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ARTICLES

LAWS, SAUSAGES, AND BAILOUTS: TESTING THE POPULIST VIEW OF THE CAUSES OF THE ECONOMIC CRISIS*

J. Scott Colesanti**

INTRODUCTION

While the lingering economic crisis has drawn much attention to individual products¹ and private sector villains² thought to have caused the market meltdown, a pointed study of the full range of *government* causes (and their attendant depth) has to date proven less attractive to authors and critics. It is now axiomatic—even among the financial survivors and victors of the crisis—that Wall Street fell victim to an unprecedented myopia.³ It is commonly accepted that regulation was flawed,⁴ but the exact degree to

* Folklore attributes the referenced quote, “No one should be forced to see how laws or sausages are made,” along with a variety of other constructions, to Mark Twain or Otto Von Bismark. See Fred R. Shapiro, *Quote . . . Misquote*, N.Y. TIMES MAG., July 21, 2008, available at <http://www.nytimes.com/2008/07/21/magazine/27wwwl-guestsafire-t.html>; see also Memorable Quotes and Quotations from Mark Twain, <http://www.memorable-quotes.com/mark+twain,a99.html> (last visited Apr. 29, 2010).

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1. See generally GILLIAN TETT, *FOOL’S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE* (2009) (detailing the origin, growth, and abuse of credit default swaps between 1994 and 2008).

2. See, e.g., James Surowiecki, *Ratings Downgrade*, NEW YORKER, Sept. 28, 2009, at 25 (noting President Obama’s “well-deserved shots at some of the villains of the financial crisis: greedy bankers, reckless investors, and captive regulators” during a speech in New York the same month).

3. See Jenny Anderson, *As Goldman Thrives, Some Say an Ethos Fades*, N.Y. TIMES, Dec. 16, 2009, at A1 (reporting former partners’ words that while Goldman has always sought to maximize profits, the bank used to take a longer term view).

4. Admissions by regulators of their lapses range from the generic to the pointed. See *Financial Regulatory Revision: Before the J. Economic Comm.*, 111th Cong. (2009) (unpublished written testimony of Timothy F. Geithner, Secretary of the Department of the Treasury), available at <http://www.ustreas.gov/press/releases/tg413.htm>.

which any one public sector can be blamed has, like the corresponding remedies presently languishing in Congress, been seemingly postponed until a consensus can be reached on the ultimate means of ending the downturn.⁵ Moreover, such a direct allocation of culpability may just be a condition precedent to our economy's recovery. For example, the savings and loan crisis of the late 1980's, which led to the demise of over 1000 regional banks, arguably stopped short of a financial Armageddon because Federal Judge Stanley Sporkin lambasted the accounting and legal professions.⁶ The Stock Market Crash of 1987, which was over in less than a month, was blamed on those gamblers known as 'program traders,' thus resulting in new rules designed to shut down the stock exchanges when

In the years leading up to the crisis, our financial regulatory regime permitted an excessive build-up of risk, both inside and outside of the traditional banking system. The shock absorbers critical to preserving stability – capital, margin, and liquidity cushions in particular – were inadequate. Outdated, ineffective regulation left our system too weak to withstand the failure of major institutions.

Id.

Likewise, Federal Reserve Chairman, Benjamin Bernanke, recently stated "[s]tronger regulation and supervision aimed at problems with underwriting practices and lenders' risk management would have been a more effective and surgical approach to constraining the housing bubble than a general increase in interest rates." Catherine Rampell, *Lax Oversight Caused Crisis, Bernanke Says*, N.Y. TIMES, Jan. 4, 2010, at A1; see also SEC OFFICE OF INSPECTOR GEN., *Executive Summary* to INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME 1 (2009), <http://www.sec.gov/news/studies/2009/oig-509-exec-summary.pdf>. ("[T]he SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination . . . despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed.").

5. See, e.g., Sarah Kellogg, *Financial Crisis 2008: Where Were the Lawyers?*, WASH. LAW., Jan. 2010, at 20, available at http://www.dcbbar.org/for_lawyers/resources/publications/washington_lawyer/january_2010/financial_crisis.cfm ("By most measures, the United States remains in the grip of a prolonged financial crisis . . . More than a year after the bottom fell out of the U.S. economy, the masterminds on Wall Street and in Washington continue to struggle.").

6. The full quote from Judge Sporkin reads as follows:

Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?

Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?

What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.

Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990) (upholding the seizure by the OTS of the Phoenician resort and affiliated thrift).

daily trading swings proved too volatile.⁷ Meanwhile, the mortgage debt crisis of the early '90s lost steam once the Orange County Treasurer went to jail and counterparty firms paid unprecedented fines.⁸ Earlier this decade, when a number of large corporations evidenced accounting irregularities, specific company management was indicted, prompting a law that obligated CEOs and CFOs to swear to the accuracy of financial statements.⁹

Mindful of the pressing need for such resolute finger-pointing, this Article seeks to provide a cross-boundary analysis of the statutes, initiatives, cases, agency decisions, and regulatory reporting lines that either paved the way or aggravated the economic crisis of 2007–2010 (the Crisis). Accordingly, this Article seeks to test postulates of blame in four distinct categories: the enactments of the federal legislature, the decisions by the federal judiciary, the mortgage policy of the Department of Housing and Urban Development (HUD) (as steered by the White House), and the actions/omissions by the Securities and Exchange Commission (SEC or Commission). To that end, this Article identifies the popular wisdom concerning the culpability of each government sector, locates predating trends in the underlying “law,” and compares the two for a variance. The resulting five postulates are summarized as follows:

- The perceptions of the Crisis’ causes are hindered by the search for predicate actions in the past five years, while the true origins of the Crisis seem to be rooted in decades past.
- The more that a perception focuses on an investment product, the less illustrative the critique.
- The contributions to the Crisis by the judiciary and White House during its genesis period are, to one degree or another, understated.
- The ultimate causes for the Crisis may be more subtle and atmospheric than direct and empirical.
- Not only have the laws governing the contributors to the Crisis grown outdated, so has our collective ability to levy blame. Until we recognize that the nightmare scenario of Wall Streeters victimizing the commoner has been supplanted by more complex wrongs, the corresponding analysis will continue to stagger and fall short.

In sum, unlike studies of prior financial crises, the clearest (and least self-serving) reconstructions of the most recent catastrophe have been undertaken by the financial press. This Article seeks to put such populist perceptions to the legal test. Owing homage to the existing literature

7. See NYSE, Inc., Dealings and Settlements, Rule 80B (Trading Halts Due to Extraordinary Market Volatility) (1998), available at http://rules.nyse.com/NYSETools/PlatformViewer.asp?searched=1&selectednode=chp_1_3_4_20&CiRestriction=80B&manual=/nyse/rules/nyse-rules/.

8. See *State v. Morgan Stanley & Co.*, 459 S.E.2d 906, 910–13 (W. Va. 1995).

9. See Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262 (Supp. 2002).

confirming the sins of over-exotic products and profligate spending, this Article eschews any focus on private actors (e.g., credit rating agencies) in favor of examination of government accelerants and responses (much in the same way that a scrutiny of gaming laws confesses the existence of gambling but refuses to blame the horses or dice). Overall, this Article hopes to contribute to academia a categorical assessment of the service offered by the public servants collectively charged with maintaining the first line defense against the very economic abyss that continues to threaten both national and international markets. Stated otherwise, one *should* be forced to see how meltdowns and bailouts are made, if only to prevent their frequent recurrence.

I. THE POPULIST VIEW ON THE ORIGINS OF THE CRISIS

Although it has become politically expedient to characterize the prolonged economic slump as unforeseeable, in fact, nothing could be further from the truth. It is the position of this Article that in government, industry, and academia, the warning signs were almost as pronounced and as old as the seeds of the crisis themselves. Perhaps, when the fear of inviting blame has subsided, all parties will accede to this simple truth.

A. RELEVANT TIMELINE FOR THE ANALYSIS OF THE SUBPRIME MELTDOWN

Wall Street possesses a time-honored affection for novel investment vehicles. While individual residential mortgage loans are insignificant to investment bankers, during the relevant years, these mortgages were bundled and sold, about half of the time, to entities known as “government sponsored enterprises” (GSEs) such as Fannie Mae and Freddie Mac.¹⁰ The purchases of securitized bundles by GSEs, often called Collateralized Debt Obligations (CDOs)¹¹ grew rapidly,¹² from \$81 billion of such securities in 2003 to \$169 billion in 2005.¹³

10 See Zachary A. Goldfarb & David Cho, *U.S. Considers Remaking Mortgage Giants*, WASH. POST, Aug. 6, 2009, at A1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/08/05/AR2009080504063.html>; see also Federal Home Loan Mortgage Corporation Act of 1970, tit. III, Pub. L. No. 91-351, 84 Stat. 451 (codified as amended at 12 U.S.C. §§ 1451–1459 (2006)) (chartering Freddie Mac as a GSE in 1970); Federal National Mortgage Association Charter Act of 1956, ch. 649, tit. II, § 201, 68 Stat. 612 (codified as amended at 12 U.S.C. § 1717) (chartering Fannie Mae as a GSE in 1968).

11. See *infra* notes 151, 152.

12. See, e.g., *SEC Actions Relating to the Financial Crisis: Hearing Before the Subcomm. on Financial Servs. and General Government Operations of the Comm. on Appropriations*, 111th Cong. 249 (2009) [hereinafter Schapiro Testimony] (forthcoming testimony of Mary Schapiro, Chairman of the SEC), available at <http://www.sec.gov/news/testimony/2009/ts031109mls.htm>.

13. Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis: Subprime Loans Labeled ‘Affordable,’* WASH. POST, June 10, 2008, at A1.

The Federal Reserve helped spur the growth of the exotic investments. The Federal Funds rate was lowered to 1% and kept there throughout the 2004 fiscal year.¹⁴ This prompted lenders to make loans, and to disregard vague suitability guidelines.¹⁵ In turn, the entities that bought these loans shot right past all rational limits on their purchasing ability.¹⁶ The result was a dramatic increase in a risky category of debt known as “subprime lending,” which represented just 8.6% of all mortgage debt in 2001 but rose to over 20% in 2006.¹⁷

The growth was also attributable in part to academic hubris. In 2003, a University of Chicago professor and winner of a Nobel Prize in Economics, haughtily declared that the “central problem of depression-prevention has been solved, for all practical purposes.”¹⁸ Ultimately, radical credit became the *must* game in town. The now defunct Lehman Brothers ratcheted up its debt to leverage ratio from twenty-five times equity to thirty-five times equity in one year.¹⁹ Surprisingly, instead of inviting scorn, its model became the standard to which large firms aspired.²⁰ CEOs quickly learned that, regardless of their intuition, unfettered faith in the upswing of the real estate market was the only course of action if they intended to prove their competitive entrepreneurialism to corporate boards.²¹

B. DRAMATIC ACTIONS TAKEN BY THE WELL-HEELED

In an era characterized by the free flow of money, significant eyes took heed. In 2005, insurance giant AIG stopped underwriting CDOs.²² In 2006,

14. James Grant, *Weekend Journal: Why No Outrage?*, WALL ST. J., July 19, 2008, at W1.

15. Edmund L. Andrews, *Fed and Regulators Shrugged as the Subprime Crisis Spread*, N.Y. TIMES, Dec. 18, 2007, at A1 (“The Fed helped stoke the housing market by slashing short-term interest rates from 2000 to 2004. The rate cuts drastically reduced the effective cost of buying a house, which added more fuel to what was already a powerful housing boom.”).

16. Joseph A. Giannone, *Lehman Leverage Still Too High: Einhorn*, REUTERS, June 9, 2008, <http://www.reuters.com/article/idUSN09178720080609>.

17. John Cassidy, *Subprime Suspect: Annals of Business*, NEW YORKER, Mar. 31, 2008, at 78.

18. PAUL KRUGMAN, THE RETURN OF DEPRESSION ERA ECONOMICS AND THE CRISIS OF 2008 9 (2009) (elaborating that the professor was not claiming that the “irregular alternation of recessions and expansions” was over, but rather that efforts were better expended in studying “long-term economic growth”).

19. WILLIAM D. COHAN, *HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET 3* (2009).

20. See Devin Leonard, *How Lehman Brothers Got its Real Estate Fix*, N.Y. TIMES, May 3, 2009, at BU1 (citing the comment of one noted analyst that “a lot of Wall Street firms tried to duplicate Lehman’s commercial real estate strategy”).

21. See, e.g., The Balance Sheet, <http://www.newyorker.com/online/blogs/jamessurowiecki/2009/01/who-saw-the-dan.html> (Jan. 6, 2009) (noting the July 2007 comment by the Citigroup CEO that “as long as the music is playing, you’ve got to get up and dance.”); see also 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* 14 (2009) (“[L]ike everyone else on Wall Street, [Lehman Brothers CEO Richard Fuld] couldn’t pass up the opportunities.”).

22. See Cassidy, *supra* note 17.

the Consumer Federation of America published its famed report, *Exotic or Toxic: An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*.²³ In February 2007, HSBC, an international banking giant, announced that it was reserving \$10 billion to cover non-performing American mortgages.²⁴ The next month, the burgeoning scrutiny of bank regulators prompted Senator Christopher Dodd to send letters to Federal Reserve Chairman Ben Bernanke and other officials decrying lagging supervision of subprime lenders.²⁵

In March 2007, *The Wall Street Journal* openly questioned whether federal regulators were to blame in the disastrous expansion in subprime lending.²⁶ In June 2007, a “seismic quiver” shot up the spine of Wall Street when it was disclosed that two Bear Stearns mortgage hedge funds could not meet margin calls.²⁷ In September 2007, former Federal Reserve Chairman Alan Greenspan blandly confessed nearly two months of market turmoil, noting that “[t]he human race has never found a way to confront [stock market] bubbles.”²⁸ Regardless, that month, the dire news appeared in full swing, as a former Federal Reserve Governor turned author reminded the public that he foretold that the “predictable result” of the residential real estate boom was “carnage.”²⁹

C. REGULATORY NOTICE

By the end of the summer of 2007, the brokerage industry’s chief regulator put firms on notice that sales of “complex structure products” such as mortgage-related securities would be expressly examined.³⁰ The catastrophe became a bit more public in the fall, as more storied Wall Street firms admitted their bad bets.³¹ Shortly before Halloween, Merrill Lynch

23. ALLEN J. FISHBEIN & PATRICK WOODALL, CONSUMER FED’N OF AM., *EXOTIC OR TOXIC? AN EXAMINATION OF THE NON-TRADITIONAL MORTGAGE MARKET FOR CONSUMERS AND LENDERS* (2006), http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf.

24. Cassidy, *supra* note 17.

25. Greg Ip & Damian Paletta, *Lending Oversight: Regulators Scrutinized in Mortgage Meltdown; States, Federal Agencies Clashed on Subprimes as Market Ballooned*, WALL ST. J., Mar. 22, 2007, at A1 (Senator Dodd wrote in a letter to regulators that “the crisis has been in the making for several years, and, in my view, it has taken far too long for the regulators to act.”).

26. *Id.*

27. CHARLES R. MORRIS, *Forward* to THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH, at ix–xviii (2008).

28. Greg Ip, *Credit Crunch: Greenspan Says Turmoil Fits Pattern*, WALL ST. J., Sept. 7, 2007, at C2, available at <http://online.wsj.com/article/SB118913318976220324.html>.

29. Greg Ip & Stephen Miller, *Remembrances*, WALL ST. J., Sept. 8, 2007, at A6 (describing the prophecies of Edward Gramlich, who had died days earlier, and his prescient book, *Subprime Mortgages: America’s Latest Boom and Bust*, which was published in June 2007).

30. FINRA, REGULATORY NOTICE 07-43 (2007), http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p036816.pdf.

31. Susan Pulliam & Kara Scanell, *Pricing Probes on Wall Street Gather Steam: SEC-Led Investigations Focus on Public Notice, In-House Discrepancies*, WALL ST. J., Dec. 21, 2007, at C1.

reported its first quarterly loss in nearly six years based upon a write-down of nearly \$8 billion.³²

In December 2007, the SEC and other regulators were said to be investigating brokerages regarding the pricing of mortgage securities and the need for public disclosure of their rapidly declining prices.³³ In the presence of \$80 billion in write-downs in the last few months of the year, the Commission was said to have initiated three dozen investigations.³⁴ However, such parries were usually tempered by uncertainties. For example, since the securities in question were difficult to accurately value, an SEC official was concurrently quoted as stating, "We don't know now that we will be recommending any enforcement actions in the subprime area."³⁵

Private watchdogs were less equivocal. In March 2008, a full six months before the newspapers publicized the onset of the Crisis, an investment advisor running a consumer friendly website posted the warning that "[t]he great credit unwind is upon us. Credit default swaps on all brokers, particularly Lehman [Brothers] and Bear Stearns, are blowing out, big time."³⁶

D. COSTLY STARTS AND STOPS, PUBLIC AND PRIVATE

Particularly disconcerting throughout 2008 were the unhalting trends, unfathomable losses, and unpunished errors. In late January 2008, Merrill Lynch, which had written down \$10 billion of mortgage-related securities, disclosed its intent to abandon the structured credit business.³⁷ The same month, New York's Attorney General Andrew Cuomo directed his staff to issue subpoenas and utilize the broad Martin Act to examine whether big-name firms failed to disclose risks to customers.³⁸ Yet again there was trepidation, as the sources for the story concurrently cited unrealistic credit firm ratings, thus undermining a direct link to investor harm.³⁹

In Spring 2008, it was reported that "6.35% of all mortgages were at least 30 days delinquent, not including those already in foreclosure."⁴⁰ The

32. Jenny Anderson & Landon Thomas Jr., *Loss and Larger Write-Down at Merrill*, N.Y. TIMES, Oct. 24, 2007, available at <http://www.nytimes.com/2007/10/24/business/24merrill-web.html>.

33. Pulliam & Scanell, *supra* note 31.

34. *Id.*

35. *Id.*

36. COHAN, *supra* note 19. "Lehman reportedly has two times [its] capital in [commercial mortgage backed securities]." *Id.* at 11.

37. Shanny Basar, *Thain Declares Structured Credit Exit*, FIN. NEWS ONLINE, Jan. 31, 2008, <http://www.efinancialnews.com/story/2008-01-31/thain-declares-structured-credit-exit>.

38. Kate Kelly et al., *State Subprime Probe Takes a New Track*, WALL ST. J., Jan. 31, 2008, at A3.

39. *Id.*

40. Michael Corkery et al., *Real-Estate Woes of Banks Mount; Lenders Dumping Bad Loans at Discount; Regulators See Losses Continuing*, WALL ST. J., June 6, 2008, at A1.

next month, Merrill Lynch suffered its fourth consecutive quarterly loss, writing off another \$9.75 billion in assets and bringing its overall write-downs for the year to \$43 billion.⁴¹ Separately, banks worldwide reported write-downs of \$335 billion.⁴²

The mammoth numbers, at times, seemed to eclipse the severity of the official observations. In May 2008, it was disclosed without fanfare by then SEC Chairman Christopher Cox that regulators had “discovered a host of perverse incentives in the securiti[z]ation process.”⁴³ The confusion and pain were hardly reserved for the stock market. While approximately 1.3 million residential foreclosures took place in 2007,⁴⁴ by the second quarter of 2008, such statistics were up 121%, and it was estimated that 1 out of every 171 homes was in foreclosure.⁴⁵

While the Dow Jones Industrial Average continued to exhibit a remarkably consistent fall (ultimately shrinking approximately 40% in 2008),⁴⁶ more entities reevaluated their holdings, leading to further write-downs.⁴⁷ Tallies of losses at Citibank and Merrill Lynch reached over \$80 billion by mid-2008.⁴⁸ Simultaneously, the Treasury and the Federal Reserve combined forces to prop up the two GSEs owning half of the mortgages in the country.⁴⁹ In October 2008, Congress passed a first bailout (valued at \$700 billion),⁵⁰ and the government rescued Freddie Mac and Fannie Mae⁵¹ while providing more directed relief to insurance behemoth

41. *Write-downs Put Merrill Lynch in Red*, CHI. TRIB., July 18, 2008, at 3.

42. *Leaders: Barbarians at the Vault*, ECONOMIST, May 17, 2008, at 15.

43. Joanna Chung, *SEC Looks to Subprime Lessons*, FIN. TIMES, May 23, 2008, at 15.

44. *Number of Foreclosures Soared in 2007*, ASSOCIATED PRESS, Jan. 29, 2008, available at <http://www.msnbc.msn.com/id/22893703/>.

45. Press Release, RealtyTrac.com, *Foreclosure Activity Up 14 Percent in Second Quarter* (July 25, 2008), <http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4891>.

46. Yahoo! Finance, *Historical Prices for the Dow Jones Industrial Average*, <http://finance.yahoo.com/q/hp?s=DJI&a=11&b=31&c=2007&d=11&e=31&f=2008&g=d> (last visited Mar. 11, 2010) (detailing the daily drop in the DJIA closing price between Dec. 31, 2007 (13,264) and Dec. 31, 2008 (8,668)).

47. Michael M. Grynbaum, *New Worries About Credit Drive Down Stock Markets*, N.Y. TIMES, Nov. 20, 2007, at C1.

48. Jon Hilsenrath, *Markets Police Themselves Poorly, But Regulation Has Its Flaws*, WALL ST. J., July 21, 2008, at A2.

49. Stephen Labaton & Edmund L. Andrews, *In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. TIMES, Sept. 8, 2008, at A1, available at <http://www.nytimes.com/2008/09/08/business/08fannie.html>.

50. See generally Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, 122 Stat. 3765 (codified as amended in scattered sections of 12 U.S.C.) (establishing the Troubled Assets Relief Program).

51. Peter J. Wallison & Charles W. Calomiris, *The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac*, FIN. SERVICES OUTLOOK (Am. Enter. Inst. for Pub. Policy Research, Washington, D.C.), Sept. 2008, at 1, http://www.aei.org/docLib/20080930_Binder1.pdf; see also Daniel Gross, *Saving the People's Bank of China: Who the Fannie Mae/Freddie Mac Bailout is Really Supposed to Help*, SLATE, Sept. 8, 2008, <http://www.slate.com/id/2199564>.

AIG, amounting to \$75 billion.⁵² In February 2009, Congress provided a second, generalized bailout (valued at \$787 billion).⁵³

Ultimately, observers, regardless of political dispositions, agreed on the unprecedented myopia in the economic sector that jeopardized a nation.⁵⁴ However, outspoken interests comprehended ahead of time that, when it came to exotic investments and the new derivatives designed to hedge bets thereon, there was much that was dangerously underestimated.⁵⁵ In sum, the Crisis was created due to reckless behavior by its architects, had predictable effects, and started with an inordinate amount of attention (and financing) being paid to residential homeowners.

II. WHITE HOUSE HOUSING POLICY: RARELY HAVE SO FEW CONTRIBUTED SO MUCH

A. PERCEPTION

Early in the Crisis, the press highlighted the previous decision by HUD to require GSEs to purchase more loans made to subprime borrowers.⁵⁶ That perception posits that the GSEs, ignoring the time-honored dictate of Keynesian economics that there is no true liquidity for markets on the whole,⁵⁷ contemplated an ever-increasing source of demand (for both homes and CDOs).⁵⁸ They were drastically wrong. By late 2009, the public appeared to overwhelming favor a close, watchful eye over the agencies that both prompted the Crisis and later cost so much to prop up.⁵⁹

52. Mary Williams Walsh & Michael J. de la Merced, *A Race For Cash at A.I.G.*, N.Y. TIMES, Sept. 16, 2008, at C1; see also Gretchen Morgenson, *Behind Insurer's Crisis, A Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1.

53. See *Economic Stimulus*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/subjects/u/united_states_economy/economic_stimulus/index.html (last visited Mar. 5, 2010) (referencing the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009)).

54. See, e.g., Laurence Grafstein, *The Real Banker Boondoggle*, NEW REPUBLIC, Sept. 23, 2009, at 23, 22–23. “[W]e can acknowledge that every major commercial and investment bank in the United States faced a direct threat to its insolvency arising from (a) its level of leverage, (b) its interrelationships with other leveraged institutions—‘counterparties’—and (c) its reliance on short-term funding from those counterparties.” *Id.* at 22.

55. Ip & Miller, *supra* note 29.

56. Leonnig, *supra* note 13.

57. “[T]here is no such thing as liquidity of investment for the community as a whole.” John Cassidy, *Rational Irrationality: Annals of Economics*, NEW YORKER, Oct. 5, 2009, at 32 (quoting JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY* 139 (Atl. Publishers & Distrib. 2006) (1964)).

58. Greg Ip, *His Legacy Tarnished, Greenspan Goes on Defensive; Future of U.S. Financial Reform Is at Stake*; ‘I Am Right,’ WALL ST. J., Apr. 8, 2008, at A1.

59. See Nick Timiraos, *U.S. News: Support Grows for Fan-Fred Plan: Proposals to Reshape Mortgage Firms Call for Retaining Public-Private Structure*, WALL ST. J., Dec. 14, 2009, at A7 (“A consensus appears to be growing among academics, investors and housing experts that the federal government should retain a role in the U.S. mortgage market over the long term . . .”).

B. DETAILS

Upon closer inspection, the ground floor of the baleful “own a home at no cost” strategy had been built by the White House about fifteen years before.⁶⁰ Thereafter, a trifecta of U.S. Chief Executives, from both parties, consistently combined to lower the financial thresholds to home ownership.⁶¹

In November 1990, President George H.W. Bush signed the Cranston-Gonzalez National Affordable Housing Act (NAHA) designed to, among other things, provide federal assistance to the planning and financing of conversions of public housing projects from private rental to ownership.⁶² Among other things, NAHA:

- (1) proposed a \$25.5 billion budget for HUD in 1992;⁶³
- (2) established a “National Homeownership Trust” within HUD to provide assistance for first time buyers;⁶⁴
- (3) permitted HUD mortgage insurance up to 98.7% of the appraised value of the property;⁶⁵ and
- (4) made permanent the maximum single family mortgage loan limit of \$124,875.⁶⁶

Symbolically, NAHA signaled the start of nearly two decades of assistance for those who failed to meet traditional minimal requirements for mortgages:

[NAHA] puts power in the hands of people. First, it authorizes a major administration initiative: Homeownership and Opportunity for People Everywhere, the HOPE Initiative. HOPE will provide new opportunities for low-income families to buy their own homes—urban homesteaders, if you will—and helps the residents of public housing to buy their own units.

60. Leonnig, *supra* note 13; see also Ann Mariano, *Panel Rejects Housing Money Transfer; Kemp Requested Funds for HUD's Ownership, Rental Initiatives*, WASH. POST, Mar. 7, 1991, at A7.

61. Leonnig, *supra* note 13.

62. *Id.*

63. Cranston-Gonzalez National Affordable Housing Act (NAHA) § 323, Pub. L. No. 101-625, 104 Stat. 4079 (1990) (codified as amended at 12 U.S.C. § 1709 (b)(2) (2006)).

64. NAHA § 302 (codified as amended at 42 U.S.C. § 12851 (2006)).

65. NAHA § 324 (codified as amended at 12 U.S.C. § 1709(b)(2) (2006)).

66. See *generally* NAHA, tit. III (codified as amended in scattered sections of 12 and 42 U.S.C.).

Tenant management, control and, ultimately, ownership of public housing is an idea whose time has come.⁶⁷

Several years later, the torch was relayed by President Clinton's "National Homeownership Strategy."⁶⁸ The National Homeownership Strategy "loosened mortgage restrictions" for first time buyers by insuring loans, eliminating the requirements that borrowers either prove prolonged stable income or be interviewed in person, and allowing lenders to hire their own appraisers,⁶⁹ thus creating the potential for inflated valuations. The ensuing tactics, which utilized such measures from the 1970s as the Community Reinvestment Act⁷⁰ and the Home Mortgage Disclosure Act,⁷¹ furthered these goals by, respectively, encouraging banks to lend to formerly ineligible customers and penalizing/fining banks that refused to lower credit standards.⁷² Subsequently, in 1995, President Clinton acquiesced to guidelines that would allow GSEs to receive credit for buying "subprime" securities as packaged products of loans creating affordable housing.⁷³

Then in 2003, President George W. Bush signed the Zero-Down Payment Act.⁷⁴ Addressing the needs of first time buyers of single family dwellings, this law authorized \$200 million in assistance with down payments. The results were dramatic: By 2007, 29% of home mortgages were estimated as originating with absolutely no down payment.⁷⁵

Additionally, in 2004, HUD guidelines were made even more favorable to financially challenged homeowners and purchases rose dramatically.⁷⁶ Between 2004 and 2006, GSEs purchased \$434 billion in securities backed by subprime loans.⁷⁷ In hindsight, these guidelines served merely as frightening yardsticks, as neither HUD nor the GSEs possessed the capability of filtering the underlying CDO loan data to inspect individual loans.⁷⁸

67. See George Bush, XLI President of the United States, Remarks on Signing the Cranston-Gonzalez National Affordable Housing Act (Nov. 28, 1990), available at <http://www.presidency.ucsb.edu/ws/index.php?pid=19101>.

68. See Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANK INST. 5, 25–26 (2009).

69. *Id.*

70. Community Reinvestment Act, 12 U.S.C. §§ 2901–2906 (2006).

71. Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801–2811 (2006).

72. Moran, *supra* note 68, at 26–28.

73. Leonnig, *supra* note 13; see also Moran, *supra* note 68, at 28.

74. Zero Downpayment Act of 2004, H.R. 3755, 108th Cong. (2004).

75. Moran, *supra* note 68, at 30.

76. Leonnig, *supra* note 13.

77. *Id.*

78. *Id.*

C. COMMENTARY

Despite the persistent attempts by the press and others to pigeonhole the Crisis as the result of overreaching homeowners,⁷⁹ it seems facile to link foreclosure statistics to any burgeoning, disastrous desire for upward mobility. Reliance upon credit had been the hallmark of the middle class for decades, and the last eight years arguably adhered to this discernible trend.⁸⁰ Between 2002 and 2007, credit card debt in this country increased over 20%.⁸¹ Between 2002 and 2005, personal bankruptcies shot up about 32%,⁸² and only ceased its upward trend because of changes in federal law that made bankruptcy discharges more difficult.⁸³ By 2008, the length of an average car loan was often extended beyond six years, as buyers saddled themselves with additional payments and interest.⁸⁴

More on point, the decision to employ HUD as the financier of, and repository for, new, untested mortgage-related products far predated any watershed presidential choice in or around 2004.⁸⁵ More significantly, to order agencies into lesser standards may be politically popular, but from a regulatory standpoint, such moves risk disjointed implementation and unprepared supervision. For example, banking regulation is notoriously fragmented, with no less than five federal entities sharing duties of setting policy, overseeing operations, and enforcing statutes and rules.⁸⁶ The collective presumption that these fiefdoms would maintain order during the prolonged festival thus proved fatal.

D. A MILLION NEW GUNS IN A TOWN WITHOUT A SHERIFF

The notion of the Federal Reserve as a strong banking regulator is misplaced. History recalls the system as originating to *preserve* banks (as

79. See, e.g., Robert Holmes, *Who's to Blame for the Economy? Homeowners*, THESTREET.COM, Mar. 11, 2009, <http://www.thestreet.com/story/10470251/whos-to-blame-for-the-economy-homeowners.html>.

80. Stacy Johnson, *A Chance to Learn from the "Greatest Generation,"* ATL. J. CONSTITUTION, Feb. 25, 2010, at A17.

81. Press Release, Credit.com, Five Shocking Credit Card Debt Statistics, http://www.credit.com/credit_information/debt_help/Five-Shocking-Credit-Card-DebtStatistics. jsp (last visited Feb. 20, 2010).

82. See ABI World, Annual Business and Non-business Filings by Year (1980–2008), <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=57826&TEMPLATE=/CM/ContentDisplay.cfm> (last visited Mar. 31, 2010).

83. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C. and 28 U.S.C.).

84. See Mellody Hobson, *Recession Rescue: Tackle Your Auto Loan Debt*, ABCNEWS.COM, Feb. 26, 2008, <http://abcnews.go.com/GMA/MellodyHobson/story?id=4170624&page=1>.

85. See Morgenson, *supra* note 52.

86. See SEC, Banking Regulators, <http://www.sec.gov/answers/bankreg.htm> (last visited Feb. 20, 2010) (listing the five federal banking regulators); see also COHAN, *supra* note 19, at 19–20, 49–50 (detailing the role of the Office of the Comptroller of the Currency in attempting to discern the financial condition of Bear Stearns in March 2008 and describing the concurrent efforts of the Federal Reserve and the SEC to obtain the same information).

J.P. Morgan himself had done in the Panic of 1907) and continuing as guarantor of the “elevated risk” game.⁸⁷ The Federal Reserve system is notoriously fragmented, comprised of twelve regional Federal banks, which, per the Banking Act of 1913, have nine member boards made up of leaders in the private sector.⁸⁸ It is safe to say that the system was designed foremost to buoy mortgagees, a goal that is assisted by other federal regulators and their regional subdivisions who, in unison, work to facilitate credit to banks.⁸⁹ For example, in the summer of 2007, it was the Atlanta Federal Home Loan Bank Board that extended its line of credit to Countrywide Financial to the tune of \$22 billion. From 2003 to the third quarter of 2007, Countrywide’s SEC filings disclosed that its operating cash flow deficits were a cumulative \$38 billion, mostly financed from federal loans.⁹⁰ Moreover, the Federal Reserve and Office of Thrift Supervision (OTS), two of the larger bank regulators, rarely bring disciplinary actions and were reportedly encouraged by the George W. Bush Administration to focus on growth.⁹¹ Indeed, the effectiveness of the Federal Reserve serving in any role as a regulator has been openly questioned.⁹²

The traditional governmental fragmentation and multiple purposes of those fragmented parts resulted in the opportunistic new residential mortgaging business lines falling across one, several, or no lines of federal supervision. As *The Wall Street Journal* reported:

In 2005, 52% of subprime mortgages were originated by companies with no federal supervision, primarily mortgage brokers and stand alone finance companies. Another 25% were made by finance companies that are units of bank holding companies and thus indirectly supervised by the Federal Reserve, and 23% by regulated banks and thrifts.⁹³

87. Peter Boone & Simon Johnson, *The Next Financial Crisis*, NEW REPUBLIC, Sept. 23, 2009, at 24.

88. Sudeep Reddy, *Fed Tightens Rules on Regional Directors*, WALL ST. J., Nov. 27, 2009, at A6.

89. Eric Dash, *New Worries for Next Tier of Banks*, N.Y. TIMES, Apr. 25, 2009, at B1; Eric Dash, *Four Major Banks Tap Federal Reserve for Financing*, N.Y. TIMES, Aug. 23, 2007, at C10.

90. MORRIS, *supra* note 27, at 154.

91. Ip & Paletta, *supra* note 25.

Regulators appointed by President Bush often have been more sympathetic to industry concerns about red tape than their Clinton administration predecessors. When James Gilleran, a former California banker and bank supervisor, took over the OTS in December 2001, he became known for his deregulatory zeal. At one press event in 2003, several bank regulators held gardening shears to represent their commitment to cut red tape for the industry. Mr. Gilleran brought a chain saw.

Id.

92. See KRUGMAN, *supra* note 18, at 172–74 (“The Fed is set up to do two main things: manage interest rates and, when necessary, provide cash to banks.”).

93. Ip & Paletta, *supra* note 25.

A more granular examination of the government's liberalized home lending programs perhaps only clouds the issue of detecting the precise problem years. HUD statistics for New York households between 1998 and 2008 disclose that assistance to family households of "very low income" increased 5% to 6% percent annually during the decade, with the exception of 11% in the year 2006,⁹⁴ a full three years after the passage of the Zero-Down Payment Act. What does seem readily apparent is that, starting in 1990, HUD's coffers had been generously opened, leading generically to alternative terms of financing and specifically to a nation of home loan intermediaries actively seeking a plethora of mortgagors.⁹⁵ Not surprisingly, home ownership among the lower income households soared.

The point to be stressed is that various presidents in the last twenty years wielded the power of promising homes to the tenant masses.⁹⁶ The more complex notion that investment professionals could turn this well-meaning refrain into lucrative portfolios seemingly separated from those home loans would, of course, need the support of more than just an elected official with a potentially short tenure. Thus, the more exacting study may center on the jurists who, during the key years preceding the crisis, helped to formally signal that Washington, D.C. was a friend and not a foe to expansive notions of capitalism.

III. THE JUDICIARY: SOMETHING IN THE AIR . . .

Scant attention has been paid to the role of the federal judiciary in the nation's current economic woes. While commentators occasionally noted the difficulty in reaching employers and third parties under the Supreme Court's holding in the *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.* case,⁹⁷ overall, cases from last decade affecting the duties of corporate America have largely escaped scrutiny in the national soul-searching that continues into 2010.

To be sure, the aggressively speculative economy, laid bare in late 2008, neither arose in a season nor originated because of one discreet cause. While it may be impossible to delineate the extent to which such an economy takes direction from the courts, what does seem apparent is that the D.C. Circuit Court of Appeals, a critical federal bench, sounded a series

94. See U.S. Dep't of Hous. & Urban Dev. (HUD), HOME Program Income Limits (1998–2008), available at <http://www.hud.gov/offices/cpd/affordablehousing/programs/home/limits/income/index.cfm> (last visited Mar. 31, 2010). The figures were arrived at through analysis of the varying assistance totals for the 4-person home in New York during the decade. *Id.*

95. Leonnig, *supra* note 13.

96. See *supra* notes 60–95 and accompanying text.

97. *Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 166–67 (2008) (holding that aiders and abettors could not be held liable as secondary actors in private securities fraud cases brought under Rule 10b-5). This decision essentially reaffirmed the Court's holding nearly 15 years prior in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 191 (1994).

of harmonious notes in the laissez-faire symphony between the years 2003 and 2008.⁹⁸

A. BACKGROUND – SOME NEW LIMITS ON AN OLD FRIEND TO INVESTORS

In July 2003, a number of securities class actions simultaneously met their dismissal in the District Court for the Southern District of New York.⁹⁹ Riding on the tail of the monumental “Global Settlement” concluded by then New York Attorney General Eliot Spitzer, the actions sought damages from highly compensated brokerage firm analysts accused of tainting their research in favor of issuers sought by firms.¹⁰⁰ The Southern District of New York’s decision rested upon a strict reading of privity, essentially holding that an analyst could not be liable to a stranger.¹⁰¹ The decision marked a new period of strict construction for SEC Rule 10b-5,¹⁰² the elastic anti-fraud prohibition outlawing everything from internet securities fraud to insider trading.

The Supreme Court took up the cause of limiting Rule 10b-5 via a number of key decisions between 2005 and 2008. In *Dura Pharmaceuticals, Inc. v. Broudo*, the Court limited the types of defendants that could be sued in securities class actions.¹⁰³ In *Merrill Lynch v. Dabit*,¹⁰⁴ the Court broke with precedent in accepting a broad definition of securities “purchaser” for purposes of removing a class action against Merrill Lynch to federal court where it could more readily be dismissed under the Uniform Standards Act of 1998.¹⁰⁵ As previously noted, also in 2008, the Supreme Court precluded “scheme liability” in private securities actions based upon Rule 10b-5 in *Stoneridge*.¹⁰⁶

Apart from constrictive interpretations of securities fraud cases, the Supreme Court also helped to conserve business assets by limiting penalties. Specifically, in *Exxon Shipping Co. v. Baker*, the Court

98. *Fin. Planning Ass’n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007); *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006); *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

99. *See, e.g., In re Merrill Lynch & Co. Research Rep. Sec. Litig.*, 272 F. Supp. 2d 243 (S.D.N.Y. 2003) (dismissing a securities class action against Merrill Lynch); *Pfeiffer v. Goldman Sachs & Co.*, No. 02 Civ. 6912-HB, 2003 WL 21505876, at *1 (S.D.N.Y. June 30, 2003) (dismissing a class action suit against Goldman Sachs, Credit Suisse, and Morgan Stanley).

100. *See* Landon Thomas Jr., *Judges Reject Suits Blaming Analysts for Losses*, N.Y. TIMES, July 2, 2003, at C1.

101. *See In re Merrill Lynch Co. Research Rep. Sec. Litig.*, 272 F. Supp. 2d at 262 (“Merrill Lynch and the Fund are not the insurers of Plaintiff’s investment in a highly speculative sector of the market where the omissions complained of are not adequately alleged to have been the proximate cause of the loss.”).

102. 17 C.F.R. § 240.10b-5 (2008) (“Employment of Manipulative and Deceptive Devices”).

103. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 346 (2005).

104. *Merrill Lynch v. Dabit*, 547 U.S. 71, 85 (2006).

105. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C. (2006)).

106. *Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159–60 (2008).

drastically reduced punitive damages in the longstanding dispute over the oil company's devastating spill in Alaska.¹⁰⁷ Most noteworthy, successful attacks in the D.C. Circuit on the very authority of the SEC to demarcate lines of corporate responsibility put the Commission's legislative authority under slow but consistent siege.¹⁰⁸

B. THE LIMITS ON SEC RULEMAKING

A closer inspection of the decisions of three key circuits within the last decade reveals a curious about-face in a region traditionally favoring regulation. Specifically, while cordial deference to Commission rulemaking has been consistently exhibited in the Second¹⁰⁹ and Ninth Circuits,¹¹⁰ in the *Goldstein v. SEC* (2006),¹¹¹ *Chamber of Commerce v. SEC* (2006),¹¹² and *Financial Planners v. SEC* (2007)¹¹³ decisions, the D.C. Circuit Court of Appeals dealt rare victories to market voices challenging SEC hegemony. In fact, these unrelated, but equally bold rulings, can be said to have both tilted the battle for business opposition to regulation and helped create the excessively entrepreneurial philosophy now blamed for Wall Street's myopic risk-taking.

1. *Goldstein* (2006)

In late 2004, the SEC announced its "hedge fund rule," which required advisers to hedge funds with (1) \$30 million in assets and (2) fifteen or more investors, to register with the Commission.¹¹⁴ Thus, this Rule would have the effect of bringing subject hedge funds onto the SEC radar screen.¹¹⁵ The Rule, which had been passed on a 3-2, partisan vote among

107. *Exxon Shipping Co. v. Baker*, 128 S. Ct. 2605, 2634 (2008).

108. *Fin. Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007); *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006); *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

109. *See, e.g., Schiller v. Tower Semiconductor Ltd.*, 449 F.3d 286, 302 (2d Cir. 2006) (upholding SEC Rule 3a12-3 by finding that Commission notices and the rule itself satisfied the required "adequate statement of basis and purpose" set forth by § 553 of the Administrative Procedure Act); *Gryl ex rel. Shire Pharms. Group PLC v. Shire Pharms. Group PLD*, 298 F.3d 136, 145 (2d Cir. 2002) ("[W]e must defer to the SEC's interpretations of its own regulations in its amicus briefs unless they are plainly erroneous or inconsistent with the regulations."); *United States v. Cusimano*, 123 F.3d 83, 88 (2d Cir. 1997) ([W]e note that in *O'Hagan* the Supreme Court held, as this Court had held previously, that [SEC] Rule 14e-3 was a valid exercise of the SEC's rulemaking authority.") (citation omitted).

110. *See, e.g., Dreiling v. Am. Express Co.*, 458 F.3d 942, 949 (9th Cir. 2006) (finding the creation of SEC Rule 16b-3(d), setting forth three exemptions from the Securities Exchange Act Section 16(b) reporting requirements, was a similar valid exercise); *Meyers v. Merrill Lynch & Co.*, 249 F.3d 1087, 1088 (9th Cir. 2001) (upholding Regulation M as a proper exercise of SEC rulemaking authority).

111. *Goldstein*, 451 F.3d at 884.

112. *Chamber of Commerce*, 443 F.3d at 909.

113. *Fin. Planning Ass'n*, 482 F.3d 481.

114. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

115. *See id.*

SEC Commissioners,¹¹⁶ centered on an expanded definition of “clients” advised by the firm. Traditionally, if the number of such clients (or groups of clients) was fifteen or less, no registration was required.¹¹⁷ Petitioners, a hedge fund and investment firm, took issue with the new definition, and the D.C. Circuit Court agreed.¹¹⁸

The D.C. Circuit Court’s criticisms of the SEC stance ranged widely. Noting that the term “hedge fund” had never been adequately defined,¹¹⁹ and that the Rule appeared to be a direct response to the press generated by the failure of notorious Long-Term Capital management,¹²⁰ the court suggested that the SEC, by seeking to compel registration of individuals affiliated with entities traditionally exempted by both the Investment Advisers Act (IA Act) and the Investment Company Act, had departed from the statutes.¹²¹

Additionally, the court’s analysis seized upon the comments of the two SEC dissenters to the Rule’s adoption.¹²² Ultimately finding the hedge fund rule to be capricious, the court concluded that the, “Commission’s rule creates a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the [IA] Act. This is an arbitrary rule.”¹²³

The unanimous court thus struck down the hedge fund rule more than eighteen months after its issuance,¹²⁴ leaving those hedge funds that had duly registered with the option of continued registered status.¹²⁵ More globally, a trillion dollar industry which had been publicly faulted for a lack of supervision,¹²⁶ was left unsure of regulatory expectations either at the government or customer level.

116. *See id.* at 72,089 (Comm’rs Glassman and Atkins, dissenting).

117. *See id.* at 72,054.

118. *Goldstein v. SEC*, 451 F.3d 873, 874–76 (D.C. Cir. 2006).

119. *Id.* at 874–75 (“The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition.”).

120. *Id.* at 877.

121. *Id.* at 875–77; *see also* Investment Company Act, 15 U.S.C. § 80(a)-6(a)(5)(A)(iii) (2006); Investment Advisers Act, 15 U.S.C. § 80b-2(a)(11)(C) (2006).

122. *Goldstein*, 451 F.3d. at 878.

123. *Id.* at 884.

124. *Id.*

125. *See* Floyd Norris, *Court Says S.E.C. Lacks Authority on Hedge Funds*, N.Y. TIMES, June 24, 2006, at A1 (noting that “nearly 1,000” hedge fund advisors had registered with the SEC as required by the stricken rule).

126. *See, e.g.*, Dale Oesterle, J. Gilbert Reese Chair in Contract Law at Moritz College of Law, Ohio State University, & David Skeel, S. Samuel Arsht Professor of Corporate Law at the University of Pennsylvania Law School, Debate on Legalaffairs.org: Should Hedge Funds be Regulated (Nov. 8–11, 2005), available at http://www.legalaffairs.org/webexclusive/debateclub_hedgefunds1105.msp.

2. *Chamber of Commerce* (2006)

The same year as *Goldstein*, the Chamber of Commerce (the Chamber), the industry group traditionally speaking for corporate management,¹²⁷ launched its second challenge in as many years at SEC authority. In *Chamber of Commerce v. SEC*, the famed trade association took aim at the Commission's response to trading scandals that had tarnished the traditionally non-controversial mutual fund industry.¹²⁸

Specifically, the Chamber took issue with the SECs revamped "investment company governance" rule¹²⁹ where it required that (1) the board Chair at all mutual funds be independent of the fund's adviser, and (2) 75% of the mutual fund board be independent of the fund adviser.¹³⁰ The Chamber's three-pronged attack alleged that the SEC (1) had exceeded its rulemaking authority under the IA Act,¹³¹ (2) had offered no justification for the changes, and (3) had failed to abide by § 553 of the Administrative Procedure Act¹³² in promulgating the amendments.¹³³

The last argument was adopted by the D.C. Circuit, which, in elevating such details as cost estimates and the recordkeeping attending SEC rulemaking, stated the following:

In sum, the combination of circumstances—inadequate notice that the Commission would base its cost estimates for the two conditions on 'publicly available' extra-record materials on which it did not typically rely in rulemakings; the Commission's acknowledgement that the rulemaking record contained gaps and did not include reliable cost data; the availability of additional implementation data for the period between the close of the rulemaking record and the Commission's response to *Chamber I* as more funds adopted the conditions; the Chamber's colorable claim that the Commission's failure to consider such implementation data harms its investment choices—suffices to show that the Chamber has been prejudiced by the Commission's reliance on materials not in, nor merely 'supplementary' to, the rulemaking record.¹³⁴

By focusing on the mechanics of the process, the D.C. Circuit Court thus vacated the two new conditions implemented by the SEC (i.e., 75%

127. See U.S. Chamber of Commerce, About Us, <http://www.uschamber.com/about/default.htm> (last visited Mar. 11, 2010).

128. *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

129. See Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, at 46,381–82 (Aug. 2, 2004).

130. Press Release, U.S. Chamber of Commerce, U.S. Chamber of Commerce v. SEC Mutual Fund "Governance" Litigation (Apr. 8, 2005), <http://www.uschamber.com/nclc/news/casealerts/ca050408.htm> [hereinafter Press Release, U.S. Chamber of Commerce].

131. 15 U.S.C. §§ 80a-1 to -64 (2006).

132. 5 U.S.C. § 553 (2006).

133. See Press Release, U.S. Chamber of Commerce, *supra* note 130.

134. *Chamber of Commerce v. SEC*, 443 F.3d 890, 906 (D.C. Cir. 2006).

outside directors and an independent director).¹³⁵ The financial services industry thus saw the nearly sacrosanct imprimatur of Commission rulemaking again sullied, and the mutual fund industry returned largely to its prior management protocols.

3. *Financial Planners* (2007)

The next year, Financial Planners Association, the umbrella group for the nation's investment advisors, successfully challenged the Commission's rulemaking.¹³⁶ Again the D.C. Circuit proved inhospitable to SEC claims, albeit, this time, its written decision spoke more directly to agency legislative authority.¹³⁷

For decades, the securities industry, home to both registered "broker-dealers" and the more heavily regulated "investment advisors," had operated under the SEC guidance that the two groups were separated by considerations of compensation.¹³⁸ The traditional dividing line was cemented in 2005 via an SEC rule¹³⁹ serving as a minefield for brokers wishing to avoid becoming subject to the IA Act.

The Financial Planners Association challenged the 2005 codification as discriminatory in that its constituency was being held to a higher legal standard despite the inroads upon its services being made by broker-dealers and the accompanying expansion of the traditional notion of "merely incidental" investment advice.¹⁴⁰ In vacating the rule, the D.C. Circuit (by 2-1 vote) held that the statutory language was clear on the topic of exemptions, that the SEC rule was in direct conflict with Congressional intent, and that IA Act subsection (f) was "not a catch-all that authorizes the SEC to rewrite the statute."¹⁴¹

The fallout from the decision was considerable. Countless brokerage accounts treated by firms as outside of the dictates of the IA Act faced reclassification, while their handlers faced uncertainty, at best, and

135. *Id.* at 909.

136. *Fin. Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

137. *Id.*

138. Elisse B. Walter, Comm'r, SEC, Address at the Mutual Fund Directors Forum Ninth Annual Policy Conference: Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? (May 5, 2009), available at <http://www.sec.gov/news/speech/2009/spch050509ebw.htm>. A broker-dealer who was compensated largely on a commission basis and whose investment advice was "merely incidental" to his brokerage services could avoid stricter rules regarding customer disclosures and record keeping. *Id.*

139. 15 U.S.C. § 80b-2(a)(1) (2006); see also *Certain Broker-Dealers Deemed Not to be Investment Advisors*, Exchange Act Release No. 51523, Investment Advisers Act Release No. 2376, 70 Fed. Reg. 20,424 (Apr. 19, 2005).

140. *Fin. Planning Ass'n*, 482 F.3d at 484-85.

141. *Id.* at 491.

violations, at worst.¹⁴² The industry's immediate response was to clamor, unsuccessfully, for the SEC to request a rehearing before the D.C. Circuit.¹⁴³ The long term strategy focused on interim Commission relief to ease the transition from compliance with one law to two.¹⁴⁴

C. MESSAGE AND AFTERMATH

Thus, in the years that the market engines were revving to unprecedented calibrations, and its chief drivers speeding with an unfathomable amount of gas, the message from the circuit housing the SEC's headquarters was clear: Even in expertised matters generally enjoying deference, the agency's rulemaking is not always legal.¹⁴⁵ Such ciphers would be mildly dangerous in quiet times; while the market was overextending itself through "toxic" vehicles, they were outright crucial.

As 2010 unfolds, courts occasionally remind observers that the judiciary shall play a role in the resolution of the economic crisis.¹⁴⁶ However, such considerations of courthouse rebuke may still be a distant second to an examination of the laws written, rewritten, or modified between 1999 and 2002.

IV. CONGRESS: WHERE LAWS, BAILOUTS, AND MELTDOWNS ARE MADE

A. PERCEPTIONS

A critically popular 2009 film documentary cataloguing the woes of subprime mortgagors commenced with this provocative summary:

To understand why this [market] is like a gambling casino, you have to understand what's at stake here. On a December evening, December 15,

142. News Alert, W. Hardy Callcott & Kevin Zambrowicz, Bingham McCutchen, SEC Rulemaking Authority Takes Another Hit: Fee-Based Brokerage Rule Vacated (Apr. 1, 2007), <http://www.bingham.com/Media.aspx?MediaID=4940>.

143. Press Release, Sec. Indus. and Fin. Markets Assoc. (SIFMA), Fee-based Account Decision Should be Reheard SIFMA Tells SEC (Apr. 10, 2007), <http://www.sifma.org/news/42771328.shtml>.

144. Letter from Ira D. Hammerman, Senior Managing Dir. and Gen. Counsel, SIFMA, to Nancy M. Morris, Sec'y, SEC (Nov. 30, 2007), http://www.sifma.org/regulatory/comment_letters/59130958.pdf.

145. See generally *Fin. Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007); *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006); *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

146. See, e.g., Mark Fass, *Judge Slashes 'Fat Cat' Bank's Bill for Subpoenaed Documents*, N.Y.L.J., Dec. 28, 2009, available at <http://www.law.com/jsp/article.jsp?id=1202437287242> (describing the rejection by a Brooklyn, New York, judge of the request by a third party (JPMorgan Chase) for reimbursement of costs attending document production in a case centering on the confirmation of an arbitration award). The judge, noting the President's reference to "fat cat bankers" during a recent interview on television's *60 Minutes*, wrote "[t]his Court is not a collection vehicle to further enrich already rich bankers." *Id.*

2000, around seven o'clock, Phil Gramm, Republican Senator of Texas, then chair of the Senate Finance Committee, walked to the floor of the Senate and introduced a 262 page bill - as a rider to the 11,000 page appropriation bill - which excluded from regulation the financial instruments that are probably most at the heart of the present meltdown.

He not only excluded them from all *federal* regulation, but he excluded them from state regulation as well, which is important because these instruments could be viewed to be gambling instruments, where you're betting on whether people will or will not pay off their loans. And he announced at the time that this measure would be a boom to the American economy, and be a boom to Wall Street, because they would be freed of any supervision in this regard. And that lack of supervision freed Wall Street to essentially shoot itself in both feet.¹⁴⁷

The referenced vehicles are known as credit default swaps (CDS), which are non-exchange traded, counterparty agreements which allow the transfer of credit risk from one sophisticated party to another.¹⁴⁸ A somewhat novel derivative, the CDS does not fall within the jurisdiction of any relevant federal regulator.¹⁴⁹ Indeed, the term itself, "credit derivative," occasionally invites skepticism. As a noted journalist has written, credit derivatives "are fashioned privately and beyond the ken of regulators—sometimes even beyond the understanding of executives peddling them."¹⁵⁰ These private insurance agreements grew in popularity as nearly unfathomable amounts of investment bank inventory were filled with CDOs, defined generically as asset-backed securities, which were "backed by a pool of bonds, loans, and other assets."¹⁵¹ Amorphous and ill-understood, the CDO, unlike the CDS, has fallen squarely within SEC jurisdiction as a "security."¹⁵²

147. AMERICAN CASINO (Table Rock Films and Argot Pictures 2009) (quoting Michael Greenberg, Director for Trading and Markets, Commodity Futures Trading Commission) (emphasis added).

148. See generally Credit Default Swap, Investopedia, <http://www.investopedia.com/terms/c/creditdefaultswap.asp> (last visited Feb. 28, 2010); see also AMERICAN CASINO, *supra* note 147.

149. Janet Morrissey, *Credit Default Swaps: The Next Crisis*, TIME, Mar. 17, 2008, available at <http://www.time.com/time/business/article/0,8599,1723152,00.html>.

150. Morgenson, *supra* note 52.

151. JACK GUINAN, THE INVESTOPEDIA GUIDE TO WALL SPEAK: THE TERMS YOU NEED TO KNOW TO TALK LIKE CRAMER, THINK LIKE SOROS, AND BUY LIKE BUFFET (2009); see also SORKIN, *supra* note 21, at 89–90. Notably, longtime Federal Reserve Chairman Alan Greenspan was quoted as follows:

"I've got some fairly heavy background in mathematics," . . . "But some of the complexities of some of the instruments that were going into CDOs bewilders me. I didn't understand what they were doing or how they actually got the types of returns out of the mezzanines and the various tranches of the CDO that they did."

SORKIN, *supra* note 21, at 90 (quoting Federal Reserve Chairman Alan Greenspan).

152. See Caroline Zimmerman, *SEC Opens Subprime Probe*, NEWSER.COM, June 27, 2007, <http://www.newser.com/story/3580/sec-opens-subprime-probe.html> (describing a dozen

Less amorphous is the regulatory zeal with which powerful market regulators embraced the creativity of the private sector to fashion these investments. It has been aptly documented that former Federal Reserve Chairman Alan Greenspan ideologically opposed regulation of credit derivatives.¹⁵³ In the late 1990s, as the SEC gained moderate, indirect ground by requiring that firms include “quantitative disclosure of market risks” in financial statements,¹⁵⁴ the drive at other agencies to inspire exposure did not lose steam. At a speech in Florida in March 1999, Greenspan openly exhorted the market utility of credit derivatives:

By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives The fact that [over-the-counter (OTC)] markets function quite effectively without the benefits of [CFTC (Commodity Futures Trading Commission) regulation] provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives These new financial instruments . . . enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it. This unbundling improves the ability of the market to engender a set of product and asset prices far more calibrated to the value preferences of consumers¹⁵⁵

B. THE LAW

The ensuing Commodity Futures Modernization Act of 2000 (CFMA)¹⁵⁶ included various sections aimed at exempting OTC derivatives dealers from CFTC jurisdiction. The most direct of these sections reads as follows:

SEC. 103. LEGAL CERTAINTY FOR EXCLUDED DERIVATIVE TRANSACTIONS.

Commission investigations into CDOs, defined as “shared debt packages reliant on faltering subprime mortgages”); *see also* FINRA, *Improving Examination Results* (May 2008), <http://www.finra.org/Industry/Regulation/Guidance/ImprovingExaminationResults/p038526> (cautioning firms that FINRA examiners review “recommendations in new and non-conventional products, such as hedge funds, CMOs/CDOs, REITS, auction rate securities and other structured products” for customer suitability); *see also* Complaint at 5, ¶ 13, *SEC v. Goldman Sachs & Co. & Fabrice Tourre*, No. 10 CV-3229 (S.D.N.Y. Apr. 16, 2010), *available at* <http://www.sec.gov/litigation/complaints/2010/comp21489.pdf> (“CDOs are debt securities collateralized by obligations including R[esidential] M[ortgage] B[acked] S[ecurities].”)

153. Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 23, 2008, at B1, *available at* <http://www.nytimes.com/2008/10/24/business/economy/24panel.html>.

154. *See* Joe Nocera, *Risk Management: Were the Measures Used to Evaluate Wall Street Trades Flawed? Or was the Mistake Ignoring Them?*, N.Y. TIMES MAG., Jan. 4, 2009, at 26.

155. TETT, *supra* note 1, at 75 (quoting a March 1999 speech by Fed Chairman, Alan Greenspan) (internal quotations omitted).

156. Commodity Futures Modernization Act of 2000 (CFMA), Pub. L. No. 106-554, 114 Stat. 2763A-365 (codified in scattered sections of 7, 11, 12 and 15 U.S.C.).

Section 2 of the Commodity Exchange Act (7 U.S.C. 2, 2a, 3, 4, 4a) is further amended by adding the following to the end:

(d) EXCLUDED DERIVATIVE TRANSACTIONS.—

(1) IN GENERAL—Nothing in this Act . . . governs or applies to an agreement, contract, or transaction in an excluded commodity if—

(A) the agreement, contract, or transaction is entered into only between persons that are eligible contract participants at the time at which the persons enter into the agreement, contract, or transaction; and

(B) the agreement, contract, or transaction is not executed or traded on a trading facility.

(2) ELECTRONIC TRADING FACILITY EXCLUSION.—Nothing in this Act . . . governs or applies to an agreement, contract, or transaction in an excluded commodity if—

(A) the agreement, contract, or transaction is entered into on a principal-to-principal basis between parties trading for their own accounts or as described in section 1a(12)(B)(ii);

...

(C) the agreement, contract, or transaction is executed or traded on an electronic trading facility.¹⁵⁷

When combined with definitions found in § 105 and § 106 of the CFMA,¹⁵⁸ the above provisions succeeded in exempting from the definition of *futures* (and thus, CFTC examination) OTC derivative transactions between sophisticated parties, away from a stock exchange—a category that would later become synonymous with credit default swaps.¹⁵⁹ Separate modifications to the two primary securities laws were designed to erase the SEC from the equation.¹⁶⁰

Among the authorities not altered by the CFMA were: (1) banking jurisdiction, (2) SEC fraud jurisdiction, and (3) extraterritorial reach (which

157. CFMA § 103, 7 U.S.C. §§ 2–4a (2006) (internal quotations omitted). Separately, Section 2A of the Securities Act, 15 U.S.C. § 77b-1 (2006), and Section 3A of the Securities Exchange Act, 15 U.S.C. § 78c-1 (2006), were contemporaneously amended to prohibit the SEC from imposing registration or recordkeeping requirements related to security-based swap agreements. *See Over-the-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 45 n.1 (2009) (prepared statement of Mary L. Schapiro, Chairman of the SEC).

158. CFMA § 105, 7 U.S.C. §§ 2–4a (2006); CFMA § 106, 7 U.S.C. §§ 2–4a; *see also infra* note 180 and accompanying text.

159. CFMA § 103, 7 U.S.C. §§ 2–4a; CFMA § 206, 15 U.S.C. § 78f (2006).

160. *See infra* note 163 and accompanying text.

was nonexistent both before and after the CFMA).¹⁶¹ As has been also noted, the exclusion, albeit the incarnation of Greenspan's dreams, nonetheless successfully precluded oversight of the new vehicles by any *single* regulator.¹⁶² Professor John Coffee of Columbia University School of Law later testified that the CFMA achieved its goals:

In my judgment, the [current energy derivative] Amendment does not "undo" the desirable legal certainty that the CFMA created. The original uncertainty that led up to the CFMA arose because both the SEC and the CFTC could dispute whether a complex derivatives transaction was more like a futures contract (in which case the CFTC had jurisdiction) or more like an option (in which case the SEC arguably had jurisdiction). Nothing in the . . . Amendment will change the fact that the SEC is now totally out of the picture, as the CFMA amended both the Securities Act of 1933 and the Securities Exchange Act of 1934 to deny the SEC any authority over OTC derivatives (financial and non-financial).¹⁶³

C. COMMENTARY

Freed from the oversight of both the SEC and the CFTC, market players thus embarked on a course of internecine capitalism. The largest investment houses over-leveraged themselves by stockpiling CDOs, while having the risk of such ventures cushioned through reliance on [unregulated] CDS agreements with third parties.¹⁶⁴

But the populist view, that any emphasis in the CFMA on imposing legal certainty was subordinated to commercial interests, supposes three things: (1) that derivative businesses sprung up after the CFMA; (2) that SEC and CFTC examiners, if given the chance, would have been able to timely intervene; and (3) that anyone was capable of understanding the exotic instruments at issue. Sources indicate that nary one of these suppositions is reliable.¹⁶⁵

First, the CFTC crusades to gain sovereignty over the swaps market had repeatedly fallen short in the past. Perhaps overshadowed by a larger, ongoing debate concerning sovereignty over futures,¹⁶⁶ regulation of swaps

161. See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 85–87 (6th ed. 2009).

162. TETT, *supra* note 1, at 75 (quoting a lobbyist as declaring that "Congress nailed the door shut in 2000 [on unified regulation], with the passage of the Commodities Futures Modernization Act").

163. *CFTC Regulation and Oversight of Derivatives: Hearing Before the Comm. on Agriculture, Nutrition, and Forestry*, 107th Cong. 133 (2002) (statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University School of Law).

164. See SORKIN, *supra* note 21, at 14–15, 156–58.

165. See *infra* notes 166–90, 205 and accompanying text.

166. See generally U.S. DEP'T OF TREASURY, *THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE* 106–09 (2008), available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf> [hereinafter *TREASURY BLUEPRINT*] (detailing the debate over the dividing line between securities and future contracts, and its key

ultimately fell irreparably behind the market,¹⁶⁷ forcing Congress' hand in 2000 in adopting any feasible measure to address the issue.

Second, the CFMA was hardly a one-sided law. What is often overlooked is the fact that Congress simultaneously (and somewhat inexplicably) expanded the express scope of § 10(b) of the Securities Exchange Act to cover the newly exempted, non-security.¹⁶⁸ Thus, the CDS, while not subject to registration or routine examination, could be the subject of a fraud case. The Commission routinely relies on such cases to deter deleterious market behavior by professionals not subject to registration requirements.¹⁶⁹

Concurrently, the courts have not blindly applied the CFMA's blanket exemption. The most frequently cited (and pointed) example is *Caiola v. Citibank, N.A.*,¹⁷⁰ a Second Circuit decision from 2002. In that case, a sophisticated individual specializing in the trading of Philip Morris Co. stock, engaged in synthetic option transactions to offset equity swap agreements.¹⁷¹ The complex arrangement was motivated by the desire to shield the size of the plaintiff's positions from the market in general.¹⁷² The defendant bank was alleged to have, at some point, secretly countered the complicated plan by effecting large trades that mirrored the plaintiff's synthetic transactions.¹⁷³

timeline moments of 1975 (CFTC approval of the trading of GMNA certificates), 1981 (SEC approval of GNMA options), 1982 (Futures Trading Act codifies the 1981 Shad-Johnson Accord, which prohibited certain futures and cementing SEC jurisdiction over securities-based contracts), and 1988 ("Report of the Presidential Task Force on Market Mechanisms," recommending a sole regulator)).

167. See TETT, *supra* note 1, at 23–27 (describing, among other things, applicability of outdated "Basel I" banking standards to those engaging in derivatives).

168. The Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338, added the following section to Section 10(b) of the Securities Exchange Act:

Rules promulgated under subsection (b) . . . that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading), and judicial precedents decided under subsection (b) . . . and rules promulgated thereunder that prohibit fraud, manipulation, or insider trading, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities. Judicial precedents decided under section [17(a)] of [the Securities Act of 1933] and sections [9, 15, 16, 20 and 21A] . . . and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities.

15 U.S.C. § 78j (2006).

169. See, e.g., SEC v. Petters et al., Litig. Rel. No. 21, 124 (July 10, 2009) (announcing asset freeze of hedge fund manager), available at <http://www.sec.gov/litigation/litreleases/2009/lr21124.htm>.

170. *Caiola v. Citibank, N.A.*, 295 F.3d 312, 312 (2d Cir. 2002).

171. *Id.* at 315.

172. *Id.* at 317.

173. COX ET AL., *supra* note 161, at 81–84.

The Second Circuit, adhering to the text of the CFMA only insofar as the effective date of the Act and its exemption were concerned, effectively confirmed the uncertainty surrounding application of the securities laws to the exotic products both prior to and after 2000.¹⁷⁴ Finding Caiola's equity swaps from the late 1990s were not securities (and thus not subject to Rule 10b-5), the court simultaneously concluded, "[h]ad Caiola entered into his synthetic stock transactions after the enactment of the CFMA, they clearly would now be covered under Rule 10b-5" pursuant to the statutory exemption.¹⁷⁵

Moreover, the court simultaneously found the *synthetic options* to fall within the statutory definitions of securities.¹⁷⁶ Ruling contrary to some federal court precedent,¹⁷⁷ the Second Circuit rejected Citibank's contention that only an option on a security would be covered by the law, and "not an option based on the value of a security."¹⁷⁸ Relying upon the language of § 3(a)(10) of the Securities Exchange Act, the court answered the question of "whether a cash-settled over-the-counter option on Philip Morris Stock similar to options commonly traded on the market" was a security in the affirmative.¹⁷⁹

This result is disturbing at best, for applicable § 206 of Gramm-Leach-Bliley Act (GLBA) had expressly defined "swap agreements" to include options "based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to" securities or other assets.¹⁸⁰ Regardless, the end result was that the plaintiff—who was found to have hedged non-security swap agreements with security over-the-counter options—earned a reversal of the dismissal of his complaint and his day in court, despite the contrary goal of the CFMA.¹⁸¹

Separately and subsequently, the Second Circuit in 2009 both animated the CFMA and reminded observers of one of its purposes in *SEC v. Rorech*.¹⁸² In that insider trading case, the U.S. District Court for the Southern District of New York refused to grant judgment for the defendants on jurisdictional issues, noting:

In 2000, Congress passed the [CFMA], which amended § 10(b) to extend the rules promulgated by the SEC under § 10(b) to prohibit fraud, manipulation, and insider trading (but not the SEC's prophylactic reporting requirements), and judicial precedents decided under § 10(b), to

174. *Caiola*, 295 F.3d at 331.

175. *Id.* at 327.

176. *Id.* at 324.

177. *Proctor & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1278 (S.D. Ohio 1996).

178. *Caiola*, 295 F.3d at 325.

179. *Id.* at 325–26.

180. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, § 206, 113 Stat. 1338, 1393–94 (codified at 15 U.S.C. 78c (2006)).

181. *Caiola*, 295 F.3d at 330–31.

182. *SEC v. Rorech*, No. 09 Civ. 4329, 2009 WL 4729921 (S.D.N.Y. Dec. 10, 2009).

“security-based swap agreement[s] (as defined in [§] 206B of the [GLBA]). . . .

. . . .

. . . .

. . . In this case, the face of the contracts does not reveal whether a material term of the CDS was based on a security. . . . In any event, it cannot be that traders can escape the ambit of § 10(b) and Rule 10b-5 by basing a CDS’s material term on a security, but simply omitting reference to the security from the text of the CDS contract.¹⁸³

The decision also cited a separate Southern District of New York case for the premise that the “economic reality” of the instruments and the public’s expectations of their nature” govern definitional debates.¹⁸⁴ Thus, a key circuit in the battle against securities fraud has on several occasions subjugated the CFMA to larger notions, thus jeopardizing that legislation’s legacy as a purely pro-business advancement.¹⁸⁵

Third, it has always been within the authority of both the SEC and CFTC to expand their respective jurisdictions to examine exotic products.¹⁸⁶ An example of this can be seen in the March 2008 accord between the two agencies, hastily drawn in response to calls from the Treasury Department to merge the dueling entities. That agreement contained “specific principles to guide future consideration of novel products, with the goal of reviewing product filings expeditiously, providing legal certainty for participants, encouraging market neutrality and choice, and enhancing innovation and competitive growth.”¹⁸⁷ In short, the overriding goals of the CFMA could be met at any time with two strokes of agency pens.

Likewise, it bears noting that, even post-catastrophe, a consensus could not be reached that the SEC and CFTC should be merged to end turf wars and solidify jurisdiction. Although the goal was prioritized by the “Treasury

183. *Id.* at *4–5. *But see* Sch. Dist. of Erie v. J.P. Morgan Chase Bank, No. 08 CV 07892, 2009 WL 234128, at *1 (S.D.N.Y. Jan. 30, 2009) (finding a swap to not be “security-based” for purposes of §10(b) and Rule 10b-5 because the “only material term” was the floating interest rate based upon the London Interbank Offered Rate).

184. *Rorech*, 2009 WL 4729921, at *6 (citing *Stechler v. Sidley, Austin Brown & Wood, L.L.P.*, 382 F. Supp. 2d 580, 596–97, 597 n.121 (determining whether options contract was a security under the Exchange Act)).

185. *See Caiola*, 295 F.3d 312; *see also Rorech*, 2009 WL 4729921. Class action attorneys have filed federal class action lawsuits alleging violations relating to CDS portfolios. *See, e.g.*, Class Action Complaint at 2, Jacksonville Police & Fire Pension Fund v. Am. Int’l Group, Inc., No. 1:08 Civ. 04772, 2008 WL 2196366 (S.D.N.Y. May 21, 2008) (alleging that the insurer improperly represented the status and health of its CDS portfolio).

186. *See* Press Release, U.S. Commodity Futures Trading Comm’n, CFTC, SEC Sign Agreement to Enhance Coordination, Facilitate Review of New Derivative Products (Mar. 11, 2008), available at <http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5468-08.html>.

187. *Id.*

Blueprint”¹⁸⁸ for regulatory reform released by the Department of the Treasury in March 2008, the idea fell out of favor in the successor administration as political forces acknowledged that historically distinct Congressional committees would not accede to a loss of oversight power.¹⁸⁹ Simply put, if the turf war between securities and commodities regulators were truly to blame for billions in losses, it would have been remedied by now.

Thus, the perception that the CFMA opened the floodgates to unregulated products is, at best, simplistic. The more edifying examination might then be a study of the GLBA.¹⁹⁰

D. GRAMM-LEACH-BLILEY ACT

Amidst a relatively tranquil bull market, and a growing concern of foreign competition, Congress moved in the waning months of the Clinton administration to eradicate the last barrier to financial entity consolidation, the Glass-Steagall Act.¹⁹¹ The barrier had been erected by § 20 of the Glass-Steagall Act which, for over 60 years, forbade affiliation in any manner between a bank and any “organization engaged principally in the issue, flotation, underwriting, public sale, or distribution” of securities.¹⁹²

Exceptions of the statutory, administrative, and judicial nature had reduced the barrier to something less than absolute. Namely, § 16 of Glass-Steagall expressly permitted banks of the 1930s to continue to buy and sell securities “solely upon the order, and for the account of, customers.”¹⁹³ Also, litigation later clarified that banks could purchase brokerages that provided only “incidental services” to customers (*i.e.*, that did not render investment advice).¹⁹⁴ Most importantly, government agency guidelines established that bank ownership of securities, capped by a percentage threshold, was permissible.¹⁹⁵

188. See TREASURY BLUEPRINT, *supra* note 166, at 11–13.

189. See Jennifer Liberto, *Avoiding the Next Big Financial Crisis*, CNNMONEY.COM, June 8, 2009, http://money.cnn.com/2009/06/05/news/economy/financial_regulation/index.htm (explaining the political reasons for the SEC and CFTC continuing “on their separate ways”).

190. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

191. Banking Act of 1933 (Glass-Steagall Act), Pub. L. No. 73-66, 48 Stat. 162 (1933) (repealed 1999).

192. *Id.* § 20.

193. *Id.* § 16.

194. See *Sec. Indus. Ass’n v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 207 (1984) (upholding the approval by the Board of the purchase of The Charles Schwab Corp. by BankAmerica Corp., a bank holding company, under the exception found in the Bank Holding Company Act of 1956, 12 U.S.C. § 1843(c)(8) (2006)).

195. See Revenue Limit on Bank-Ineligible Activities of the Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750-01 (Dec. 30, 1996) (amending the interpretation of “engaged principally” as stated in Section 20 of the Banking Act of 1933 to increase “from 10 percent to 25 percent the amount of total revenue that a nonbank subsidiary of a bank holding company . . . may derive from underwriting and dealing in securities . . .”); see also *Frontline: The Wall Street Fix* (PBS television broadcast May 8, 2003).

Nonetheless, perhaps primarily as a symbolic gesture, Congress removed all technical barriers to conglomeration.¹⁹⁶ Later on, the statute clarified the presumed breadth of the term “financial” activities by, among

I think it's pretty clear to say that [Citigroup CEO] Sandy Weill forced the hand of Congress. I think it's equally clear to say that the Fed forced the hand of Congress to do something that they knew full well could not be done. What they said was, 'At the end of two years, if [Glass-Steagall was not repealed], you [Sandy Weill] will have to disgorge.' But everyone up here said, "Oh my. We can't do that to our dear friend Sandy Weill."

The Wall Street Fix, *supra* (quoting Representative John Dingell (D. Mich.), commenting on the Federal Reserve's granting merging Citigroup Inc. and Salomon Inc. a 2-year exemption from the prohibition of Glass-Steagall before its repeal in 1999).

196. The operative language of the GLBA, which amended Section 4 of the Bank Holding Act of 1956, reads as follows:

SEC. 103. Financial Activities

(a) In general.—Section 4 of the Bank Holding Company Act of 1956 (12 U.S.C. 1843) is amended by adding at the end the following new subsections:

(k) Engaging in Activities That Are Financial in Nature.—

(1) IN GENERAL.—Notwithstanding subsection (a), a financial holding company may engage in any activity, and may acquire and retain the shares of any company engaged in any activity, that the Board, in accordance with paragraph (2), determines (by regulation or order)—

(A) to be financial in nature or incidental to such financial activity;

or

(B) is complimentary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally

. . . .

. . . .

(5) ACTIONS REQUIRED.—

(A) IN GENERAL.—The Board shall, by regulation or order, define, consistent with the purposes of this Act, the activities described in subparagraph (B) as financial in nature, and the extent to which such activities are financial in nature or incidental to a financial activity.

(B) ACTIVITIES.—The activities described in this subparagraph are as follows:

(i) Lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities.

(ii) Providing any device or other instrumentality for transferring money or other financial assets.

(iii) Arranging, effecting, or facilitating financial transactions for the account of third parties. . . .

Gramm-Leach-Bliley Act, Pub. L. 106-102, § 103(a), 113 Stat. 1138, 1342, 1345 (1999) (emphasis in original) (internal quotations omitted).

other things, authorizing the Federal Reserve Board to permit banks' involvement with "[l]ending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities,"¹⁹⁷ "[p]roviding any device or other instrumentality for transferring money or other financial assets,"¹⁹⁸ and "[a]rranging, effecting, or facilitating financial transactions for the account of third parties."¹⁹⁹

The authority to exempt was thus detailed and replete, and the passage of the law invited universal praise. The press reported that the bill had passed easily and constituted "one of the most significant achievements this year by the White House and the Republicans leading the 106th Congress."²⁰⁰ Likewise, Treasury Secretary Lawrence Summers was quoted as saying that the "historic legislation" would "better enable American companies to compete in the new economy."²⁰¹

E. COMMENTARY

Critics of the allocation of blame to the GLBA note that, while the act did formally repeal Glass-Steagall, it was well known within financial circles that the 1987 appointment of Alan Greenspan as Federal Reserve Chairman signaled a move away from the artificial distinctions between commercial and investment banks.²⁰² Further, a defense of the GLBA has surfaced. This position asserts that, even with the benefit of hindsight, the law is laudable because it has permitted floundering investment banks to continue as commercial banks.²⁰³

What appears undeniable, however, is that the GLBA publicly raised the stakes; the law created a financial world where the largest players *had* to engage in the most speculative strategies to compete. As one award-winning financial journalist summarized:

The repeal of Glass-Steagall legitimized the concept of combining commercial and investment banking to construct 'one-stop-shopping' empires, and many more mergers quickly followed, not just across different sectors of finance but across national borders, too. The formerly stodgy German commercial lender Deutsche Bank announced that it was purchasing the freewheeling Bankers Trust. Deutsche also hired a large chunk of Merrill Lynch's former trading group, tasking them with creating a derivatives business. Credit Suisse, the once-dull Swiss group, grabbed DLJ, another American broker. The industry was rapidly adjusting to a

197. *Id.*

198. *Id.*

199. *Id.*

200. Stephen Labaton, *Congress Passes Wide-Ranging Bill Easing Bank Laws*, N.Y. TIMES, Nov. 5, 1999, at A1.

201. *Id.*

202. See, e.g., Clyde Mitchell, *Ten Years After Gramm-Leach-Bliley: A Defense*, N.Y.L.J., Dec. 16, 2009.

203. *Id.*

new reality that banks needed to be big and offer a full range of services in order to compete at all.²⁰⁴

Most importantly, the resulting data is unavoidable. Lehman Brothers, in efforts to transform itself from a “second-tier bond trading shop into a full-service investment bank,” took sizeable real estate positions on to its balance sheets (resulting in short-lived but significant profits in years such as 2006).²⁰⁵ Between 2007 and 2008, Lehman raced from twenty-five times leveraged to thirty-five times leveraged.²⁰⁶ The ensuing market demise has been sublime: A company whose stock traded over \$80 a share in 2007 has seen the price ride under \$1 a share since mid-September 2008.²⁰⁷ Overall, euphoric visions of rising to the level of a multi-service financial power led the 158-year old firm, like other entities, to hazardously ratchet up its asset-debt ratio to precipitate its own ruin.²⁰⁸

AIG remains the most illustrative case in point. The enormous CDS business attributed to that troubled giant was housed in a London subsidiary titled “AIG Financial Products” (AIGFP).²⁰⁹ AIGFP dates from the late 1990s and is not subject to the jurisdiction of the SEC or any insurance regulator. Most tellingly, since 2004 (i.e., post-GLBA), it has been overseen by the OTS.²¹⁰ Such a line of supervision seems obtuse in that, based upon a CDS portfolio of approximately \$500 billion, the subsidiary generated \$250 million in annual *insurance premiums* by 2007.²¹¹

F. AFTERMATH

In the wake of the Crisis, a wide variety of pending federal remedies attested to the quantifiable change in Congressional mood, as well as the diversity and specificity of that deliberative body’s interest, once adequately provoked. Bills introduced in 2008 and 2009 would have mandated shareholder say in corporate governance,²¹² reinstated the stock exchanges’

204. TETT, *supra* note 1, at 73.

205. Leonard, *supra* note 20.

206. COHAN, *supra* note 19, at 1.

207. See the company’s historical stock quotes at MarketWatch.com, Lehman Bros. Historical Stock Quotes, <http://www.marketwatch.com/investing/stock/LEHMQ> (last visited Feb. 25, 2009).

208. In September 2008, Lehman Brothers filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. See Press Release, Lehman Brothers, Holdings Inc. Announces it Intends to File Chapter 11 Bankruptcy Petition; No Other Lehman Brothers’ U.S. Subsidiaries or Affiliates, Including its Broker-Dealer and Investment Management Subsidiaries, are Included in the Filing (Sept. 15, 2008), http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf. Various authors, journalists and critics have posed the unanswered question as to why that entity did not receive a government bailout. See, e.g., Morgenson, *supra* note 52 (referencing the federal officials who “let Lehman die”).

209. Morgenson, *supra* note 52.

210. *Id.*

211. *Id.*

212. Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009).

“uptick rule” abolished by the SEC in 2007,²¹³ imposed uniform requirements on mortgage loan originators,²¹⁴ legislated registration of hedge funds,²¹⁵ expanded the prosecutorial authority of the SEC,²¹⁶ created a “systemic risk monitor” to oversee all markets,²¹⁷ or clarified the regulation of credit default swaps.²¹⁸

Such legislative solutions offered by the nation’s highest deliberative body may best signal that effective regulation was always within Washington’s grasp. Stated bluntly, there would likely be no AIG bailout in 2008 or 2009 but for the GLBA eradication of business restrictions imposed after the Great Depression in the absence of replacement safeguards.

There is a postscript on the deleterious effects of the GLBA. While it was to be expected that established entities would increase their presence in other markets, the GLBA also created a new type of company on the regulatory scorecard, the Financial Holding Company.²¹⁹ Certain of these entities would fall through the cracks of existing lines of federal supervision, leading to one of the most embarrassing of SEC failures in recent years.²²⁰

V. THE SECURITIES AND EXCHANGE COMMISSION: DECISIONS TOO WEAK TO DEFEND?

A. PERCEPTIONS

The negative perceptions of the SEC seemed to have coalesced in the nation’s recent, trying times. An under-funded and generally inept SEC failed to foresee the dangers in the growing use of leverage and the dramatic alterations in industry relationships. Further, acquiescence to the White House’s conservative views on regulation under George W. Bush

213. H.R. 302, 111th Cong. (2009).

214. Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110th Cong. (2008).

215. The Hedge Fund Transparency Act of 2009, S. 344, 111th Cong. (2009).

216. Compliance, Examinations, and Inspections Restructuring Act of 2009, H.R. 2622, 111th Cong. (2009).

217. Financial System Stabilization and Reform Act of 2009, H.R. 1754, 111th Cong. (2009).

218. Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. (2009). As this article goes to print, the United States Senate is considering a broad array of financial reforms. See David M. Herszenhorn & Edward Wyatt, *Republicans Allow Debate on Financial Overhaul*, N.Y. TIMES, Apr. 28, 2010, available at <http://www.nytimes.com/2010/04/29/business/29regulate.html?dbk>.

219. See JOHN C. COFFEE, JR. & HILLARY A. SALE, *SECURITIES REGULATION: CASES AND MATERIALS* 48–50 (11th ed. 2009).

220. See *Testimony Concerning the Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. (2008) (unpublished statement of Christopher Cox, Chairman of the SEC), available at <http://www.sec.gov/news/testimony/2008/ts102308cc.htm>.

endangered market participants.²²¹ The dangers hit home when the Madoff scandal broke and it was manifestly clear that red flags had been ignored. As a result, the agency that so often boasted of serving as “the investor’s advocate,” celebrated its 75th birthday by fighting to justify its existence.²²²

Indeed, the perception has been perpetuated, somewhat, by the Commission’s post-President Bush management, which has repeatedly cited growing obligations and scarcity of Congressional funding as largely to blame for the inefficiencies of recent years.²²³ As cited by current SEC Chairwoman Mary Schapiro, during the most critical years of the Crisis, the Commission saw its modest staff of approximately 3600 employees reduced by 10%, a decline attributed to “several years of flat or declining budgets.”²²⁴ As has been concurrently noted, even before the agency assumes any proposed registration responsibilities for hedge funds and private equity firms, it already oversees 12,000 public companies; 4600 mutual funds; 11,300 investment advisers; and 5500 broker-dealers.²²⁵ Further, the budgetary defense for the agency’s failures has thus, at times, resulted first and foremost in a polarized debate between Congress and Commission officials,²²⁶ resulting in the delay of significant reform.

B. DETAILS

But staffing and budgets in the years 2005-2008 do not appear as stultifying as Commission officials may claim. The SEC’s own numbers, as evidenced in its annual *Performance and Accountability Reports* for 2005 and 2008, showed that when compared to 2005, the SEC was more successful in 2008 for obtaining Enforcement results (92% vs. 91%), reducing the time necessary to review corporate filings (25.2 days vs. 26.1 days), and increasing the percentage of timely resolved Self Regulatory Organizations (SROs) rule filings (86% v. 80%). In addition, the percentage of investment adviser and mutual funds registrants examined in 2008 remained the same as in 2005 (14%).²²⁷ Moreover, while the Commission

221. See, e.g., Stephen Labaton, *S.E.C. Seeks to Curtail Investor Suits*, N.Y. TIMES, Feb. 13, 2007, at C1 (citing speeches by Commission officials and an amicus brief urging the Supreme Court to adopt a pleadings test requiring a “high likelihood” of intent to commit fraud as indicia that the agency had “begun to take steps on two fronts to protect corporations, executives and accounting firms from investor lawsuits that accuse them of fraud”).

222. See, e.g., Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785 (2009).

223. Schapiro Testimony, *supra* note 12.

224. *Id.*

225. *Id.*

226. See, e.g., Stephen Labaton, *S.E.C. Chief Pursues Tougher Enforcement*, N.Y. TIMES, Feb. 22, 2009, at B1.

227. See SEC, 2008 PERFORMANCE AND ACCOUNTABILITY REPORT 29, 32, 36, 44 (2008), available at <http://www.sec.gov/about/secpar/secpar2008.pdf#sec2>. The report notes that “[i]n [fiscal year] 2008, the percentage of first enforcement actions filed within two years exceeded the planned level” and was “higher than [fiscal year] 2007 results.” *Id.* at 31.

may have continued to evidence its traditionally high attrition rate among employees there was no departmental collapse, as the multi-purposed, widespread structure of the agency remains intact.²²⁸ Further, the Commission is quick to tout its prompt, dedicated responses to the Crisis, all of which belies any budgetary paralysis.²²⁹

Separately, while the journalistic trend is to lampoon the efforts of the SEC to follow leads or detect overwhelming frauds,²³⁰ the problem runs longer and deeper than any missed tips. Commencing in 2000, and perhaps reaching a crescendo in 2004, the SEC, albeit understaffed and strife with political interference, deliberately and consistently pursued ill-advised courses of action with direct consequence to the market.

Three such questionable interpretations at the Commission warrant the most scrutiny: (1) the easing of traditional net capital restrictions for broker-dealers; (2) the reluctance to impose regulation on credit ratings agencies; and (3) the avoidance of any restrictions on burgeoning margin lending to customers.

1. The Consolidated Enterprise Compromise of 2004

It is now axiomatic that the SEC erred when, in April 2004, it privately agreed to a relaxation of the net capital rules in favor of the largest broker-dealers.²³¹ The agreement (acquiesced to by all five Commissioners) permitted the nation's largest financial service firms to legally "upstream" funds to their Bank Holding Companies, thus freeing up millions in funds for purchase of exotic investments.²³² The ugly compromise²³³ has received

228. See Schapiro Testimony, *supra* note 12; see also SEC, Organization of the SEC, <http://www.sec.gov/images/secorg.pdf> (the SEC's current organizational chart).

229. Press Release, SEC, SEC Actions During Turmoil in Credit Markets (last updated Jan. 22, 2009), <http://www.sec.gov/news/press/sec-actions.htm> (listing in excess of two dozen responses in areas of enforcement, rulemaking, and examination).

230. See John C. Coffee, Jr., *Credit Ratings Agencies in Congressional Crosshairs*, N.Y.L.J., Jan. 21, 2010, at 5 (comparing the agency to bumbling Inspector Clouseau of the *Pink Panther* movies).

231. Kevin Drawbaugh, *US SEC Clears New Net-Capital Rules for Brokerages*, REUTERS, Apr. 28, 2004, http://securities.stanford.edu/news-archive/2004/20040428_Headline08_Drawbaugh.htm.

232. See Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. TIMES, Oct. 3, 2008, at A1 (discussing the exemption codified in Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Release No. 49,830, 69 Fed. Reg. 34,428 (June 21, 2004)); see also COHAN, *supra* note 19, at 448 (referencing the June 2004 changes to net capital rules that permitted "securities firms to increase the amount of leverage they could use on their balance sheets to forty times equity while traditional banks, by statute, had to keep the leverage closer to ten times equity").

233. See Labaton, *supra* note 232 (A "senior staff member" was quoted as stating that the compromise would result in meaningful access to holding company ledgers, as the SEC would utilize "people with strong quantitative skills to parse the banks' balance sheets.").

far-reaching attention in the years since, even inviting scrutiny from such off-topic popular periodicals as *Rolling Stone Magazine*.²³⁴

i. Purpose of (and Relief From) 15c3-1

Since 1965, SEC Rule 15c3-1 has been in force.²³⁵ The Rule serves at least three purposes: (1) avoidance of dependence on customer funds; (2) efficient operation of markets; and (3) deterrence to violative conduct.²³⁶ The Rule is generally perceived as establishing “early warning thresholds.”²³⁷ Concurrently, even errors in (or omissions of) requisite calculations are disciplinable.²³⁸

It was thus no coincidence that the largest financial firms came to the SEC seeking relief from the strict and ubiquitous net capital rule before feeling comfortable with the now notorious rush to unprecedented leveraging.²³⁹ The SEC expressly responded, via a formal rule interpretation allowing certain broker-dealers to utilize a “voluntary, alternative method of computing deductions to net capital.”²⁴⁰ In return, this short list of firms agreed to a heightened internal alarms system and to subject its holding company and affiliates to “group-wide Commission supervision” (termed Consolidated Entity Supervision).²⁴¹

In fairness to the Commission, the hazardous move was made, at least in part, to obtain jurisdiction over investment bank holding companies who were not subject to U.S. bank regulators because they did not own commercial banks,²⁴² and in a climate of urged competitive deregulation. The financial press, in particular, gave much attention to the notions that the

234. See Matt Taibbi, *Wall Street's Naked Swindle*, ROLLING STONE, Oct. 15, 2009, at 50, available at http://www.rollingstone.com/politics/story/30481512/wall_streets_naked_swindle/2; see also Julie Satow, *Ex-SEC Official Blames Agency for Blow-Up of Broker-Dealers*, N.Y. SUN, Sept. 18, 2008, available at <http://www.nysun.com/business/ex-sec-official-blames-agency-for-blow-up/86130/> (discussing the collapse of Lehman Brothers, Bear Stearns, and Merrill Lynch).

235. 17 C.F.R. § 240.15c3-1 (2008).

236. See Net Capital Rule, Exchange Act Release No. 27249, 54 Fed. Reg. 40,395, at 40,396 (Oct. 2, 1989) (“Finally, if the liability of a broker-dealer to its customers from violations of state and federal law is to be a deterrent to improper conduct, a firm should be required to maintain a reasonable financial stake in its business.”).

237. See COFFEE & SALE, *supra* note 219, at 666–67.

238. See, e.g., Direct Brokerage, Inc., NYSE Hearing Panel Decision No. 05-171 (Sept. 12, 2006), available at http://www.nyse.com/DiscAxn/discAxn_10_2006.html (finding violations of SEC Rule 15c3-1 and NYSE Rule 325 based upon failure to both maintain firm net capital at required levels and to compute net capital as required).

239. See, e.g., Coffee, *supra* note 230 (noting that mid-decade, five underwriter firms handled “the majority of mortgage-backed securitizations”).

240. Alternative Net Capital Requirements for Broker-Dealers that are Part of Consolidated Supervised Entities, Exchange Act Release No. 49830, 69 Fed. Reg. 34,428, at 34,428 (June 21, 2004).

241. *Id.*

242. See Christopher Cox, Chairman, SEC, Address at the Security Traders 12th Annual Washington Conference (May 7, 2008), available at www.sec.gov/news/speech/2008spch050708cc.htm.

Sarbanes-Oxley Act of 2002 had so encumbered American businesses with red tape that their European counterparts were raising money cheaper and faster.²⁴³ Nonetheless, Consolidated Entity Supervision was, by all accounts, a disaster. With the express blessing of their most immediate regulator, the largest broker-dealers facilitated leveraging at the parent company level that would reach Biblical proportions. Both the ensuing blurred ledgers and billions in losses were unprecedented.

ii. Aftermath

Consolidated Entity Supervision was *de facto* terminated via the inevitable and involuntary transformation of its participants: two of the five holding companies filed for bankruptcy, two converted to commercial banks to avail themselves of federal funding, and one merged.²⁴⁴ As an ongoing concept, the notion was tersely, but resolutely, abolished by the White House's Financial Reform Plan of June 2009.²⁴⁵ In view of the massive monies freed for speculation, the consistent criticism thereof, the relatively weak motives for the move and the immediate remedy by the new White House, the variegated form of accounting does seem justifiably blamed for a large share of the Crisis. But SEC inaction in other areas was just as harmful.

2. Unregulated Credit Rating Agencies

Investment banking houses could only grow their CDO inventories to unspeakable proportions if a third party was blessing them. The top three ratings agencies thus served as the seal of approval for an investment that was, at best, misunderstood. As one *Wall Street Journal* writer tersely described the phenomenon: "Rating firms became a crutch."²⁴⁶

243. See, e.g., Gariel Nahoum, Note, *Small Cap Companies and the Diamond in the Rough Theory: Dispelling the IPO Myth and Following the Regulation A and Reverse Merger Examples*, 35 HOFSTRA L. REV. 1865, 1865 (2007) (detailing the focus of *The Wall Street Journal* in 2007 on the possibility of the U.S. "losing its appeal to foreign investors").

244. See Labaton, *supra* note 232.

245. FIN. STABILITY OVERSIGHT BD., DEPT. OF THE TREASURY, FINANCIAL REGULATORY REFORM A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 12 (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf ("We propose also eliminating the SEC's Supervised Investment Bank Holding Company program. Investment banking firms that seek consolidated supervision by a U.S. regulator should be subject to supervision and regulation by the Federal Reserve.").

246. David Wessel, *Lessons from the Housing Bubble*, WALL ST. J., May 29, 2008, at A2, available at <http://online.wsj.com/article/SB121200132477426865.html>.

[I]nvestors who relied on the ratings agencies—particularly supposedly sophisticated pension funds and other institutions—are at fault, too. Rating firms became a crutch for investors who simply didn't want to spend the time and money required to be prudent investors at a time when low interest rates had everyone reaching for higher returns without contemplating the higher risks.

Regarding ratings agencies, the SEC was, and still is, the law. Although the statutory responsibility of the Commission to oversee national credit ratings agencies has been sketchy, the fact remains that the Commission has exercised its authority to *designate* such agencies since at least 1975.²⁴⁷

The SEC floated the idea of formal rating agency registration in 1997, but the idea was received in lukewarm fashion by the industry.²⁴⁸ In 2003, the Commission invited public comment on new rules for the agencies.²⁴⁹ That SEC Release perhaps begged the question of just how conflicted the rating game had gotten when it asked the industry the following question: "Is it appropriate to require strict firewalls between the broker-dealer employees who develop internal credit ratings and those responsible for revenue production?"²⁵⁰

Nearly fifty commenters weighed in on the release, often in stark terms.²⁵¹ An accounting professor at MIT outright called for the requirement that credit rating agencies disclose the source of their revenues.²⁵² State regulators in Texas expressly suggested that agencies be required to adopt procedures addressing issuer and subscriber "influence."²⁵³

Many commentators on the 2003 release expressly opined that the credit rating agency demarcation had outlived its utility;²⁵⁴ credit rating agencies needed to be regulated in the same manner as the companies they

247. See Memorandum from Davis Polk & Wardwell to Interested Persons 2 (June 24, 2008), <http://www.davispolk.com/files/Publication/15413afd-084a-47cc-af827b7a5371c669/Presentation/PublicationAttachment/1e0cd7b8-9b1a-4f61-80c67d969df334f9/06.24.08.nrsro.proposals.pdf> ("Before the Credit Rating Agency Reform Act [of 2006], the SEC staff followed an informal practice of recognizing certain credit rating agencies as [National Recognized Statistical Rating Organizations] for regulatory purposes through the issuance of no-action letters."); see also Coffee, *supra* note 230 (referencing the "de facto regulatory licenses" long granted the credit rating agencies by the SEC and banking agencies).

248. See Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Securities Act Release No. 8236, Exchange Act Release No. 47,972, Investment Company Act Release No. 26,066, 68 Fed. Reg. 35,258 (June 12, 2003) (discussing the 1997 proposal and the SEC's decision not to act on it).

249. *Id.*

250. *Id.* at 35,259.

251. See *id.*

252. Letter from Joseph Weber, Assistant Professor of Accounting, Mass. Inst. Tech. Sloan Sch. of Mgmt., to Jonathan G. Katz, Sec'y, SEC (June 25, 2003), available at <http://www.sec.gov/rules/concept/s71203/jweber062503.htm>.

253. See Letter from Denise Voigt Crawford, Sec. Comm'r, Tex. Sec. Bd., to Jonathan G. Katz, Sec'y, SEC (July 28, 2003), available at <http://www.sec.gov/rules/concept/s71203/dcrawford072803.pdf>.

254. See Letter from Lawrence White, Professor of Econ., N.Y. Univ. Stern Sch. of Bus., to the SEC (July 25, 2003), available at <http://www.sec.gov/rules/concept/s71203/lwhite072503.txt>. "I strongly urge the SEC to abolish the regulatory category of 'nationally recognized statistical rating organization' (NRSRO) and to cease its use of the NRSRO criterion for deciding which rating company's ratings can be used for the SEC's regulatory purposes." *Id.*

rate,²⁵⁵ or under a separate scheme altogether.²⁵⁶ One commentator exhibited clairvoyance when he suggested that the SEC act “in a timely fashion to provide these answers now, instead of after some (another) financial or stock market calamity.”²⁵⁷

Between 2003 and 2006, the SEC did nothing tangible in response to the comments. In 2006, Congress took up the task and passed the Credit Rating Agency Reform Act.²⁵⁸ That law called upon the Commission to implement new rules, which it did in 2007.²⁵⁹ The timeline thus edifies that the agency, uneasy with a supervisory role it inherited by default, simply shunned final action until it was ordered by Congress. Of course, the credit rating agencies, unfettered by meaningful regulation in the years preceding the Crisis, profited mightily from the “issuer pays” system that produced so many questionable evaluations of CDOs.²⁶⁰

3. Unwillingness to Tighten Margin Lending

One area where the SEC’s oversight ability is not subject to claims of vagueness is margin lending. However, the primary purpose of the margin rules (those unique limitations on the initial purchase of stock) has all but been forgotten. The constraints were originally designed to protect Wall Street from itself.²⁶¹ Indeed, scholars remain stunned by the fact that brokerage houses in the 1920s were lending customers 95% of the purchase

255. See Letter from Malcolm S. Macdonald, Vice President Fin. and Treasurer, Ford Motor Co., to Jonathan G. Katz, Sec’y, SEC (July 28, 2003), *available at* <http://www.sec.gov/rules/concept/s71203/ford072803.pdf>.

256. See Letter from Barbara Roper, Dir. of Investor Prot., Consumer Fed’n of Am., to Jonathan G. Katz, Sec’y, SEC (July 28, 2003), *available at* <http://www.sec.gov/rules/concept/s71203/roper072803.pdf>.

257. Letter from Martin Goldberg to the SEC (June 7, 2003), *available at* <http://www.sec.gov/rules/concept/s71203/mgoldberg060703.txt>.

258. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified in scattered sections of 15 U.S.C.).

259. See Final Rule: Oversight of Credit Rating Agencies Registered as Nationally Registered Statistical Rating Organizations, Exchange Act Release No. 55,857, 72 Fed. Reg. 33,564 (June 18, 2007).

260. See, e.g., Amanda Bahena, Univ. of Iowa Ctr. for Int’l Fin. and Dev., What Role Did Credit Rating Agencies (CRAs) Play in the Financial Crisis?, http://www.uiowa.edu/ifdebook/issues/financial_crisis/posters/Amanda%20Final%20Draft.pdf (last visited Feb. 19, 2010); see also Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, § 6003(c), 111th Cong. (2009) (as passed by House of Representatives, Dec. 11, 2009, creating a private cause of action for investors against credit ratings agencies).

261. See THOMAS LEE HAZEN & DAVID L. RATNER, BROKER DEALER REGULATION: CASES AND MATERIALS 554–56 (2003) (“Although the basic purpose of the margin regulations is to restrict stock market speculation, rather than to protect individual customer . . .”).

value of their securities.²⁶² If not the incontrovertible cause of the Great Depression, it was most certainly an aggravating factor.²⁶³

Thus, in 1934, when the Securities Exchange Act was adopted, § 7 therein²⁶⁴ delegated margin rulemaking authority to one agency: The Federal Reserve Board (the Fed). The Fed adopted famed Regulation T,²⁶⁵ which, since 1974, has capped the amount that a brokerage house may lend a retail customer for the initial purchase of most stock at 50%.²⁶⁶ After that day of purchase, margin is regulated by the brokerage houses themselves (who routinely set “house rates” that are stricter than the 25% set by the stock exchanges).²⁶⁷ The problem, simply stated, is that the more brokerage houses lend, the more money they make, and the temptation has never been eradicated.²⁶⁸

In prior crises, regulators worked feverishly to rein in the amount of consumer credit on Wall Street. For example, in the Spring 2000, both the Fed and the Commission publicly questioned the increased amount of margin being afforded American investors.²⁶⁹ The stock exchanges themselves subsequently threatened to tighten lending rules governing their membership.²⁷⁰ The scrutiny of broker-dealer lending culminated in SEC approval of an National Association of Securities Dealers (NASD) rule change obligating firms to delivering a uniform disclosure statement on the

262. See Paul Alexander Gusmorino, *Main Causes of the Great Depression*, GUSMORINO WORLD, May 13, 1996, <http://www.gusmorino.com/pg3/greatdepression/index.html>.

263. See also JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929 20* (Houghton Mifflin Harcourt Publishing Company 2009) (1954).

Margins—the cash which the speculator must supply in addition to the securities to protect the loan and which he must augment if the value of the collateral securities should fall and so lower the protection they provide—are effortlessly calculated and watched . . . Wall Street, however, has never been able to express its pride in these arrangements. They are admirable and even wonderful only in relation to the purpose they serve. The purpose is to accommodate the speculator and facilitate speculation. But the purposes cannot be admitted. If Wall Street confessed this purpose, many thousands of moral men and women would have no choice but to condemn it for nurturing an evil thing and call for reform.

Id.

264. 15 U.S.C. § 78g (2006).

265. 12 C.F.R. §§ 220.1–220.12 (2009).

266. *Id.*

267. See, e.g., NYSE, Inc., Rule § 431 (2008), available at <http://nyserules.nyse.com/NYSE/Rules/> (follow “General Rules” hyperlink; then follow “Operation of Member Organizations (Rules 325 – 465)” hyperlink in sidebar).

268. See Gretchen Morgenson, *Something Borrowed May Leave Market Blue*, N.Y. TIMES, Jan. 30, 2000, at 3.1 (stating “lending money to investors is very lucrative for these firms; they reap both margin interest and extra commissions from investors buying twice the stock they would have otherwise”).

269. See, e.g., Knight Tribune News Service, *Use of Margin Buying Soars to the Chagrin of SEC*, FLA. TIMES UNION, Apr. 2, 2000, at H5.

270. See *Margin Credit Fell in April*, N.Y. TIMES, May 16, 2000 (“The NASD said last month that it would prod the NYSE to join it in trying to toughen margin requirements.”).

dangers of margin investing to all existing and potential margin customers.²⁷¹ Whether it was because of the scrutiny, the rule change, or both, margin debt fell at both the New York Stock Exchange (NYSE) and NASD firms in 2001.²⁷²

But as time passed, so did the scrutiny. Between 2002 and 2006, margin totals increased 60% at NYSE firms and over 200% at NASD firms.²⁷³ Such brokerage houses effect trades for hedge funds and other speculators, all of which were allowed to increase their leverage. For some, the lack of new margin rules or tightened regulations was hardly a surprise. In fact, commentators had casually expected the administration of George W. Bush to effectuate its professed desire to ease up on business regulation.²⁷⁴ Perhaps more than anywhere else, that drive reached fruition in the everyday world of stock brokerage. Thus, any survey of SEC actions/omissions precipitating the Crisis must note the agency's reluctance to tighten margin lending, which credit enabled untold market losses.

C. STATUS

The dedicated hesitancy of the Commission to rein in Wall Street's net capital, credit rating, and lending practices inevitably leads to cries by journalists and practitioners alike of political intervention.²⁷⁵ The anger has spread to academics, who are quick to also point to the dubious timing of many SEC trial tactics.²⁷⁶

271. See FINRA, NASD Notice to Members 01-31: Margin Disclosure, SEC Approves NASD Rule Proposal Requiring Delivery of Margin Disclosure Statement to Non-Institutional Customers 285 (May 2001), available at http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003871.pdf (explaining SEC approval of new NASD Rule 2341).

272. See Press Release, FINRA, Margin Statistics (Jan. 4, 2010), <http://www.finra.org/InvestorInformation/InvestmentChoices/MarginInformation/p005923> (providing a historical, monthly listing of margin totals for both of the major stock exchanges and disclosing a 33% drop at NYSE firms and a 44% drop at NASD firms between 2000 and 2001).

273. See *id.* (summarily concluding, "[i]ncreasingly, investors are purchasing on margin").

274. See, e.g., William L. Watts, *Bush Regulators May Relax: But Completely Hands-off Approach Unlikely*, CBS.MARKETWATCH.COM, Dec. 26, 2000, <http://www.marketwatch.com/story/bush-regulators-may-be-more-relaxed>.

275. See, e.g., Deborah G. Heilizer et al., *FINRA 2008: An Oscar Winning Year?*, 37 SEC. REG. L.J. 279, 280 (2009), available at http://www.sutherland.com/files/Publication/0190aaf4-bdb0-4919-ade1-4cb1dc7c1c43/Presentation/PublicationAttachment/e4efad1b-3725-418b-ad75-51f0e0c81ccc/Rubin_2009.pdf (citing Zachary A. Goldfarb, *In Cox Years at the SEC, Policies Undercut Action; Red Tape Halted Cases, Drove Down Penalties*, WASH. POST, June 1, 2009, at A1) (referencing "the SEC's well-publicized retrenchment on the enforcement front").

276. See Velvel on National Affairs: The SEC's Brief Filed Before Judge Lifland in Madoff, <http://velvelonnationalaffairs.blogspot.com/2009/12/secs-brief-filed-before-judge-lifland.html> (Dec. 21, 2009, 03:22pm). Lawrence Vlevel, Dean of the Massachusetts School of Law, decries the timing and substance of the SEC's brief filed in a case centering on valuation of Madoff victims' claims, asserting that the Commission would support the Judge's decision "if he follows the SEC's method of partial alleviation." *Id.*

Still others steadfastly defend the agency, the abolition or subordination of which does seem to be both premature and impractical.²⁷⁷ The more enlightened approach parses the myriad SEC responsibilities, according high marks for prosecutions and low ones for oversight of financial planning.²⁷⁸

The latest words of reform accentuate the difficulties in detection. Specifically, the Wall Street Reform and Consumer Protection Act of 2009, among many other changes, would create the interagency Financial Services Oversight Council to oversee systemic risk, identify “systemically important companies and activities . . . [and] resolve jurisdictional disputes” between federal agencies.²⁷⁹ Likewise, a new Consumer Financial Protection Agency would focus on consumer financial activities, including mortgage loan practices and disclosures.²⁸⁰ As the inclination to re-tool the government arsenal gets set to weather political storms, the more accurate appraisal (and obtainable result) may posit that the Commission must simply set more consistent priorities and make better choices, or once again find itself fighting for survival.

CONCLUSION: OF LAWS AND SAUSAGES . . .

To be sure, there are regulatory issues to be explored other than the ones detailed herein in an effort to hone the blade of culpability for the two-year economic freefall. The bizarre alliance of private and public flaws that caused the Crisis perhaps serve to isolate any one contributor from blame. One could easily ask whether the 1970 NYSE decision to allow investment firms to go public foretold of the days when management would place quarterly profits above fundamental corporate health.²⁸¹

Frightfully scarce from critiques to date are detailed studies of the oversight of major firms like Bear Stearns and Lehman Brothers by the stock exchanges—those entities that are only permitted to utilize the

277. See, e.g., Arthur S. Greenspan, *Responses and Strategies in Dealing with a Changed SEC*, N.Y.L.J., Dec. 10, 2009, at 5 (“It has come under considerable public criticism over the past few years, but the U.S. Securities and Exchange Commission remains one of the most important civil law enforcement authorities for the U.S. financial services industry and for U.S. public companies.”).

278. See John C. Coffee, Jr., *Downsizing the SEC?*, NAT’L L.J., June 22, 2009, at 22 (“Relatively speaking, the SEC deserves good grades for enforcement and investor protection, but may have flunked the course on prudential financial supervision.”).

279. See Davis, Polk & Wardwell L.L.P., Summary of the Wall Street Reform and Consumer Protection Act Passed by the House of Representatives, December 11, 2009 (Dec. 15, 2009), http://www.sifma.org/uploadedFiles/SIFMA_Homepage/DPW-summary-wallstreet-reform.pdf. The U.S. House of Representatives passed the Act on December 11, 2009. *Id.*

280. *Id.* at 15, 17.

281. See James Surowiecki, *Public Humiliation*, NEW YORKER, Sept. 29, 2008, at 30 (describing the most applicable result of two waves of IPO booms among investment banks in recent decades: the ability of the previously private entities to “raise huge amounts of capital, which, in turn, increased the amount of money they could borrow to leverage their bets”).

moniker “national securities exchange” in return for guaranteeing to the government that, in addition to serving as centers of capital formation and transfer, they will simultaneously serve as self-regulatory organizations (SROs).²⁸² SRO examination for violations and transgressions is made possible by the separate requirement that exchange member firms file a monthly Financial and Operational Combined Uniform Single (FOCUS) report detailing the firm’s financial condition.²⁸³ Yet, no cries have been heard for either gross reform at the SRO level, or, alternatively, to eradicate its obsolete warning system. Likewise, while the serious questions and drastic ramifications abound, it is not altogether clear that the public wishes to hold aggressive entrepreneurs accountable via criminal actions.²⁸⁴

282. Section 6 of the Securities Exchange Act (“National Securities Exchanges”), 15 U.S.C. § 78f (2006), requires of exchanges as follows:

(5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the exchange.

(6) The rules of the exchange provide that (subject to any rule or order of the Commission pursuant to section 78q(d) or 78(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of this chapter, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

(7) The rules of the exchange are in accordance with the provisions of subsection (d) of this section, and in general, provide a fair procedure for the disciplining of members and persons associated with members, the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with a member thereof, and the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or a member thereof.

15 U.S.C. § 78f(b)5–7 (2006). In July of 2007, the investigative/prosecutorial arms of the two largest SROs, the NYSE and the NASD, merged to form the Financial Industry Regulatory Authority (FINRA). Press Release, FINRA, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulation Authority – FINRA (July 30, 2007), <http://www.finra.org/Newsroom/NewsReleases/2007/P036329>.

283. The NYSE web site touts the FOCUS Report as giving the exchange “a complete, detailed picture of member firms’ financial and operational conditions” and goes on to explain that all member firms “must respond quarterly to several hundred questions about financial and operational conditions and activities.” NYSE, Glossary, Financial and Operational Combined Uniform Single Report (FOCUS), <http://www.nyse.com/glossary/Glossary.html> (last visited Feb. 17, 2010).

284. See Zachary Kouwe & Dan Slater, *2 Bear Stearns Fund Leaders are Acquitted*, N.Y. TIMES, Nov. 11, 2009, at A1 (describing the jury acquittal of two hedge fund managers of securities fraud charges based upon their alleged misstatements to investors regarding the health of funds invested heavily in mortgage securities).

The analyses conducted by this Article served to illustrate that any hindsight needs to be a movie reel as opposed to a snapshot, and that the camera needs to focus more on the risk incentives permitted to prosper on trading desks than on any trendy investment vehicles engaged thereby. Clearly, the judiciary and the White House played an often downplayed yet smoldering role in creating that risky climate; clearly Congress and the SEC can bring on a cloudy day in a heartbeat.

Thus, as the GLBA and ill-advised SEC policies emerge as the most damaging contributions to the Crisis, the expedient blame attributed to the growth of the CDO or the CFMA's exclusion of a sole investment product seems too expedient. In light of management's commitment to non-traditional structures and profit centers (both in anticipation of and after enactment of the law), a related flaw in recent years appears to be in government failing to commensurately staff and train the agencies. This is supported by the words of Alan Greenspan, who in his speech to Congress in October 2008 outlined the failures of Washington to comprehend the regulatory task at hand, stating:

"I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms". . . . "And it's been my experience, having worked both as a regulator for eighteen years and similar quantities in the private sector, especially ten years at a major international bank, . . . that the loan officers of those institutions knew far more about the risks involved in the people to whom they lent money than I saw *even our best regulators at the Fed capable of doing*."²⁸⁵

To make Wall Street appreciate the value of regulating itself thus seems ideal. The concept may even be said to be historical. It was FDR himself who, when introducing the first of the federal securities laws, noted that the government could not vet all the nation's stock offerings;²⁸⁶ the spirit of that advice bears repeating as regulators scramble to find the cure for malingering economic woes

Undoubtedly, the government plays a critical role in instilling such diligence. As detailed herein, four vital sectors of government contributed

285. DAVID WESSEL, IN *FED WE TRUST* 65 (2009) (quoting Fed Chairman Alan Greenspan) (emphasis added).

286. See CHARLES R. GEISST, *WALL STREET: A HISTORY* 230 (1997).

The Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit. . . . There is however an obligation upon us to insist that every issue to be sold in interstate commerce shall be accompanied by full publicity and information.

Id. at 228 (quoting a statement by President Franklin Delano Roosevelt made upon his submission of the Securities Act of 1933 to Congress).

to the atmospheric change attending the Crisis. “The movement to deregulate the financial industry went too far by exaggerating the resilience—the self-healing powers—of laissez-faire capitalism,” a pioneer of the Chicago School of economics recently wrote.²⁸⁷ Maybe so, but, upon inspection of the verdicts of populist trials, it appears that it was still agents of the government who often helped to sell us the snake oil. As economist and journalist Paul Krugman has argued: “Influential figures should have proclaimed a simple rule: anything that does what a bank does, anything that has to be rescued in crises the way banks are, should be regulated like a bank.”²⁸⁸

This Article sought to test public perceptions of (and consequentially specifically apportion blame to) an array of government sectors. As the lingering autopsy of the 14,000 Dow Jones Industrial Average continues, heightened scrutiny by Washington, D.C. appears mainly to cast blame in old directions. This author thus suggests that the compass point towards an amalgamated inquiry: The existing laws and framework failed simply to instill in sophisticates the need to protect themselves from other sophisticates. For, if all our scrutiny of financial relationships continues to sound in metaphors involving sheep and wolves,²⁸⁹ we may never reach the requisite understanding that the Crisis was caused by the well-heeled fooling the well-heeled.²⁹⁰

Despite any controversy about the true author of the “laws and sausages” quote, no one contests that the great Twain did advise so long ago: “[N]o country can be well governed unless its citizens as a body keep religiously before their minds that they are guardians of the law, and that the law officers are only the machinery for its execution, nothing more.”²⁹¹ Clearly, that machinery broke down in recent times, chiefly in keeping iconic sophisticates from fatal avenues of speculation. Hopefully, a progressive survey of the lessened defenses that allowed Wall Street to fail

287. John Cassidy, *After the Blowup: Laissez-Faire Economists Do Some Soul-Searching—and Finger-Pointing*, NEW YORKER, Jan. 11, 2010, at 28 (quoting RICHARD A. POSNER, *A FAILURE OF CAPITALISM*, at xii (2009)).

288. KRUGMAN, *supra* note 18, at 163 (discussing the fall of the “shadow banking system” that emerged globally in the last decade).

289. See, e.g., GEISST, *supra* note 286, at 230 (noting that the New Deal Congress was “bent upon reforming banking so that the poachers and the gamekeepers were kept separate”).

290. As this Article goes to press, the Congressional Financial Crisis Oversight Commission begins its hearings in Washington, D.C. As a noted Wall Street journalist has pointed out, the focus has seemingly “shifted to new ground” in view of concerns that Goldman Sachs simultaneously sold CDOs and hedged against their failure. Andrew Ross Sorkin, *Wall St. Ethos Under Scrutiny at Hearing*, N.Y. TIMES, Jan. 14, 2010, at A1. In turn, Goldman’s CEO has defended that such CDO purchasers were “professional investors who want[ed] this exposure.” *Id.*

291. MARK TWAIN & CHARLES DUDLEY WARNER, *THE GILDED AGE* 216 (Modern Library Paperback 2006) (1873).

to comprehend the dangers of Wall Street will aid in our collective repair of those engines.

