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RISKY BUSINESS: THE CREDIT CRISIS AND FAILURE (PART III)

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I. CONSUMERS, INDUSTRY, AND REGULATORY COSTS

Collection and effective analysis of financial market data may help prevent future crises. The high human costs of market crises, which may significantly affect those least well positioned to bear such costs,[1] make prevention of future crises a high priority. This is particularly true in light of the pervasive financial market networks that characterize contemporary financial markets. Further, through their influence on financial variables such as interest rates and currency prices, financial market networks reach deep into the homes and pocketbooks of a significant portion of the world's population.[2] The fallout from the subprime mortgage market collapse thus illustrates fundamental ways in which financial market participants and the broader global community are linked.

A. Costs of Ineffective Regulation

Individuals and businesses bear costs in connection with regulatory and industry failures that lead to market crisis. First, although federal financial regulators "are largely self-supporting through fee collections, assessments, or other funding sources,"[3] individuals in their roles as consumers, taxpayers, workers, and investors pay the costs for ineffective yet costly U.S. regulatory frameworks,[4] including significant levels of business financing of regulation.[5] Second, although the costs of U.S. bailouts are projected to

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1 EDWARD LIPUMA & BENJAMIN LEE, FINANCIAL DERIVATIVES AND THE GLOBALIZATION OF RISK 3–5 (2004).

2 *Id.*

3 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-02-864, SEC OPERATIONS: IMPLICATIONS OF ALTERNATIVE FUNDING STRUCTURES 9 (2002), http://www.gao.gov/new.items/d02864.pdf (link).

4 Thomas D. Hopkins, *Regulatory Costs in Profile*, 31 POLICY SCI. 301, 310 (1998).

5 *Id.*; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-02-302, SEC OPERATIONS: INCREASED

be significantly less than the estimated $700 billion authorized under the Troubled Asset Relief Program (TARP),[6] taxpayers bear much of the cost of financial industry bailouts.[7] Third, taxpayers may suffer significant deleterious consequences from the impact of the credit crisis on the real economy, which is suggested by a broad range of economic data, such as unemployment and mortgage foreclosure statistics, personal bankruptcies, and more restricted access to credit.[8] Although the costs for financial market players have been high, financial institutions' losses have been subsidized by the U.S. government, and ultimately borne to some extent by U.S. taxpayers.[9] Losses and costs from the credit crisis, including credit losses, U.S. stock market losses, lost production and costs associated with declining gross domestic product, have likely reached the trillions.[10]

Given the enormous costs imposed by the credit crisis, regulatory reform efforts need strengthening, and reformers must fundamentally rethink the U.S. regulatory architecture. If the credit crisis does not lead to a fundamental redesign of U.S. financial market regulation, it is not clear what level of financial market catastrophe would be required to do so. With the exception of the Treasury Blueprint optimal regulatory structure, none of the existing reform proposals come close to fundamental redesign, which is troubling given the profound costs imposed by the credit crisis and ineffective yet costly U.S. regulatory frameworks. Further, ineffective regulation is doubly costly, because it may lull market participants, including investors, consumers, and professional market actors into thinking that the government is actually monitoring risk.

WORKLOAD CREATES CHALLENGES 29–30 (2002), http://www.gao.gov/new.items/d02302.pdf (noting that although federal bank regulation is self-funded, SEC collections are deposited with the U.S. Treasury in an account that provides for SEC appropriations and other uses and that SEC collections significantly exceed the amount of SEC appropriations) (link). In 2003, SEC collections were projected to be $1.3 billion, while the President's appropriation request for the SEC was $467 million. *Id.*

[6] CONGRESSIONAL BUDGET OFFICE, REPORT ON THE TROUBLED ASSET RELIEF PROGRAM 2 n.6 (2010), *available at* http://www.cbo.gov/ftpdocs/112xx/doc11227/03-17-TARP.pdf (noting that the authority for the Troubled Asset Relief Program (TARP) was originally set at a maximum of $700 billion but was later reduced by about $1.3 billion) (link).

[7] *Id*. at 1 (estimating that TARP will cost taxpayers $109 billion and noting that Office of Management and Budget cost estimates total $127 billion).

[8] *See* COMM. ON CAPITAL MKTS. REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 7–23 (2009), *available at* http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf (detailing the impacts of the financial crisis and noting that some aspects are difficult to quantify) (link).

[9] Meredith Whitney, *The Credit Crunch Continues*, WSJ.COM, Oct. 1, 2009, http://online.WSJ.com/article/SB10001424052748704471504574445470989162030.html (noting that "taxpayer dollars have supported 'too big to fail' businesses") (link).

[10] COMM. ON CAPITAL MKTS. REGULATION, *supra* note 8, at 10–11.

B. *Financial Literacy and Risk Penalties: Creating Incentives for Better Risk Management and Disclosure*

In the absence of fundamental regulatory redesign, other useful actions might help better align internal industry and regulatory incentives, such as intensifying penalties for behaviors that create systemic risk, creating broader mechanisms for financial literacy and education about risk at all levels of activity, and developing better risk disclosure practices for market participants.

1. *Meaningful Penalties: Sliding Scale Incentive Regulation*

In addition to ensuring that private market discipline rests on incentives that encourage market participants to properly price risk, regulatory penalties should be reconsidered in light of existing incentives. Auction Rate Securities (ARS) markets illustrate the impact of incentives for financial market participants. ARS, which were first issued in 1984, are "long-term, variable-rate instruments that have their interest rates reset at periodic and frequent auctions."[11] The ARS market, which collapsed in February 2008, seemingly offered benefits to both issuers and investors.[12] ARS enabled issuers to vary their credit spread over time by issuing long-term variable-rate debt without establishing either a fixed interest rate or a variable benchmark and credit spread for the life of the instrument at the time of issuance, as would be the case with traditional fixed-rate or variable-rate instruments.[13] ARS were the subject of a 2006 SEC settlement in which firms settled for $13 million, without admitting or denying SEC charges.[14] This settlement is negligible when compared to the amount of money that banks made from underwriting and managing ARS auctions. Given the revenue flows from the $330 billion that the ARS market reached before its collapse,[15] and banks' earnings of 1% for underwriting fees and twenty-five

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[11] STEPHANIE LEE, NERA ECONOMIC CONSULTING, AUCTION-RATE SECURITIES: BIDDER'S REMORSE? 1 (2008), http://www.nera.com/image/PUB_Auction_Rate_Securities_0708.pdf (describing ARS securities) (link).

[12] *Id.*

[13] *Id*. at 4. A typical fixed rate debt instrument would have the fixed interest rate for the life of the instrument determined at the time of issuance and would not change with interest rate fluctuations. RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 398 (9th ed. 2008). In contrast, a variable rate debt instrument would generally have the method of interest rate calculation determined based on a variable benchmark interest rate and credit spread at the time of issuance (e.g., LIBOR (London Interbank Offered Rate) + 1%). *Id*. As a result, even though the effective interest rate would vary over the life of the variable interest rate debt instrument, the method of calculation and the credit spread above the benchmark rate of interest would be established at the time of issuance.

[14] Press Release, SEC, Fifteen Broker-Dealer Firms Settle SEC Charges Involving Violative Practices in the Auction Rate Securities Market (May 31, 2006), http://www.sec.gov/news/press/2006/2006-83.htm (link); Order Instituting Administrative Cease-and-Desist Proceedings, Securities Act Release No. 8,684 (May 31, 2006), http://www.sec.gov/litigation/admin/2006/33-8684.pdf (link).

[15] LEE, *supra* note 11, at 2.

basis points for each auction,[16] it is likely that banks gained far in excess of the $13 million SEC settlement. For example, if the $330 billion in sales occurred in a single year, with auctions of all outstanding ARS taking place monthly, bank revenues from ARS underwriting fees in that year alone could exceed $3 billion.[17]

Given the monetary incentives that existed in the ARS market, the 2006 settlement likely constituted a minor slap on the wrist. The ARS settlement occurred during a time of declining penalty collections by the SEC.[18] In contrast, sliding scale penalties might provide a better mechanism for aligning incentives in some instances. Sliding scale regulation has been applied in the context of regulated industries such as telecommunications.[19] In the financial market context, sliding scale penalties could be conceptualized as forced profit or revenue-sharing, with payments into a fund established by regulators for certain first or continuing regulatory violations. Assuming that the amount of the profit or revenue-sharing could be set at an appropriate level, the prospect of such profit or revenue penalties would likely facilitate internal firm risk management and shareholder monitoring to avoid the penalties. In the ARS case, even a penalty of as low as 10% of profits accrued for using the practices that led to the SEC charges, or some percentage of firm profits during the periods in which violations occurred, might have had a greater impact on future behavior. Recognition of the importance of meaningful penalties was a factor in Judge Rakoff's 2009 rejection of an SEC settlement with Bank of America in relation to its acquisition of Merrill Lynch, which reflects judicial concern about the nature, fairness, and amount of SEC settlements.[20] Judge Rakoff described the proposed settlement as "neither fair, nor reasonable, nor adequate" and noted that the $33 million settlement was "a trivial penal-

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[16] *See* LEE, *supra* note 11, at 12 (noting that the underwriter typically receives a fee of 25 basis points); Administrative Complaint at 37-38, In the Matter of UBS Securities, Inc., No. 2008-0045 (Mass. Sec. Div. June 26, 2008), *available at* http://www.sec.state.ma.us/sct/sctubs2/ubs2_complaint.pdf (stating that UBS' underwriting fee is typically 1%) (link).

[17] For example, 1% of $330 billion would garner $3.3 billion in annual underwriting fees.

[18] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-358, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT 6–8 (2009), http://www.securitiesdocket.com/wp-content/uploads/2009/05/gaoreportsec.pdf (noting declining levels of SEC penalties in the period preceding the credit crisis, with penalties becoming more like disgorgement) (link).

[19] Donald J. Kridel, David E.M. Sappington & Dennis L. Weisman, *The Effects of Incentive Regulation in the Telecommunications Industry: A Survey*, 9 J. REG. ECON. 269, 290–293 (1996) (finding increasing productivity under incentive regulation schemes in the telecommunications industry); *see generally* Michael A. Crew & Paul R. Kleindorfer, *Incentive Regulation in the United Kingdom and the United States: Some Lessons*, 9 J. REG. ECON. 211, 221 (1996) (noting that different structures of incentive regulation can yield different outcomes); Thomas P. Lyon, *A Model of Sliding-Scale Regulation*, 9 J. REG. ECON. 227, 228 (1996) (giving an efficiency rationale for sliding scale regulation).

[20] SEC v. Bank of America Corp., 653 F. Supp. 2d 507, 509, 512 (S.D.N.Y. 2009) (mem. order).

ty for a false statement that materially infected a multi-billion dollar merger."[21]

2. Risk Education and Financial Literacy

The credit crisis also demonstrates a significant need for better financial education with respect to risk, both for sophisticated market participants and regulators who need a more comprehensive understanding of complex financial products, trading strategies, and networks. Financial market regulation that is based on an assumption of private market discipline implicitly assumes that market participants have sufficient knowledge and education to enable them to effectuate the discipline that is part of the foundation on which market regulation rests. Although education can be a blunt tool, a pervasive lack of knowledge by multiple parties was no doubt a factor in the crisis. For example, the ARS market was developed by broker-dealers who were willfully ignorant about the products they sold. Interviews by Massachusetts officials of ARS financial advisors revealed knowledge based only on conversations with other advisors and mere anecdotal understanding of the products they were selling, much of which was incorrect.[22] In many instances, ARS customers, including sophisticated purchasers such as Pulitzer Prize-winning financial writer James Stewart, lacked knowledge about the risks of what they were buying.[23]

In addition to better professional education for market participants and regulators, greater consideration should be given to ways to make retail investor education more comprehensive and interactive. A televised public service announcement series that focuses on investment and financial market basics might assist retail investors in understanding financial market products and investment best practices. Further, current methods for determining retail investor qualifications may also be inadequate. In addition to the financial thresholds that exist for individual investors under Regulation D,[24] greater consideration should be given to having standardized in-

[21] *Id.* at 512.

[22] Administrative Complaint at 25–29, In the Matter of UBS Securities, Inc., No. 2008-0045 (Mass. Sec. Div. June 26, 2008), *available at* http://www.sec.state.ma.us/sct/sctubs2/ubs2_complaint.pdf (noting lack of training and understanding about ARS by UBS financial advisors that sold ARS) (link).

[23] *See* James B. Stewart, *Risks of a 'Safe' Investment Are Found Out the Hard Way*, WSJ.COM, Feb. 27, 2008, http://online.WSJ.com/article/SB120406650371394765.html (link).

[24] Regulation D, 17 C.F.R. § 230.501(a) (2010), *available at* http://edocket.access.gpo.gov/cfr_2009/aprqtr/pdf/17cfr230.501.pdf (defining an accredited individual investor to include banks and savings institutions as well as persons with an individual or joint net worth in excess of $1 million or person with an individual income in excess of $200,000 or joint income in excess of $300,000 in the two most recent years with a reasonable expectation of the same level of income in the current year) (link). The Restoring American Financial Stability Act of 2010 Senate bill would significantly change the operation of Regulation D and permit the SEC to disqualify certain Regulation D offerings. *See* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 926 (2010), *available at* http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf (link).

vestor tests as a key aspect of private market discipline. True assessment of investor qualifications should go beyond the check-the-box approach of some investor qualification questionnaires. For example, this could involve developing interactive investor knowledge tests (IKTs), which could be geared to the specific nature of varied investment opportunities. The purpose of such tests would not be to require a particular score from a prospective investor alone or together with the investor's representative, but to help ensure that potential investors and financial service providers are forced to focus on the types of financial instruments, trading strategies, and risks associated with potential investment opportunities.[25] Such IKTs could be used for their informational value (rather than their raw score) to help increase investors' awareness about what they should know, or at least investigate, prior to participating in a particular investment. A hedge fund, for example, could have a stated level of preferred IKT score for a particular investment opportunity. Investors below that level could participate, but they and hedge fund managers would be on notice that they might not understand the risks of the investment opportunity. IKTs could facilitate better incorporation of risk into decision-making by clarifying the nature of knowledge that might be desired for participation in particular investment opportunities.

Better risk education is an important factor in enhancing risk management. Some of the lack of attention to risk that led to the credit crisis is a consequence of incentive structures within the financial services industry. However, better risk education might encourage retail investors, sophisticated market participants, and regulators to more closely question transactions and investment opportunities, such as the Madoff Ponzi scheme, that seemingly offered a riskless premium return.[26]

3. Interactive Disclosure

In addition to regulatory penalty reform and greater focus on education, changes could also be made that promote greater disclosure surrounding financial markets, financial products, and risk. Regulated entity disclosure requirements should be supplemented to require additional disclosure concerning dynamic risk. Required risk disclosure under Regula-

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[25] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-200, HEDGE FUNDS: REGULATORS AND MARKET PARTICIPANTS ARE TAKING STEPS TO STRENGTHEN MARKET DISCIPLINE, BUT CONTINUED ATTENTION IS NEEDED 29 (2008), http://www.gao.gov/new.items/d08200.pdf (noting that "[t]he ability of market discipline to control hedge funds' risk is limited by some investors' inability to understand and evaluate the information they receive . . . ") (link).

[26] *See* Kara Scannell, *SEC Had Chances for Years to Expose Madoff's Alleged Ponzi Scheme*, WSJ.COM Dec. 15, 2008, http://online.WSJ.com/article/SB122928886040304911.html?mod=articleoutset-box ("The revelations are the latest blow to the reputation of an agency that has been criticized for insufficient enforcement and the failure to better monitor the dangerous risk-taking on Wall Street that triggered this year's financial crisis.") (link).

tion S-K,[27] which contains many of the specific disclosure requirements to which reporting companies are subject, reflects a largely top-down perspective that focuses on aggregate risks to the reporting entity, which may not adequately aggregate risks embedded in networks of connectivity that may reach down to the level of individual traders.[28] Mandatory disclosure about risk should be supplemented to include more bottom-up perspectives, including discussion of company risk management policies and training, as well as the specific ways in which all employee compensation, not just that of senior executives, aligns with the potential risks that employees may undertake. Such disclosure is particularly important for all employees that directly engage in capital market trading activities.

C. Revolving Doors and Consequences for Failure

In the final analysis, the credit crisis should provide lessons about the importance of appropriately addressing failure. Consumers have felt the consequences of the credit crisis. They were encouraged to invest in housing by government policies on interest rates and home-buying incentive programs.[29] Creative industry packaging of mortgages, some of which were "built to self-destruct,"[30] occurred alongside what some have characterized as significant declines in loan documentation standards and increases in subprime mortgage originations.[31] Prior to the credit crisis, a wide range of homeowners, not just subprime borrowers, engaged in risky behavior that essentially took a directional bet on the continued increase of housing prices. Some borrowers had insufficient incentive to avoid high-risk mortgage loans that they might not be able to pay.[32] In the credit crisis aftermath,

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[27] Regulation S-K, 17 C.F.R. § 229 (2009), *available at* http://www.access.gpo.gov/nara/cfr/waisidx_09/17cfr229_09.html (link).

[28] *See id.* at § 229.305, *available at* http://edocket.access.gpo.gov/cfr_2009/aprqtr/pdf/17cfr229.305.pdf ("In preparing the foreign currency value at risk disclosures, this registrant should report the aggregate potential loss from hypothetical changes in both the DM/ FF exchange rate exposure and the FF/$US exchange rate exposure.") (link).

[29] *See* Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, NYTIMES.COM, Oct. 23, 2008, http://www.NYTimes.com/2008/10/24/business/economy/24panel.html ("Mr. Greenspan's critics say that he encouraged the bubble in housing prices by keeping interest rates too low for too long and that he failed to rein in the explosive growth of risky and often fraudulent mortgage lending.") (link); Jo Becker, Sheryl Gay Stolberg & Stephen Labaton, *White House Philosophy Stoked Mortgage Bonfire*, NYTIMES.COM, Dec. 20, 2008, http://www.NYTimes.com/2008/12/21/business/21admin.html ("'This administration made decisions that allowed the free market to operate as a barroom brawl instead of a prize fight,' said L. William Seidman, who advised Republican presidents and led the savings and loan bailout in the 1990s. 'To make the market work well, you have to have a lot of rules.'") (link).

[30] Michael Lewis, *The End*, PORTFOLIO.COM, Nov. 11, 2008, http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom/ (link).

[31] *Id*.

[32] Martin Feldstein, *How to Help People Whose Home Values Are Underwater*, WSJ.COM., Nov. 18, 2008, http://online.WSJ.com/article/SB122697004441035727.html (link). Various government policies further encouraged consumer leveraging trends. The Bush administration initiated a program to encourage home ownership that permitted home purchases with no money down. Tax policies, includ-

consumers have been punished, in many instances far beyond the scope of any risk-taking activities they might have undertaken.[33] Although consumers in the U.S. do have the option of walking away from their mortgages, doing so is financially costly and likely to negatively impact their credit.[34]

In contrast to failures by consumers, failures by industry participants and regulators occur in an environment of revolving doors, where failure may be rewarded with a better position.[35] Revolving doors enable industry participants to move from current failures to future prospects. For example, being involved in the failure of a hedge fund has not limited future career options in a number of high-profile cases.[36] Although some firms such as Lehman Brothers were permitted to fail, many financial services institutions whose activities would otherwise have led to firm failure were saved by government intervention.[37] Even though the systemic failure rationales for

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ing the deductibility of home mortgage interest payments and tax exemption for capital gains from home sales adopted in 1997 during the Clinton administration, further encouraged consumers to purchase homes. *See* Vikas Bajaj & David Leonhardt, *Tax Break May Have Helped Cause Housing Bubble*, NYTIMES.COM, Dec. 18, 2008, http://www.NYTimes.com/2008/12/19/business/19tax.html (link). The Federal Reserve under Alan Greenspan maintained low interest rates that many assert led to a housing bubble. *Id.*; *see also* Joseph E. Stiglitz, *Capitalist Fools*, VANITY FAIR, Jan. 2009.

[33] *See* Clyde Ashley & Krystal D. Wilson, *The Credit Crunch and the Impact on the US Economy and Global Markets: How Damaging Will It Be?* 16 Proceedings OF AMER. SOC. BUSINESSES & BEHAVIORAL SCIS. 3–5 (2009), http://www.asbbs.org/files/2009/PDF/A/AshleyC2.pdf (describing negative impact of credit crisis on consumers, including increasing mortgage defaults and foreclosures, which has put downward pressure on housing prices and decreasing levels of available credit) (link); Simon Johnson, *Can the Federal Reserve Protect Consumers?*, N.Y. TIMES ECONOMIX BLOG, Aug. 13, 2009, http://economix.blogs.NYTIMES.COM/2009/08/13/can-the-federal-reserve-protect-consumers/ ("More broadly, the former Fed chairman Alan Greenspan famously stood by despite being warned by his colleagues about the housing bubble and the associated abuses of consumers. As the housing frenzy developed in 2003 and low-income people got sucked in and—many of them—suckered, Mr. Bernanke argued for a further lowering of interest rates on the basis of short-run macroeconomic considerations; apparently he was oblivious to the dangers that implied to consumer-as-borrowers.") (link).

[34] Nick Timiraos, *Some Buy a New Home to Bail on the Old*, WSJ.COM., June 11, 2008, http://online.WSJ.com/article/SB121314811278463077.html ("To be sure, walking away from a mortgage, even if legal, has plenty of drawbacks: Borrowers lose the ability to take out unsecured loans, since foreclosures can stay on a credit report for seven years. In some states, lenders can sue for assets, including a new house.") (link).

[35] Michael Lewis & David Einhorn, *The End of the Financial World as We Know It,* NYTimes.com, Jan. 3, 2009, http://www.NYTimes.com/2009/01/04/opinion/04lewiseinhorn.html (describing the SEC as "plagued by wacky incentives" based on prospect of future employment on Wall Street) (link).

[36] *See* Frank Partnoy, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 182–183 (2003) (noting that Kidder Peabody trader Joseph Jett, whose trades generated $350 million in losses for Kidder Peabody, was acquitted of securities fraud, avoided damages from civil lawsuits and revived his career, becoming chief investment officer of a multi-million dollar offshore investment fund) (link); James M. Clash, Robert Lenzner & Michael Maiello with Josephine Lee, *The $500 Billion Hedge Fund Folly,* FORBES.COM, Aug. 6, 2001, http://www.forbes.com/2001/08/06/070.html (noting that Michael Berger, Joseph Jett and John Meriwether of Long-Term Capital all found opportunities after their initial hedge funds failed) (link).

[37] OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 33–48 (2010), *available at* http://www.sigtarp.gov/reports/congress/2010/April2010_Quarterly_Report_to_Congress.pdf (giving

such rescues may be cogent and reasoned, preventing firms from failing poses a significant problem for the future. Institutions that cannot fail are likely to continue to take outsized risks that generate significant private profits on the upside and large public losses on the downside. Failures by individual industry participants and firms may thus not be sufficiently penalized.

Although industry failures have and should be highlighted, greater attention also needs to be paid to government failures. Prevention of future crises will greatly depend on the extent to which both government and industry participants can be held accountable for failure.[38] Although greater industry expertise and additional resources are needed at the SEC,[39] the revolving door between the SEC and Wall Street may have contributed to SEC regulatory failures.[40] Similarly, SEC staff supervision of the Madoff investigation may have been more concerned about damaging future career prospects than giving teeth to the SEC investigation.[41] Concerns about future career opportunities may also have been a factor in the SEC failure to pursue action against Ponzi operator Allen Stanford. The head of Enforcement in the SEC's Forth Worth, Texas office did not undertake an enforcement action against Stanford—despite repeated examinations by SEC staff

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overview of TARP programs and status of firms receiving TARP funds as of March 31. 2010) (link); *see also* BAIRD WEBEL, CONG. RESEARCH SERV., R 40438, ONGOING GOVERNMENT ASSISTANCE FOR AMERICAN INTERNATIONAL GROUP (AIG) 2 (2009), *available at* http://www.fas.org/sgp/crs/misc/R40438.pdf (describing the "essential failure" of AIG) (link); OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, INITIAL REPORT TO THE CONGRESS 41–90 (2009), *available at* http://www.sigtarp.gov/reports/congress/2009/SIGTARP_Initial_Report_to_the_Congress.pdf (listing recipients of bailout funds, which include financial services firms such as J.P. Morgan, Citigroup, Goldman Sachs, Morgan Stanley, and Bank of America, as well as AIG, General Motors, and Chrysler) (link); Bryan Burrough, *Bringing Down Bear Stearns*, VANITYFAIR.COM, Aug. 2008, http://www.vanityfair.com/politics/features/2008/08/bear_stearns200808 (describing the near failure of Bear Stearns) (link).

[38] Congress, for example, bears few consequences for legislation that produces failed and fragmented regulatory frameworks. Ironically, fear of failure at the SEC may have been a factor in the failure to pursue the Madoff investigation, while the desire to avoid a case that was not bullet-proof and bring a larger quantity of cases may have been a factor in the failure to pursue an enforcement action against the Stanford Ponzi Scheme. *See* Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story* (Georgetown Law Faculty Working Paper No. 116, 2009), *available at* http://scholarship.law.georgetown.edu/fwps_papers/116/ (describing how sensitivity to failure influences SEC investigations) (link).

[39] *See id*. at 4–6; Suzanne McGee, *Revolving Credit*, PORTFOLIO.COM, Dec. 3, 2009, http://www.portfolio.com/industry-news/banking-finance/2009/12/03/revolving-door-between-wall-street-and-government-must-be-reformed/ (link).

[40] *See* Tom McGinty, *SEC Lawyer One Day, Opponent the Next*, WSJ.COM, Apr. 5, 2010, http://online.WSJ.com/article/SB10001424052702303450704575160043010579272.html (link); Pam Martens, *Madoff and the SEC's Revolving Door*, Counterpunch.org, Aug. 31, 2009, http://www.counterpunch.org/martens08312009.html (link).

[41] Lewis & Einhorn, *supra* note 35 ("If you work for the enforcement division of the S.E.C. you probably know in the back of your mind, and in the front too, that if you maintain good relations with Wall Street you might soon be paid huge sums of money to be employed by it.").

that strongly suggested that Stanford was running a Ponzi scheme, later sought to represent Stanford, and for a short period actually did so.[42] One recent empirical study suggests that biases in enforcement may reflect systematic SEC under-enforcement against large firms.[43] This may be the product of regulatory capture, a potential risk with any regulatory framework. Regulatory principles that emphasize transparency may be one approach for dealing with regulatory capture. In 2007, the Senate Committees on Finance and the Judiciary conducted a joint investigation of the SEC over "allegations of lax enforcement, improper political influence, [and] whistleblower retaliation."[44] This investigation was a response to negative publicity following the SEC termination of an employee involved in a hedge fund investigation, in which assertions were made about improper political influence in SEC enforcement investigations.[45] The joint congressional investigation also drew attention to the revolving door between the SEC and Wall Street that some assert improperly influences SEC investigations.[46]

Steps should be taken to prevent and reduce the extent to which revolving doors may intensify the likelihood of government or industry failure. A number of options might be available,[47] including strict enforcement of

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[42] SEC, OFFICE OF INSPECTOR GENERAL, REPORT NO. OIG-526, INVESTIGATION OF THE SEC'S RESPONSE TO CONCERNS REGARDING ROBERT ALLEN STANFORD'S ALLEGED PONZI SCHEME 17, 27–28, 131–148 (2010), *available at* http://www.sec.gov/news/studies/2010/oig-526.pdf (link).

[43] *See The Firing of an SEC Attorney and the Investigation of Pequot Capital Management: Hearing Before the S. Finance and Judiciary Comms.*, 110th Cong. 37 (2007), *available at* http://permanent.access.gpo.gov/lps86499/Leg_110_080307_SEC[1].pdf [hereinafter *Pequot Report*] ("Evidence we reviewed suggests that the reluctance to question Mack represents a much more subtle and pervasive problem than an individual partisan political favor. SEC officials were overly deferential to Mack—not because of his politics—but because he was an 'industry captain' who could hire influential counsel to represent him.") (link).

See also Joe Nocera, *Chasing Small Fry, S.E.C. Let Madoff Get Away*, NYTIMES.COM, June 27, 2009, http://www.NYTimes.com/2009/06/27/business/27nocera.html?pagewanted=1 (link); Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers* 8 (Harvard Law and Economics Discussion Paper No. 27, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1333717 ("Instead, any bias towards big firms is systematic, and thus consistent both with complaints about the agency's limited resources and with concerns about the impact of the 'revolving doors' between the SEC and the industry.") (link).

[44] *Pequot Report, supra* note 43, at 1.

[45] *Id*. at 7.

[46] *Id*. at 82–87 (discussing post-SEC employment of an Associate Director in the SEC Enforcement Decision, who joined the law firm that had contacted the SEC concerning questions relating to a firm client's role in a transaction being investigated by the SEC, and focusing on whether this employee recused himself from the investigation in a timely manner after he began pursuing employment with the same law firm).

[47] Existing conduct and conflict of interest rules already address questions relating to revolving doors. For example, SEC Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission Rule 8 "prohibits a former Commission employee from appearing before the Commission in a representative capacity in a particular matter in which he or she participated personally and substantially while an employee of the Commission." SEC, *supra* note, 42 at

bans, mandatory time lags on future employment, or clear firewalls or recusal policies with respect to prior employment.[48] Congressman Barney Frank's response to a staffer who went to work for a financial services industry lobbyist may be an approach to consider.[49] When a top staffer of the House Financial Services Committee went to work as a lobbyist for the owner of the largest credit default swap houses, Congressman Frank banned committee staff from talking to the former staffer about financial regulation or financial matters until Frank no longer chairs the Committee.[50] In the end, such steps may be one important way to address the widespread industry and regulator shortcomings that led to the credit crisis.

II. CONCLUSION

The credit crisis is a watershed event that illustrates much about both the importance and limits of regulation. It demonstrates, for example, how national regulatory frameworks may be ineffective in increasingly globalized financial markets. The credit crisis underscores the need for regulatory reform that creates frameworks that fit the contexts of their application. Regulation also needs to address the persistent problem of failure and how to ensure that existing incentives do not reward failure by either regulators or industry participants. Regulation is also increasingly a factor in global competitiveness, as well as a mechanism that can instill confidence in financial market integrity. Confidence is a huge factor in the financial services industry.[51] In addition to causing significant market volatility and instability, market crises may deleteriously impact market confidence. In an industry where physical assets are few and intangible assets are paramount, a failure in confidence may also cause financial markets to freeze. A crisis of confidence can be difficult to overcome.

Market crises often test confidence and may even trigger regulatory reactions that toughen the application of existing legal frameworks or lead to the adoption of new ones in response to a particular market crisis. The current market crisis unfolded in arenas with significant existing regulation. Existing reform legislation fails to take sufficient account of the implications of regulatory failures that contributed to the credit crisis. On May 20, 2010, the U.S. Senate passed the financial reform bill sponsored by Senator Chris Dodd.[52] Although this new legislation purports to address the under-

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10 (citing 17 C.F.R. § 200.735-8 (a)(1) (2010)).

48 *Pequot Report*, *supra* note 43, at 7–8.

49 Posting of Paul Blumenthal to Sunlight Foundation Blog, *Revolving Door Staffer Rebuked, Permanently Banned From Talking to Committee Staff* (Apr. 1, 2010, 15:11), http://blog.sunlightfoundation.com/2010/04/01/revolving-door-staffer-rebuked-permanently-banned-from-talking-to-committee-staff/ (link).

50 *Id*.

51 James Surowiecki, *Public Humiliation*, THENEWYORKER.COM, Sept. 29, 2008, http://www.newyorker.com/talk/financial/2008/09/29/080929ta_talk_surowiecki (link).

52 Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010), *available at*

lying problems that led to the credit crisis, as has been the case historically in the United States, it targets the causes of the last crisis rather than achieving overarching reform of vulnerabilities and other problems in financial market regulatory frameworks more generally.[53] More fundamental regulatory reforms are needed to address potential future market crises. Reactions to the current crisis should thus be initiated at the same time as an overall assessment of existing regulation prior to the adoption of any new regulatory requirements. Existing regulatory frameworks should be evaluated and new regulations adopted taking into account specific regulatory principles. Further, regulatory reforms in response to the current crisis should be shaped by acknowledgment of a fundamental shift in the nature of trading activities and financial market networks. Changing technology has shaped trading activities in a broad range of entities, both regulated and unregulated. The incentives that govern traders and other market participants in such trading contexts should be key considerations in proposed regulatory reforms. Such incentives can play a significant role in determining the extent to which financial market networks embody speculative risk-taking trading activities or reflect more cautious approaches to risk that truly incorporate private market discipline and minimize the potential for systemic market instability, network failure, and industry and government failure.

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http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf (implementing greater regulation of derivatives, establishing new consumer protections for financial products, and creating a liquidation process for winding down failing systemically risky financial institutions to avoid bailouts) (link).

[53] David M. Herszenhorn, *Bill Passed in Senate Broadly Expands Oversight of Wall Street*, NYTIMES.COM, May 20, 2010, http://www.NYTimes.com/2010/05/21/business/21regulate.html (discussing the Senate bill, noting that some experts characterize the bill as targeting past problems and thus leaving the financial system vulnerable to a future collapse) (link).