an express cause of action against rating agencies that engage in such harmful activity. The federal securities laws should therefore be amended by a provision such as that which is sponsored by Congressman Brad Sherman (D. CA). He received assistance in drafting it from prominent San Diego securities lawyers Darren Robbins, Benny Goodman, and the author of this Article. It reads:

A purchaser of a security given a rating by a credit rating agency shall have the right to recover for damages, without regard to whether or not the security is issued pursuant to a registration statement or prospectus, if (a) such rating was not reasonable based on the facts and circumstances at the time the rating was issued and (b) such rating was a substantial factor in the investor’s economic loss. Such credit rating agency shall not be liable to the extent it can establish it exercised due care in connection with the issuance of such rating.

5. A Rejuvenated SEC

Despite its well-documented failures that were particularly pronounced in the Madoff fraud, an aggressive and competent SEC is needed now more than ever. As Commission historian Joel Seligman has put it, “the most effective protection of the investor is a strong SEC—one that believes in using its Congressionally voted mandate to insist upon full and fair disclosure and pursue enforcement cases that will deter cupidty and irresponsibility.”\textsuperscript{174}

The SEC has a storied legacy. As one of its early Chairman (later Supreme Court Justice) William O. Douglas wrote of the Commission’s early days during the New Deal, “I was proud of the youngsters of that day. Washington, D.C., became a young man’s and a young woman’s town . . . They literally begged to work for us at the SEC.” Douglas continued, “We were rich in talent at the SEC; and the energies of the men seemed endless . . . These were honest, idealistic, hard-working, and loyal men and women to the nth degree.”\textsuperscript{175}

With such a tradition, it’s hard to say that the final chapter of the SEC has been written. And the same spirit of public service may be alive again today. Speaking of a “new patriotism,” public philospher Michael Sandel has noted, “Obama’s campaign tapped a dormant civic idealism, a hunger among Americans to serve a cause greater than themselves, a yearning to be citizens again.”\textsuperscript{176}

Restoring that sense of dedicated professionalism, of course, will require reforms. Chief among them will be a system of enhanced compensation that will reward and

\textsuperscript{172} The author provided a blueprint for that in Daniel J. Morrissey, \textit{Strengthen Investor Rights}, National L. J. 58 (Sept. 14, 2009).


\textsuperscript{174} Seligman, supra n. 32.

\textsuperscript{175} Douglas, supra n. 32, at 271, 269.

retain exceptional service by SEC staffs.\textsuperscript{177} There are hopeful signs that such changes are being made. Even the Commission's harshest critics are impressed with new initiatives taken by its current leadership.\textsuperscript{178}

V. CONCLUSION

Our country's economic crisis resulted from a failure to adequately regulate our capital markets and to enforce the laws we do have that protect investors against fraud. The nation has learned an expensive lesson. A modern, sophisticated economy in general and its financial system in particular cannot be loosely regulated. Those who solicit other people's money and purportedly put it to work for the good of society must be strictly held accountable for their actions.

As of early December 2009, the leadership of the House of Representatives has packaged the remedial measures discussed in this article into an omnibus bill called "The Wall Street Reform and Consumer Protection Act of 2009."\textsuperscript{179} At present it is comprised of 1,279 pages. According to a tongue-in-cheek comment by a colleague of mine, that is not nearly long enough to rein in all the financial abuses and predatory practices that have caused the current crisis.\textsuperscript{180} But perhaps it is a start. America has been a country offering the promise of prosperity to all its citizens—not just to the privileged few who work on Wall Street. If that sense of opportunity is to continue, our nation must safeguard its economy with these needed reforms.

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177. See supra nn. 67–69 and accompanying text.
178. See supra nn. 61–65 and accompanying text.
179. That bill is called the Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. 2009–2010. See supra n. 149 and accompanying text.

The House passed the measure on Dec. 11, 2009. Commenting in his weekly radio address the next day, President Obama hailed the legislation and blamed the recession on "the irresponsibility of large financial institutions on Wall Street that gambled on risky loans and complex financial products, seeking short-term profits and big bonuses with little regard for long-term consequences." David Streitfeld, \textit{Rates are Low, but Banks Balk at Refinancing}, N.Y. Times A1 (Dec. 13, 2009).

Senator Chris Dodd, chairman of the Senate Banking Committee, has introduced his own version of such a bill which runs 1,136 pages. See supra n. 89.

180. That appropriately skeptical remark was made by Professor George Critchlow, Acting Dean of Gonzaga University Law School.
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