Enablers of Exuberance
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DISCUSSION DRAFT

Enablers of Exuberance:
Legal Acts and Omissions that Facilitated the Global Financial Crisis

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I. Introduction

This paper explores certain legal acts and omissions that facilitated the over-leveraging and near collapse of the global financial system. These "Legal Enablers" fostered the boom that enriched a class of financial intermediaries who followed a storied tradition of gambling away "other people's money."[2] These mechanisms also made the pain of the bust disproportionately felt by the middle class and poor while shielding the middlemen who created the problems. These legal Enablers permitted the growth of a shadow banking system, without investment limits, transparency or government oversight. In the shadows grew a variety of highly leveraged private investment pools, undercapitalized conduits of securitized loans and speculation in complex credit derivatives. The rationale for allowing this unregulated, parallel system was that it helped to create innovation and provide liquidity. The conventional wisdom was that any risks associated with a hands-off approach could be managed by the "invisible hand"[3] of the market. In other words, instead of public police, it relied upon private gatekeepers. A legal framework including legislation, rules and court decisions supported this system. This legal structure depended upon corporate managers, counterparties, "sophisticated investors" and the market generally to prevent irrational conduct. [4]

The hands-off approach was premised upon a series of beliefs or expectations. The first was that corporate managers would not sacrifice long-term shareholder value for short-term gains. The second was that trading counterparties would monitor each other closely and discourage excessive risk. The third was that "sophisticated investors" had the ability to select and monitor "private" unregulated investment options and that such decisions affected the direct owners, not underlying investors and market integrity. And, the catch-all fourth belief was that even if there were blips and bubbles, the market would quickly "heal itself" before causing any major disruption or harm to society.

Only after the global financial crisis ("GFC") struck and the government committed nearly $13 trillion and spent almost $4 trillion,[5] to rescue the financial system and the economy,[6] did many ministers of "private ordering" admit that these premises were faulty. They were shocked to find that, contrary to their expectations, corporate managers were willing to pursue unsustainable short-term strategies.[7] When executives threatened shareholder value, they greatly enriched themselves personally. This was revealed not just in elevated pay that was decoupled from performance, but also in the behavior of executives in times of crisis, some literally off playing bridge while their firm went under.[8] And sophisticated investors were out-matched by the complexity of new instruments.

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[2] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 18 (1914) ("The power and the growth of power of our financial oligarchs comes from wielding the savings and quick capital of others.").

[3] ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

[4] Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management*, (Apr. 2009), available at http://www.treas.gov/press/releases/reports/hedgfund.pdf. Even after the collapse of LTCM, the official view as that private markets would work to somehow regulate excessive leverage. The President's Working Group on Hedge Funds in deciding to maintain a hand's off approach with hedge funds, expressed the view that "in our market-based economy, market discipline of risk taking is the rule and government regulation is the exception. . . . Government regulation of markets is largely achieved by regulating financial intermediaries that have access to the federal safety net, that play a central dealer role, or that raise funds from the general public."

[5] Paul Vigna, *The Recovery Conundrum*, WALL ST. J, Aug. 31, 2009, available at http://blogs.wsj.com/marketbeat/2009/08/31/the-recovery-conundrum/

[6] Mark Pittman & Bob Ivy, *Financial Rescue Nears GDP as Pledges Top $12.8 Trillion*, BLOOMBERG, Mar. 31, 2009, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=armOzfkwtCA4

[7] *See*, e.g., Testimony of Dr. Alan Greenspan, Committee of Government Oversight and Reform (October 23, 2008) at 2.

[8] Notoriously, Bear Stearns CEO James Cayne disappeared without phone or email access during a bridge tournament while two hedge funds collapsed In July 2007. See James B. Stewart, *The Real Cost of Bailing Out Bear Stearns*, WALL ST. J., Mar. 26, 2008. If that were not enough, in March of 2008, while Chairman, he and the new CEO, Alan Schwartz were both playing bridge at the same tournament as the Bear's shares plunged. Without a $30 billion government guarantee, Bear would have gone bankrupt. Meanwhile, Cayne, was responsible for the "high-risk

Unable to monitor, many were deceived and sometimes outright swindled. When President Bush declared "I've abandoned free-market principles to save the free-market system,"[9] it was evident that the market could not heal itself.[10]

These private gatekeepers failed for a few reasons. First, there was an explosion of increasingly varied and complex financial instruments. Even the most intelligent, experienced individuals using complex mathematical models could accurately price them or understand their risk because there was not enough performance history, transparency as to the amounts outstanding and they were incredibly interdependent. Indeed some estimated that it would take many days for a powerful computer to calculate the price of some collateralized debt obligations.[11] This was aggravated by the fact that whom the law deemed to be "sophisticated" enough to purchase these instruments and invest in unregulated pools were not defined by particular skills or knowledge, but wealth alone. Second, compensation structures at all levels encouraged short term gain over long-term value. Third, tremendous personal rewards came to those individuals who participated in these schemes and the players understood that it was a career stopper to be contrarian during this bubble.

It should not have taken the GFC to call the hands-off approach into question. There was plenty of historical evidence that demonstrated the dangers of excessive leverage and speculation. And, there was a largely effective legal framework available that had worked to rein in this behavior by mutual funds. This paper attempts to identify the causes of this collective amnesia. It also offers a challenge to those who resist regulation by building arguments built upon these shaky premises.

Borrowing from the social sciences, this paper deems these acts and omissions "Enablers." An enabler helps further another person's self-destructive, addictive behavior, protects the abuser from suffering consequences and denies both the abuse and the harm caused to others. The enabler takes these actions due to his or her own dependency upon the abuser. By analogy, we created laws that further an unhealthy dependency on excessive borrowing or leverage and speculation. Legal Enablers protected those who engaged in these risky practices from suffering economic and legal consequences. In addition, Legal Enablers denied redress for the harm caused to the most vulnerable victims of this credit addiction. These Enablers depend upon the faulty premises identified above – the irrational belief in the police power of corporate managers, counterparties, sophisticated investors and the market to heal itself.

There were a considerable number of Legal Enablers of the recent global financial crisis ("GFC"), however this paper focuses upon those that contributed to the excessive leverage and speculation in the financial system and/or have the potential to ignite a future boom and bust cycle. First, investor protections were diminished and systemic risk elevated when the exceptions from the securities laws for hedge funds and other "private" investment pools were expanded. These unregulated pools were supposed to be limited to "sophisticated investors" in private offerings. However, with additional loopholes created in the 1996-7, these pools were able to flourish by attracting more investors through "retailization." Unlike mutual funds, hedge funds were not restricted in areas such as use of excessive leverage. Individuals were exposed to risky investments from which they would have been protected as direct, retail investors. Yet, because their assets were gathered and then invested into these "private" pools by "sophisticated investors" such as U.S. mutual funds, corporate pension funds, public pension funds and union pension funds, they were exposed. The exceptions to government oversight through the securities laws were premised upon the ability of private gatekeepers to oversee increasingly complex instruments. However, our expectations of the ability of sophisticated investors to select and monitor investments proved unreasonably high.

Second, the Commodity Futures Modernization Act of 2000 fostered the credit default swap ("CDS") pandemic. These credit derivatives insured and ensured the origination and global distribution of risky securitized loans. Third, interpretations of and the wrong amendments to the U.S. Bankruptcy Code helped to support unwise financing trends and helped push overloaded borrowers into more debt. Fourth, court decisions in the area of corporate governance and securities fraud have created incentives for financial intermediaries to seek short-term,

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leverage" that caused the firm to implode, yet personally, he reaped millions. In the midst of the credit crisis, he purchased two apartments in Manhattan for $27.4 million, for example.

[9] Bush Weighs Options to Help Automakers, BOSTON.COM, Dec. 17, 2008 (Bloomberg news story), available at http://www.boston.com/business/articles/2008/12/17/bush_weighs_options_to_help_automakers/

[10] Indeed, we have also seen what can happen when the self-healing approach is forced. When Hoover followed Secretary of the Treasury Andrew Mellon's advice to allow for liquidation and thereby allow "enterprising people" to "pick up the wreck from the less competent people." He famously demanded: "Liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate." JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 5 (1995) (citing Hoover's memoirs).

[11] James Crotty & Gerald Epstein, *Avoiding Another Meltdown*, 52 CHALLENGE 1:9 (2009).

unsustainable, if not illusory profits and also shielded those same middlemen from liability. The convergence of undercapitalized mortgage pools, credit default swaps and leveraged hedge funds created the perfect storm.[12]

After the bust, these Legal Enablers helped the middlemen to not just walk away unscathed, but wealthier than ever, and to leave the rest of society bereft. Uncertainty about the bankruptcy treatment of complex instruments and transnational structures made commercial bankruptcy through Chapter 11 less viable, thus the "middlemen" financial firms received massive taxpayer-funded bailouts. Meanwhile, Chapter 13 after the 1993 Court decision, prevented consumers from down-sizing underwater mortgages. Finally, the ability for ultimate investors to seek redress has been eroded through securities laws changes and legal doctrines shielding fiduciaries from liability.

This paper contends that if we wish to restore investor confidence and sustain a stable financial system, we must stop enabling the excessive leverage and speculation that create cycles of irrational exuberance followed by financial panics. Specifically, it recommends that we eliminate the loopholes that allow unregistered investment pools broad discretion to operate in the shadows, without transparency or supervision, to engage in self-dealing or related-party transactions, to inaccurately value and inadequately protect assets and to take on excessive leverage and illiquid portfolio holdings. This surpasses the Obama Administration's proposal to bring hedge fund advisers under the Investment Advisers Act. In addition to the disclosure and enforcement that would affect hedge funds and advisers under that bill, this paper recommends revisiting the substantive protections of the Investment Company Act that apply to mutual funds. While the federal securities laws generally used mandated disclosure and enforcement as tools to regulate conduct, the country learned in 1929 and again in 2008 that regarding investment pools, disclosure is not enough. Substantive restrictions are more effective tools to protect pools of other people's money. As part of this recommendation, the myth of the sophisticated investor and the private offering are confronted.

Second, this paper suggests that we avoid allowing devices, like credit default swaps, initially designed to minimize and distribute risk to be used for speculation or gambling. Third, it advises that we change our Bankruptcy Code to allow lien-stripping under Chapter 7 and 13, thus discouraging poor underwriting and inflated home valuations and protect the most vulnerable from the impact of the financial system abuses. Fourth, we should remove the obstacles that shield corporate officers, directors and others from liability for enabling destructive behavior.

This paper will also address the arguments that might be offered that would resist these reforms. These include, among others: (1) that we should not regulate hedge funds because they did not cause the GFC; (2) sophisticated investors can take care of themselves; (3) human nature (i.e. greed) cannot be successful constrained; (4) government regulation is ineffective and undermines business growth; (5) lien-stripping is too expensive and creates moral hazard; and (6) one should not second guess the behavior of corporate directors and managers trying to operate in the midst of a market-wide correction or collapse.

II. The Global Financial Crisis: The Credit and the Damage Done

"[I]t was the age of wisdom, it was the age of foolishness".[13]

A. The Perfect Storm: Subprime Mortgage-backed Securities, Credit-default Swaps and Leveraged Hedge Funds

It is widely believed that the Global Financial Crisis began in mid-2007 with defaults on subprime mortgages on homes in the United States. These mortgage loans had been pooled and securitized – with the proceeds – the principal and interest on these loans passed through or sliced and diced and "paid" through to securities holders located in the US and beyond. The problems spread across the globe and to other investments.[14] Thus, to understand the nature of the crisis some general background on mortgage securitization, subprime lending and credit default swaps is useful.

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[12] SEBASTIAN JUNGER, THE PERFECT STORM: A TRUE STORY OF MEN AGAINST THE SEA (1997) (The term "the perfect storm" was used in 1991 by the National Weather Service to describe three separate weather conditions that converged at sea and sunk a fishing vessel off the New England Coast. The term was popularized due to the success of the eponymous book, and has come to mean the convergence of any three events which create a once-in-a-life time disaster).

[13] CHARLES DICKENS, A TALE OF TWO CITIES 1 (1859).

[14] GAO REP'T, *infra* note __.

1. Background on Mortgage Securitization

The housing market generates very, very large revenues. It is estimated that fees associated with home sales and mortgage originations between 2003 and 2008 totaled $2 trillion.[15] Some of these fees are paid to real estate brokers for putting together a willing buyer and seller. Other fees are paid to mortgage brokers and lenders for helping the buyer obtain the capital necessary to purchase a home or refinance an existing mortgage.

People buy homes on credit for a number of reasons. The cost of homes exceeds the amount of savings most people have. In addition, when buying the home on credit, the monthly payment may be close to what a rental payment would cost. Many hope that the home will appreciate in value over time and can be sold later for retirement or to purchase another, larger home. In addition, buying on credit allows the homeowner to leverage. For example, consider a home selling for $300,000. Assume the purchaser borrows $270,000 and puts down 10% of the purchase price (or $30,000) of her own savings. She has a ratio of asset value to equity investment (leverage ratio) of 10 to 1. If the asset (her home) goes up by 10% in value to $330,000, she has achieved a 100% return on her investment or doubled her money. In contrast, if she had bought the home for $300,000 in cash and it rose by 10%, she would only achieve a 10% return on her investment. Similarly, with a 10:1 leverage ratio, if the home declined in value by 10% she would lose 100% of her original investment. If the home declined by 20%, she would lose 200% of her investment and, depending upon how far along she was in making mortgage payments, the principal owed on the loan might exceed the value of the house. If the amount she owes exceeds the value of her home, she would be "underwater."

On the other side of the transaction, institutions loan money to home buyers for a number of reasons. In a simple example, a lending institution would consider the borrower's current income relative to her debt burdens, and her record of paying back loans in full and on time. Based upon this credit profile (as well as the prevailing rate at which the lender itself could borrow money), the institution would establish an interest rate. The interest payments are meant, in part, to compensate the lender ("creditor") for the credit risk associated with the borrower's likelihood of default. In addition, to be extra careful, the creditor would require the borrower to pledge the property as collateral or "mortgage" the house.[16] Thus the borrower is the mortgagor and the creditor institution the "mortgagee." The institution would then collect regular payments of principal and interest from the borrower. If the borrower defaulted, the creditor could eventually repossess the home and sell it, and in some states also sue the borrower for any loss in value between the sale price and the remaining principal owed. Using the example from above, upon closing the deal (commencing the loan), the lending institution would have a $270,000 loan on its books. This loan would be considered an "asset." The institution then would carry the risk that this loan might default and would need to be extra careful upfront that this and other similar loans represented sound risks to take. The lending institution could sell this "asset" for a little more than the principal amount to a third party, such as one of the federal government sponsored enterprises, including Ginnie Mae, Fannie Mae or Freddie Mac.[17] Due to this "secondary market" in mortgages, the lending institution above, could now recycle that money and lend to a new borrower. In addition, selling the loan eliminates the risk of default.

This process changed dramatically, beginning in the early 1970s.[18] At that time residential mortgages became securitized.[19] Ginnie Mae created the first publicly traded mortgage-backed security ("MBS") in 1970. It transferred a group of mortgages into a pool or conduit and sold interests in that pool to investors. An interest in the pool was called a pass-through certificate and entitled the owner to a fractional, undivided share of the mortgage principal and interest payments. Ginnie Mae provided a guarantee to the certificate owners. Thereafter Fannie Mae and Freddie Mac also launched programs to securitize mortgages, however in those programs, the agencies issued the certificates. While the Ginnie Mae certificates had the explicit US government guarantee, the others had an implicit guarantee, owners believed they were nearly as safe.[20] Given the structure of these pools, the agencies only grouped together loans of similar size and duration. As a result of these programs, the cost for homeowners to borrow was said to have dropped by 100 basis points (or one percent).[21]

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15 Crotty & Epstein, supra note __ at 7, citing John Gapper, *The Fatal Banker's Fall*, FINANCIAL TIMES, Oct. 1, 2008.

16 This paper will refer to the entire property as the "house" or "home" for the sake of simplicity.

17 In addition to the agencies, the private sector also issues MBS and CMOs.

18 *See*, DIV. OF INV. MGMT., U.S. SEC & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 5 (1992).

19 As will be noted later, however, there was an earlier, "crude" form of securitization in the late 19th Century and in the 1920's-30's.

20 HALF CENTURY, *supra* note _ at 7-8.

21 JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 12, Produced by McKinsey & Company 1988).

Innovation followed in 1983 when a new structure known as the collateralized mortgage obligation ("CMO") was developed. Like a plain vanilla MBS, mortgage loans were pooled and certificates were issued. However, with a CMO, the cash flows were carved up. The pool (sometimes called a conduit) would issue different classes of certificates called "tranches." Each tranche represented a different payment stream. These certificates were considered debt obligations or "bonds." In other words the conduit borrows from the bond purchaser and must pay back principal and interest.

Each class of bond would represent a different part of the cash flows emanated from the underlying mortgage loans. There were a variety of ways to slice and dice the streams of payments. Each bond type would have a stated maturity (such as 2, 5, and 10 years) and a unique coupon rate (the percent interest paid). The amount of interest paid to a bond holder would increase with the relative risk of the slice of payments the tranche represented. The interest rates paid could be fixed or variable, with the variable rate link to the London Interbank Offered Rate ("LIBOR"). LIBOR is the interest rate at which banks in London borrow from other banks on an unsecured basis.[22] Thus a "safer" bond might pay LIBOR plus 25 basis points (LIBOR plus ¼ of a percent) and a riskier one LIBOR plus 250 (LIBOR plus 2.5%). When the credit quality deteriorates, these rates increase substantially.

The techniques associated with mortgage loan securitization are applied to a variety of loan classes including corporate loans, high-yield bonds (aka junk bonds), credit card receivables, auto loans, equipment leases, airplane leases and the like. The common theme is that some business or institution lends money to a borrower, creating an obligation. This obligation is pooled with other similar obligations into a conduit and the conduit issues bonds to investors. These are variously called collateralized debt obligations ("CDOs"), with CMOs being just one subset of CDO. Often structures holding residential mortgages are called residential mortgage backed securities ("RMBS"), however for the sake of clarity, this paper will use the term CDO.

CDOs were thought to minimize risk. In a giant pool of mortgages, some are bound to default (or repay early). These acts reduce the amount or principal earned by the pool (and the amount of interest earned). With a plain vanilla structure (such as the Ginnie Mae conduit described above), each bond would take an even share of these losses. This works well if the default and prepayment rates are low. However, with riskier assets, the result would be poorer performance. This made it difficult to sell bonds on pools of subprime mortgages (or other risky assets). The credit rating agencies would give these poor ratings and the big spenders, institutional buyers with billions at their disposal would pre prohibited from buying them. So, by slicing away the riskier pieces, it was easier to sell the safer ones to the institutional buyers.

For example, the "safer" tranches are those that receive payments made by homeowners early in the mortgage loan. These slices were thought to be "investment grade." The safest is known as the "most senior" tranche.[23] Thus, slices farther along in time were riskier and needed to compensate the bond holder with a higher interest payment. The mid-pieces were "mezzanine." The riskiest piece is the equity (or sometimes preferred) tranche. This is often called the "first loss position."[24] Bond holders of this tranche are not paid until all others are paid off in full. Some CDOs are set up so that tranches get paid in sequence. In other words, in some cases the senior or "safest" tranches get paid in full before the next tranche gets any principal and interest payments. In other structures, all tranches receive portions of interest payments, but principal payments are made in sequence.[25] Given that tranches have long maturities sometimes of 10 years or more, the subordinated tranches, may not get paid at all or for a long period. Thus they are considered very hard to trade (illiquid).[26] CDOs have grown so complex that some CDOs hold tranches of other CDOs.[27] Each tranche of the CDO receives a rating from at least one of the major rating agencies.

While the investment grade bonds from these tranches were easy to sell, it was harder to sell the bonds representing the mezzanine and equity portions. Often these risky pieces were kept on the books at the institutions who create them. They are called the "toxic waste." While sponsors may own some of the toxic waste, they prefer to

[22] For more details on the use of LIBOR as a reference rate, see http://www.bbalibor.com/bba/jsp/polopoly.jsp;jsessionid=aGRplK67vq79?d=1621

[23] THOMAS P. LEMKE, GERALD T. LINS, KATHRYN L. HOENIG & PATRICIA S. RUBE, HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE 310 (2008-2009).

[24] LEMKE at 311.

[25] LEMKE at 317.

[26] LEMKE at 311.

[27] LEMKE at 311.

pass that risk along by selling the equity tranche to someone else. And, they found willing buyers – the hedge funds.[28]

It is worth commenting on how each participant in the distribution chain benefits from this complex structured financial arrangement. In addition, it's important to understand how the initial risk of default moves along this distribution chain and where it rests. Using the example above, and simplifying the facts for the purpose of this illustration, the homeowner borrows $270,000 to purchase a $300,000 home. The homeowner may work directly with a lending institution or an independent mortgage broker. The bank loans the money to the homeowner. Any independent or in-house broker involved also earns a fee. The bank then has the risk that the borrower will default. The bank also has the risk that the borrower will pre-pay principal. This might be in part, or, if the borrower sells the home, in full. This means the lender losses out on the lucrative interest payments over the life of the mortgage. This bank is the "Originator." The bank and the mortgage broker, if any, earn fees paid by the borrower. These include points and closing costs.[29] The Originator also earns money when it sells the loan to a larger financial institution or a government agency for an amount, or premium, slightly greater than $270,000. In large pool of mortgages worth $100 million, the Originator might receive $102 million, or a premium of $2 million.[30] The bank no longer has the risk of loss, though the bank may stay on or another entity who buys the loan will become the "servicer" of the mortgage loan, collecting the payments and passing them along the chain. Regarding the risk, in other words the original lenders:

> " did not have to worry very much about the risk of default, because they rolled these mortgages into packages called Mortgage-Backed Securities, which they then sold. They got to be off-risk within a few weeks, because by then these MBS belonged to other financial organizations."[31]

The second institution (private or government agency) who buys the loan on the secondary market now has the risk of loss. Let's call the second institution the "Sponsor." The Sponsor sets up a conduit and sells the loan (and many others similar loans) to the conduit. This conduit is often called the "Issuer." Alternatively, the Sponsor is referred to as the Issuer, by some. The Issuer sells bond to investors. The investors who purchase these bonds provide money to the Issuer. The proceeds of the bond sales are given to the Sponsor. The Issuer (conduit) is set up to be bankruptcy proof. That is, it is designed to be out of the reach of the Sponsor's creditors in the event the Sponsor becomes insolvent.

When the Sponsor sells these "assets" to the Issuer, it can sometimes take those assets off its books. Just like the lending institution in the first example above who sells the loan to an agency, the Sponsor hopes to be freed up to lend to more borrowers (or to purchase more loans). Beyond a matter of preference, this relates to regulations regarding capital adequacy and leverage at financial institutions. In short, there are limits the amount of assets (loans and so on) various financial institutions can have. So, converting the assets to cash helps with these regulatory requirements.[32] What is complicated though, is the question of whether the Sponsor truly has transferred its risk to the conduit. Indeed, Sponsors often need to buy a good portion of the riskiest bonds. So while the Sponsor may have sold the original loans to the conduit, because it purchases bonds from the conduit, it in fact keeps some of the risk.

In addition, the investors who purchase the bonds take on a portion of the default risk (and some take on the prepayment risk depending upon how it is sliced and diced and which tranche they buy), that we can trace back to that original borrow and others like her. The risk got distributed in varying amounts to the bond classes. As noted above, the level of risk that each bond investor takes on relates to where the tranche falls in the order of payments. In addition to receiving payment for the loans, sponsors may receive other value from these structures. Some CDOs are designed to allow the sponsor to take assets off balance sheet. CDOs can also be designed to arbitrage, where the Sponsor makes money on the difference or spread between the cash flow from the mortgages and the amount that had to be paid out (the LIBOR plus coupon rates).[33] Thus, if the mortgages performed better than expected, there

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[28] Paul Tustain, Bear Stearns and MBS Hedge Funds: What are the Real Risks Today? SAFE HAVEN, Jun. 22, 2007, available at http://www.safehaven.com/article-7812.htm

[29] Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Sub-prime Mortgage Credit* 5, The Federal Reserve Bank of New York Staff Report No. 318, Mar. 2008

[30] Ashcraft & Schuermann at 5.

[31] Tustain, supra note __.

[32] HALF CENTURY, *supra* note __.

[33] See FRANK J. FABOZZI & STEVEN V. MANN, THE HANDBOOK OF FIXED INCOME SECURITIES 670 (2005)

would be extra money to distribute to the equity tranche, which might be owned in part by the sponsor. On the other hand, if the mortgages underperformed, the losses would be absorbed (first) by those with the riskier tranche bonds in that they might not get fully paid back or paid at all. They often receive payments for their work setting up the conduit, issuing the bonds and making necessary government filings.[34]

In theory, this was a brilliant innovation. It helped direct capital to homeowners; it helped to channel the risk of default and allocate it to those who could best take it on and reward them handsomely for doing so. However, the devil was in the practical details. Let's return to that borrower from the example above. If a bank was keeping that loan on the books, and not selling it into the secondary market at all, the underwriting institution who originated the loan would have a greater incentive to investigate her credit history and gauge the likelihood of default (and prepayment) by considering how much total debt she would have relative to her income, the employment conditions in the area and a variety of other factors. In addition, the institution would have a greater incentive to monitor the borrower's performance. In contrast, if that loan is being originated for the purpose of sale to another entity, (the "originate to distribute" model), that lending institution, is laying off the risk and thus has less incentive to do either. As it is said, responsibility follows risk. Thus lenders can cut corners and offer loans to borrowers who would not have qualified if they were risking their institution's health. Another problem with this securitization model is that pricing a particular tranche is highly complicated. And even well-designed computer models are merely guidelines.

The risk of given tranches depended upon a variety of economic conditions in addition to the various borrowers' behaviors. When Wall Street decided to use mortgages for credit derivatives, it was not as easy to predict default rates. While complex mathematical formulas are used, surprisingly, very important inputs are unavailable. For example, individual borrowers' credit histories were typically unavailable to investors.[35]

People working with these computer models did not have enough history and did not take seriously the small percentage chances of a major catastrophe. In fact, many bankers scoffed at considering these conditions, admitting that if they occurred, the whole market would be melting down[36]. In other words, they would be able to get lost in a crowd of poor performance and escape blame. Another problem with these conduits was that they were often undercapitalized or leverage. That is to say that the amount of money collected from bond holders was a small fraction of the total assets.

In early iterations of these structures, for example, J.P. Morgan created a shell and "sold" it around 300 corporate loans of $9.7 billion that had been on its books. The conduit then issued $700 million in bonds to investors. This represented less than 8% of the risk. This was described as equivalent to a homeowner purchasing an insurance policy to cover a $1 million home from an insurer who only has $75,000 reserved.[37] JP Morgan would have to cover the losses above and beyond the $700 million unless it could take this off its books. In order to remove this risk, J.P. Morgan "sold" the risk to the American International Group, through its financial products group. Well-versed in excessive, unsound debt, this group housed former traders who helped to blow up Drexel Burnham Lambert through the creation and sale of "junk bonds" in the 1980s.[38] This division of AIG is also discussed later in this paper.

Twenty years after that first Ginnie Mae mortgage securitization, by 1991, 42% of all home mortgage debt[39] was securitized.[40] By the end of 2008, there was more than $14 trillion in mortgage debt, of which $11 trillion was residential mortgages.[41] Of the total $14 trillion in mortgage debt, $7.6 trillion, or more than half was held by shells – mortgage pools or trusts.[42] Around $5 trillion was held by major financial institutions.

Thereafter, an important shift in the mortgage securitization market occurred. Historically, "the origination of mortgages and issuance of mortgage-backed securities (MBS) was dominated by loans to prime borrowers

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34 Ashcraft & Schuermann at 5.
35 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 67 (2009).
36 TETT, *supra* note __.
37 TETT, *supra* note __ at 55.
38 TETT, *supra* note __ at 62.
39 Backed by 1 to 4 family residences.
40 HALF CENTURY, *supra* note _ at 5.
41 Board of Gov. of the Fed. Res. Syst., Mortgage Debt Outstanding, Release Date, Mar. 2009, available at http://www.federalreserve.gov/econresdata/releases/mortoutstand/mortoutstand20090331.htm
42 *Id.*

conforming to underwriting standards set by the Government Sponsored Agencies (GSEs)."[43] By 2006, non-GSEs originated 45% more than the GSEs and issued 15% more certificates (in value).[44]

2. Subprime Mortgages

A subprime mortgage loan is intended for borrowers with a poor credit history.[45] Often brokers and Originators of subprime mortgages engaged in predatory lending practices. With predatory lending, "the borrower would have been better off without the loan."[46] They took advantage of borrowers' lack of experience, charging excessive fees, encouraging them to borrow more than they could hope to pay back and pushed them into adjustable rate mortgage ("ARM") loans with deceptively low payments up front that would reset a short period later.[47] The reset moment correlates with foreclosure risk. According to one study, 12 % of subprime mortgages will default as a result of reset.[48] Most egregiously, some borrowers who qualified for conforming loans were put into subprime loans. This practice benefited the brokers and lenders as they earned higher fees. Correspondingly, this hurt the borrowers. On average the borrowers who should have been offered a regular ("conventional") loan, paid additional fees of more than $5,222 when they were put into a subprime loan. There were huge incentives at the point-of-sale, then, to push a borrower into a subprime loan and to push a borrow into more debt and higher payments than he or she could afford. This hurt the people on both ends of the distribution chain. Borrowers were three times more likely to default.[49] And, ultimately, investors experienced huge losses. These investors included the direct owners of these subprime mortgage-backed securities (mainly institutional owners), as well as the investors whose money the institutions control. This is a microcosm of the entire financial crisis whereby those at the beginning and end of the distribution chain suffered, but many in the middle profited during the boom and the bust.

While the Sponsor of a conduit is supposed to investigate (or "due diligence" on) the practices of Originators and mortgage brokers, they often deliberated look the other way when faced with substantial evidence to support wide spread fraud and predation. In addition they hid this information from investors and rating agencies.

> "Investment banks that bundle and sell home mortgages often commissioned reports showing growing risks in subprime loans to less creditworthy borrowers but did not pass much of the information to credit rating agencies or investors."[50]

Between 2001 and 2006, subprime mortgage origination and securitization skyrocketed. In 2001, $190 billion subprime loans were originated. In that year $87 billion in bonds for pools of subprime loans were issued. This is a 46% ratio.[51] Five years later, in 2006 there was $600 billion in subprime origination and $448.6 billion in issuance, a 75% ratio.[52] In contrast, there was a substantial decline in conventional mortgage origination and issuance.

This reflected an "explosive demand from investors around the world."[53] The mortgage-backed bonds paid higher interest rates than corporate bonds that had the same ratings issued by the major rating agencies.[54] These rates seemed commiserate with the risk that the subprime borrowers were default. Alan Greenspan noted, this reflected an error in judgment, "with U.S. home prices still rising, delinquency and foreclosure rates were deceptively modest. Losses were minimal. . . . The consequent surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem. Demand became so aggressive that too many securitizers and lenders believed they were able to

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[43] Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Sub-prime Mortgage Credit*, The Federal Reserve Bank of New York Staff Report No. 318, Mar. 2008
[44] *Id.*
[45] Ashcraft & Schuermann, supra note __.
[46] Ashcraft & Schuermann, supra note __ at 70, Appendix 1.
[47] See generally, the Center for Responsible Lending website at http://www.responsiblelending.org/mortgage-lending/
[48] Ashcraft & Schuermann, supra note __ at 21, citing Christopher Cagan, Mortgage Payment Reset (2007).
[49] Center for Responsible Lending, Snapshot of a Foreclosure Crisis, 15 Fast Facts, available at http://www.responsiblelending.org/mortgage-lending/research-analysis/snapshot-of-a-foreclosure-crisis.html
[50] Patrick Rucker, *Wall Street Often Shelved Damaging Subprime Reports*, REUTERS, Jul. 27, 2007.
[51] In comparison in that same year $1.433 trillion in conforming loans were originated around $1.087 trillion issued, for a 76% ratio.
[52] In comparison in 2006, there were $1.04 trillion confirming originated and $904 billion issued, for an 87% ratio.
[53] Greenspan testimony supra note __ at 2-3.
[54] Ashcraft & Schuermann, supra note __.

create and sell mortgage backed securities so quickly that they never put their shareholders' capital at risk and hence did not have the incentive to evaluate the credit quality of what they were selling. Pressures on lenders to supply more "paper" collapsed subprime underwriting standards from 2005 forward. [55]

Greenspan also blamed purchasers of these bonds for "[u]ncritical acceptance of credit ratings." However, investors were not provided with complete and honest disclosure. "While subprime mortgage security prospectuses warned about the perils of such loans in recent years, they did not enumerate the findings of due diligence reports."[56] In addition, Fed staff recognized that investors in are "typically not financially sophisticated enough to formulate an investment strategy, conduct due diligence on potential investments, and find the best price for trades."[57]

A large contributor to the rapid origination and sale of subprime mortgage backed bonds were hedge funds. As noted in a previous section, hedge funds were willing to buy the equity tranche or the "toxic waste." Many of these hedge funds borrowed from a prime broker and other market participants using the toxic waste as collateral for these loans. As one commentator noticed in the summer of 2007 as two Bear Stearns hedge funds were imploding:

> Next, and this is what hedge funds are all about, it will leverage its risk, too. The hedge fund goes out to a lending bank, holding its high-performing but illiquid toxic waste in its hand, and it asks to borrow money using the waste as collateral. The bank has access, whether directly or indirectly, to cheap money . . . and so it has the prospect of lending for spectacular profits. Now the MBS wheel is fully in motion. The hedge fund loses no time in marking up the value of its equity CDOs on the basis of rising house prices. There is an overwhelming pressure to do so, since the hedge fund's managers are rewarded based on performance - a figure which is far too easy to manipulate if your investments are illiquid and hard to value in the absence of an open market price. . . .The toxic waste gets marked up without the waste itself getting tested on an open market."[58]

3. Credit-default Swaps and Other Credit Derivatives

To explain how a credit-default swap functions, it's useful to draw a loose analogy. A credit default swap is like a home insurance policy. With an insurance policy, the buyer pays the seller premiums. In exchange the seller agrees to cover the buyer's losses if there is some bad event occurs and damages the home covered under the policy. Similarly with a CDS, the buyer pays the seller a premium based upon a percentage of the underlying asset, typically on a quarterly basis.[59] In exchange, the seller will compensate the buyer if there is a bad "credit event" involving a "reference obligation." Typical credit events include the underlying borrower's default, reorganization or bankruptcy, though contracts vary.

CDS contracts were created in the mid 1990s.[60] In 2000, the notional value was around $800 billion.[61] At that time, a small group of parties were involved in the CDS market and the buyers typically under the corporate or municipal bond (reference credit) for which they bought protection.[62] Originally, it was banks that purchased CDS as a way to transfer some of the risk of the loans (assets) on their books to a third party.[63] "Banks used the CDS market to remove risk from their balance sheet, thereby reducing the regulatory capital they were required to put up to back that risk."[64]

Selling credit insurance also is a form of leverage. For example, someone who believes that corporation XYZ is poised for steady growth and has a strong balance sheet, might purchase some of its bonds, investing cash and receiving an annual return of 6%. This investment would reflect confidence that XYZ would not default A credit-default swap provides an alternative that is cheaper in the short-run. This confident investor could sell credit insurance to a buyer, using XYZ's bond as a reference credit. The investor acting as a seller would receive quarterly

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[55] Greenspan testimony supra note __ at 2-3.
[56] Ashcraft & Schuermann, supra note __.
[57] Ashcraft & Schuermann, supra note __.
[58] Tustain, supra note __
[59] *Credit Default Swaps: From Protection to Speculation*, PRATT'S J. BANKR. L. (Sept. 2008).
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] Shadab, *Guilty by Association?* at 23.
[64] PRINS *suppra* note __, at 108-109

payments from the buyer and would not have to put any money down. The only obligation is the promise to pay if XYX experiences a bad credit event. This seemed like easy money to dealers (and insurance companies) who underestimated the risk they were taking on.[65]

4. The Perfect Storm: Subprime CDOs, CDS and Leveraged Hedge Funds Converge

After 2000, there were major changes to the CDS market. A secondary market developed for CDS contracts. A single CDS contract might be sold 15 – 20 times.[66] A seller could trade its right to premium and its obligation to cover to someone else. Similarly, a buyer could sell its right to coverage and its obligation to pay premiums to someone else.

In addition, sellers began to "insure" a variety of conduits. This was very different from writing protection on corporation XYX or a bond or loan of XYZ. Corporation XYX was far more transparent with required publicly filed financial statements and could be monitored. In comparison, these CDO conduits were shell entities largely exempt from securities laws disclosures and oversight.[67]

The third important change was that market participants were speculators. Buyers no longer owned the underlying reference credit.[68] Indeed, there was a whole mechanism under the standard industry agreements governing CDS that allowed for cash settlements. That is to say, the buyer did not need to deliver the actual underlying instrument (or even a related instrument) to the seller after the bad credit event, but could settle out the contract in cash. It became clear many years before the global financial crisis that the amount of insurance sold on certain debt instruments by far exceeded the total value of the debt.[69] In others words, this was a speculators' market that did not contain risk, but created it. This was gambling. This was insurance without reserve requirements. These were securities without investor protections. As described below, in 2000 these CDS contracts were exempted from laws covering insurance, gambling and securities sales.

Speculation arose because buyers were able to buy insurance on bonds, mortgage-backed-securities and a variety of other obligations they did not own. This is the equivalent of being able to buy an insurance policy on your neighbor's home, or allowing millions of people to buy insurance on a few homes located near the shore. A smart insurance company would never take on that risk, indeed, without an insurable interest, the policy would not be sold. But by analogy, this was the situation with CDS. There were more bets place on a single home than the value of the house. Using our home from the MBS example, let's use the $300,000 home. If 100 people had purchased insurance on the home for its full value, the notional value of the insurance would be $30 million. If the weather report showed no signs of hurricane for the upcoming season, the premiums for buying insurance on that home would decline. However, if two hurricanes headed in its direction, the premiums to buy a new CDS contract would go up. And, existing contracts would gain value. The holder of the existing contract might choose to sell for a profit. Meanwhile, if that same insurance company sold contracts on many homes in the same area, there might be concern that the firm would not be able to settle the claims. Because, if the hurricane came, the insurance seller would need to pay out $30 million. If the 100 people had a lot of political power, they might arrange for the government to bailout the home insurance seller so that they will be sure to get their $30 million payment if the storm hit. In other words, the insurance buyers bear the risk of the seller's credit worthiness. In turn the insurance seller bears the risk that the buyer will stop making premium payments. To manage these risks, sellers may have to post collateral if their credit rating declines, and buyers might have to make large payments up front.

The perfect storm arose when subprime CDOs, CDS and leveraged hedge funds converged. Many on Wall Street were well aware that there were a lot of risky loans in the mortgage pools. So, to provide some assurance that the bond holders would be protected, even conforming mortgage pools often contained a "credit enhancement." This might be bond insurance or some extra collateral inside the structure. However, there was a demand for additional protection, so giant market in CDS grew. Buying a CDS contract was a way of betting that the hurricane would level the homes. The market was about speculation on hurricanes (or in the real world, home owners defaulting). A market built upon the hope that people would fall behind, pay extra fees and possible be foreclosed upon, homeless and struggling. Stated more formally, "buying CDS on mortgage-backed securities was used by hedge funds and

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[65] See Hu, infra note __.
[66] Janet Morrissey, *Credit Default Swaps: The Next Crisis?* TIME, Mar. 7, 2008 (interviewing bankruptcy attorney Harvey Miller).
[67] A trustee of the CDO plays a role, for example, acting as a gatekeeper only allowing eligible assets to go into the pool.
[68] *Id.*
[69] See, e.g. Practicing Law Institute,

other asset managers for a variety of purposes, including in strategies to profit from the relative mispricing of such securities and to express a negative view of (short sell) the mortgage market as a whole."[70]

In the CDS market, AIG was like that home insurer who sold policies to people who did not own the debt instrument (the "credit") being insured. AIG and other sellers grew this business because it generated a lot of cash up front. "Historically, bond issuers almost never go bankrupt. So, many banks and hedge funds figured they could make a fortune by selling CDSs, keeping the premium, and almost never having to pay out anything."[71]

By 2002, the notional value of CDS contracts grew to $2.19 trillion. By 2006, Alan Greenspan remarked that "Credit default swaps are becoming the most important instrument I've seen in decades."[72] By the 2007 peak, it was somewhere around to $57.8 to $63 trillion[73] depending upon the source consulted. This rapid expansion is tied to a Legal Enabler discussed below, the passage of the Commodities Futures Modernization Act in 2000 which deregulated CDS and helped solidify legal rights of buyers and sellers of CDS.

It should be mentioned that the notional value can be deceptive in that some players are both buyers and sellers of a CDS contract on the same reference credit. For example a dealer might sell credit insurance to client A and buy credit insurance from client B.[74] If this were the house, then, if the hurricane came, the dealer would owe client A $300,000 and would receive $300,000 from client B. These contracts cancel out and thus at the outset can be netted by the dealer.

In the post-2000 world this risk reduction device had become a form of gambling. The primary buyers of credit protection were hedge funds and dealers (at banks) for trading, not reducing risk and bank loan portfolios (for reducing risk). The primary sellers were insurance companies, dealers and hedge funds.[75] In other words insurance companies like AIG were mostly on the sell side, collecting huge premiums up front, hoping the reference credits would not have bad credit events. Some others were more careful to be on both sides of trades, selling and buying insurance. AIG was a significant insurer of collateralized mortgage obligations. Before its collapse, AIG had outstanding around $440 billion of CDS where it was the seller of protection to institutions all over the world. When it was downgraded by the rating agencies, the buyers of insurance demanded it put up more collateral on its contracts. AIG began to sell assets to cover these obligations and its stock dropped as it descended. Many have attributed the collapse of Bear Stearns, Lehman Brothers and AIG to these "financial weapons of mass destruction."[76]

> "The securitization of subprime mortgages and other loans can enable banks and securities firms to transfer credit risk from their balance sheets to parties more willing or able to manage that risk. However, the current crisis has revealed that much of the subprime mortgage exposure and losses have been concentrated among leveraged financial institutions, including banks, securities firms, and hedge funds."[77]

Early into the crisis a former hedge fund manager and risk manager spotted the contagion:

> "The subprime mess that is cutting so wide a swath through financial markets can be traced to the alchemy of creating collateralized debt obligations (CDOs) compounded by the enormous amount of leverage applied by big hedge funds."[78]

The perfect storm arose when, using our earlier analogy, when the hurricane hit the shore and began washing away houses, the 100 buyers of insurance wanted to get paid. But, the insurance seller did not have reserves set aside to cover the claims. In the words of the New York state superintendant of insurance, when underlying loans

[70] Houman B. Shadab, *Guilty by Association? Regulating Credit-default Swaps*, forthcoming in the ENTREPRENERIAL BUSINESS LAW JOURNAL, fall 2009 at 22, citing BIS, OTC Derivatives Market Activity in the Second Half of 2008 at 31, May 2009
[71] Adam Davidson, *How AIG Fell Apart*, REUTERS Sept. 18, 2008.
[72] See, Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, Seton Hall Public Law Research Paper No. 906613, Jul 17, 2007, referencing Caroline Salas, *Derivatives, Not Bonds, Show What Pimco, TIAA-CREF Really Think*, BLOOMBERG.COM, May 31, 2006.
[73] Shadab, *Guilty by Association?* at 22, citing BIS, OTC Derivatives Market Activity in the Second Half of 2008 at 7, May 2009.
[74] Shadab, *Guilty by Association?* at 25.
[75] Shadab, *Guilty by Association?* at 23.
[76] Edward Jay Epstein, *Warren Buffet's Hidden Stake in Financial Weapons of Mass Destruction*, VANITY FAIR, Feb. 2, 2009.
[77] GAO REP'T, *supra* note __ at 19, citing David Greenlaw, Jan Hatzius, Anil K. Kashyap, and Hyun Song Shin, "Leveraged Losses: Lessons from the Mortgage Meltdown," paper for the U.S. Monetary Policy Forum (2008).
[78] Richard Bookstaber, *Blowing up the Lab on Wall Street*, TIME, Aug. 6, 2007.

were performing badly, "everybody wanted to get paid, had a right to get paid on those credit default swaps. And there was no 'there' there. There was no money behind the commitments. And people came up short. And so that's to a large extent what happened to Bear Stearns, Lehman Brothers, and the holding company of AIG."[79] These institutions had sold too much credit insurance. In the end, Bear Stearns was bought by JPMorgan with a $30 billion government assistance. Lehman was not saved, but filed for bankruptcy and AIG received over $170 billion in taxpayer funded bailout. An estimated $50 billion of that bailout money passed right through to AIGs CDS counterparties,[80] between 15- 24 or more financial institutions[81], including to Deutsche Bank, [82] Goldman Sachs, Bank of America and Citigroup.[83] In other words, the taxpayers had to bailout the institutions that contracted with AIG. They were not sophisticated enough, or the markets were not transparent or efficient enough for them to accurately assess AIG's credit risk. Yet, they did not internalize that error. The risk was passed along to the taxpayers.

These events led to a further market decline due to the excessive use of leverage to purchase or gain exposure to assets. When one class of assets deteriorated in value, leverage ratios increased, creating a need to either raise more capital or to sell off other assets as well. These fire sales can put a downward pressure on prices. The market price, or what buyers were willing to pay, for some assets was so low that holders refused to sell. These "illiquid" assets were deemed "toxic" or "troubled."

The GAO affirmed this in its July 2009 study. There was an attempt to raise new capital. Financial institutions raised approximately $200 billion tapping capital from private investors and sovereign wealth funds.[84] When that was not sufficient, the next choice was asset sales. Broker-dealers reduced their assets in the 4th quarter of 2008 by $785 billion and banks reduced credit by approximately $84 billion.

B. The Damage Done

Looking back from the vantage point of summer 2009, it is easy to conclude that we are still "in the midst of the worst financial crisis in more than 75 years."[85] Since the recession began in late December of 2007[86] through July 2009, a net 6.7 million jobs have been lost.[87] The unemployment rate rose from 4.9% to 9.4%.[88] At least 14.5 million people were looking for work. The jobless rate reached 15.2%[89] in Michigan in June 2009, the hardest hit state, compared to 7.3% when the recession began.[90]

In 2009 alone more than 2.3 million notices of home mortgage defaults, auction or repossession were issued.[91] During the second quarter of 2009, 4.3% of U.S. homes, or 1 in 25 properties were in foreclosure. [92] In

[79] *The Bet That Blew up Wall Street: Steve Kroft on credit-default swaps and their central role in the unfolding economic crisis*, CBS, available at http://www.cbsnews.com/stories/2008/10/26/60minutes/main4546199.shtml
[80] Serena Ng & Carrick Mollenkamp, *Top U.S., European Banks Got $50 Billion in AIG Aid*, Wall St. J., Mar. 7. 2009.
[81] Carol Loomis, *Revealed: 15 AIG Bailout Counterparties*, FORTUNE, Mar. 7, 2009, available at http://money.cnn.com/2009/03/07/news/companies/aig.fortune/index.htm
[82] Serena Ng, *Hedge Funds May Get AIG Cash: Some Bailout Money is Set Aside to Pay Firms that Bet Housing Market Would Crater*, WALL ST. J., Mar. 18, 2009.
[83] Joe Nocera, *The Problem with Flogging AIG*, N.Y. TIMES, Mar. 21, 2009.
[84] GAO REP'T, *supra* note __ at 20.
[85] U.S. G.A.O. REP'T, FINANCIAL MARKETS REGULATION: FINANCIAL CRISIS HIGHLIGHTS NEED TO IMPROVE OVERSIGHT OF LEVERAGE AT FINANCIAL INSTITUTIONS AND ACROSS SYSTEM 2, Jul. 27, 2009.
[86] On December 11, the National Bureau of Economic Research announced that the peak was December 2007 and that we've been in a recession since that date. BUSINESS CYCLE DATING COMMITTEE, NATIONAL BUREAU OF ECONOMIC RESEARCH, DETERMINATION OF DECEMBER 2007 PEAK IN ECONOMIC ACTIVITY, Dec. 11, 2008 (A recession is defined as: "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators. A recession begins when the economy reaches a peak of activity and ends when the economy reaches its trough.")
[87] Bureau of Labor Statistics, The Employment Situation – July 2009, Aug. 7, 2009, available at http://www.bls.gov/news.release/empsit.nr0.htm Employment Situation, *supra* note __.
[88] See Bureau of Labor Statistics, Labor Force Statistics from the Current Population Survey, Aug. 17, 2009, available at http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000
[89] Bureau of Labor Statistics, Local Area Unemployment Statistics, available at http://www.bls.gov/lau/
[90] Bureau of Labor Statistics, Local Area Employment Statistics, Michigan, extracted August 17, 2009, available at http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LASST26000003
[91] Lynn Adler, *Home Foreclosures Set Another Record in July*, REUTERS, Aug. 13, 2009, available at http://www.reuters.com/article/gc03/idUSTRE57C0M620090814
[92] Kathleen M. Hawley, *U.S. Home Prices Tumble 6.1% on Surging Foreclosures*, BLOOMBERG.COM, Aug. 25, 2009, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=aNnP_i73Xc.4

California, 1 in 7 homes were in a foreclosure process.[93] And, in Florida, 23% or nearly 1 in 4 homes were past due or in foreclosure.[94] In early 2008, 10% of homeowners were "underwater" on their mortgages. In other words, they owed more than their homes were worth.[95] At the end of of 2008, the number of "underwater" mortgages rose to 8.3 million, or 20% of all properties with mortgages.[96] By June 2009, more than 33% of all mortgaged homes in the U.S. were under water.[97]

In 2008, US stock markets lost an estimated $7 trillion and in overseas equity markets $5 trillion disappeared. In addition, $10 trillion in homeowner value vanished in the global housing market.[98] Corresponding with these market declines were other individual, personal losses. The net worth of U.S. households slid from $64.4 trillion in mid-2007 to $51.5 trillion by the end of 2008.[99] Business and consumer bankruptcies were on the rise. In 2008, there were more than 1.1 million bankruptcies filed, compared to approximately 851,000 in 2007.[100] Of these, 96% were consumer filings. By June of 2009, 99 U.S. public companies had filed for bankruptcy.[101] While there are typically fewer public company filings than other business or consumer filings in a given year, the assets involved per debtor are substantially higher, between $20 billion and $691 billion.[102]

Over 1,500 hedge funds were liquidated by July, 2009,[103] By mid-August there had been 77 bank failures in 2009.[104] By the end of August, the total since the recession a total of 109 failed had failed. Washington Mutual represented the largest bank failure in history with $307 billion in assets.[105] Since the crisis began, there have been approximately $1.55 trillion in credit losses and write downs at financial institutions.[106] Moreover, with $3.5 trillion outstanding commercial property loans outstanding[107] given the problems in that market, many remained concerned about the impact of future defaults.[108]

In 2008, Consumer spending, which typically accounts for close to 70% of economic activity[109] declined. In the second half of 2008, college endowments decreased by an average of 24%.[110] Problems had spread across many sectors of the economy.

The crash impacted a middleclass already squeezed by declining or stagnating real wages. Even prior to the recession, the prosperous times were not really so prosperous. Mountains of debt shielded the populace from having to feel the immediate pain of reduced income. The cost of housing and healthcare had each increased by 70% in just one generation.[111] The cost of education was up 100% in that same timeframe. Meanwhile, wages increased only by approximately one percent.[112]

State and local governments faced severe budget shortfalls. This was partially due to the decline in housing values, which alone was estimated to cost them $1 trillion in property taxes.[113] Forty eight states had to address or still face gaps, just a month into the 2010 fiscal year, totaling at least $165 billion. Deficits for the next year are anticipated to be at least $180 billion.[114] California independently faced a $45.5 billion shortfall.[115] Across

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[93] Jen Lebron Kuhney, *One in 7 homes in foreclosure process*, DAILY TRANSCRIPT, Aug. 20, 2009.
[94] Monica Hatcher, *Florida Foreclosures on the Rise*, MIAMI HERALD Aug. 21, 2009.
[95] GERALD F. DAVIS, MANAGED BY THE MARKETS: HOW FINANCE RE-SHAPED AMERICA 231 (2009).
[96] Mara Der Hovanesian, *Report: 1 in 5 Mortgages Are Underwater*, BUSINESSWEEK, Mar. 3, 2009.
[97] Bob Tedeschi, *The Depths of Mortgage Debt*, N.Y. TIMES, Aug. 28, 2009.
[98] Heather Landy, *The Stock Slump of 2008: The Wrecking Ball to Wealth*, WASH. POST, Jan. 11, 2009.
[99] David Heschler, *Response to the Economy will Affect History*, Clinton Herald, Aug. 17, 2009.
[100] American Bankruptcy Institute, *Annual Business and non-Business Filings by Year (1980-2008)*, available at http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=57826
[101] *Public Companies Bankruptcies to Make 2009 a Record Year*, PTI, June 2, 2009.
[102] *20 Largest Public Bankruptcy Filings 1980 – Present*, BANKRUPTCY DATA.COM, published by New Generation Research, Inc. (with most recent filing the June 1, 2009 filing of General Motors).
[103] Speech by SEC Commissioner Luis A. Aguilar, Hedge Fund Regulation on the Horizon: Don't Shoot the Messenger, Spring 2009 Hedgeworld Fund Services Conference, New York, NY, June 18, 2009.
[104] Eric Dash, *BB&T Takes Over Failing Colonial BancGroup*, N.Y. TIMES, Aug. 14, 2009.
[105] Damian Paletta, *Raft of Deals for Failed Banks Puts U.S. on Hook for Billions*, WALL ST. J., Aug. 31, 2009.
[106] Viven Lou Chen & Carol Massar, STIGLITZ SAYS U.S. FACES A "VERY SLOW" RECOVERY FROM RECESSION, BLOOMBERG, Aug. 5, 2009.
[107] Editorial, *The View from the Bottom*, N.Y.TIMES, Aug. 16, 2009.
[108] Chen & Masser, *supra* note __.
[109] *The View*, *supra* note __.
[110] Gillian Wee, *University of Pennsylvania Endowment Beats Harvard with Stocks*, BLOOMBERG, Aug. 13, 2009, available at http://www.bloomberg.com/apps/news?pid=20601109&sid=a1.YKDrXJVc8
[111] JAMES D. SCURLOCK, MAXED OUT: HARD TIMES, EASY CREDIT AND THE ERA OF PREDATORY LENDERS 163 (2007).
[112] SCURLOCK, *supra* note __ at 163.
[113] DAVIS, *supra* note __ at 230.
[114] Iris Lav & Elizabeth McNichol, *New Fiscal Year Brings No Relief From Unprecedented State Budget Problems*, CENTER ON BUDGET AND POLICY PRIORITIES, Aug. 12, 2009.

the nation, from community to community, announcements of school budget cuts abound. States and local governments cut back on teachers,[116] the arts, sports teams, closed buildings and instituted layoffs, pay cuts and furloughs.[117] The damage from the U.S. mortgage market meltdown crossed borders. Examples surface from the large institutions to the obscure communities. A tiny Norwegian village lost municipal services after an investment in credit derivatives sold to them by Citigroup collapsed due to the defaults by Florida real estate speculators.[118]

Most remarkably, all of this devastation occurred, even with the tremendous government intervention. As of March, 2009, the total financial rescue plan commitment, including the $787 billion stimulus, approached $13 trillion, around the size of the 2008 GDP of $14.2 trillion.[119] This amounts to $42,105 per person including children, in the U.S.[120]

C. Timeline of the Credit Crisis and Bailout

The recent global financial crisis seems to move with the same "surrealistic slowness"[121] as the Great Crash of 1929. An early indicator of trouble ahead appeared on February 27, 2007 when the Federal Home Loan Mortgage Corporation ("Freddie Mac") announced it would stop buying certain risky subprime mortgages and related securities.[122] In particular, Freddie Mac declared it would only buy those adjustable rate mortgages for which the underwriters had determined the borrowers were capable of paying not just the initial teaser rate, but the fully adjusted rated.[123] Then, in early April of 2007, a major mortgage lender filed for protection under Chapter 11 of the Bankruptcy Code.[124] In late April of 2007, Standard and Poor's put out a special report expressing concern about the rising home mortgage delinquencies for "recent vintage" subprime loans.[125] In this special report, S&P intimated that for at least two years, concerns about lax underwriting standards had been a "topic of speculation."[126] On June 7, a hedge fund offered through Bear Stearns barred redemptions by investors. This hedge fund had the unfortunately deceptive name, the High-Grade Structured Credit Strategies Enhanced Leverage Fund, and its managers were equally dishonest.[127]

Merrill Lynch had grown its CDO issuance business from $4 billion to $28 billion in the first six months of 2007. At that moment, with the full blown subprime crisis, Merrill had $41 billion in CDO securities and no willing buyers.[128] On July 11, S&P placed more than 600 mortgaged-backed securities on credit watch.[129] On July 24, major mortgage originator, Countrywide Financial Corporation made its quarterly filing with the SEC. Countrywide was the largest issuer of bonds on pools of subprime mortgages. In 2006, it issued more than $38 billion, or 8.6% of the total issued. Chairman and CEO, Angelo Mozillo admitted that "difficult housing and mortgage market conditions" were expected to continue.[130] However, he said that "management remains optimistic about the long-term future growth prospects and profitability." On July 31, two hedge funds operated through Bear Stearns were liquidated. Both hedge funds were heavily invested in mortgage-backed securities.[131]

By August of 2007, there were more signs of trouble. On August 6, American Home Mortgage Corporation filed for Bankruptcy under Chapter 11.[132] BNP Paribas froze redemptions on three of its hedge funds.[133]

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[115] Leslie Eaton, Ryan Knutson and Philip Shiskin, *States Shut Down to Save Cash*, WALL ST. J., Sept. 4, 2009, A1.
[116] California laid off 27,000 teachers, see Eaton at al, supra note __
[117] In Michigan 38,000 employees faced furloughs.
[118] DAVIS, *supra* note __ at 230.
[119] Mark Pittman & Bob Ivy, *Financial Rescue Nears GDP as Pledges Top $12.8 Trillion*, BLOOMBERG, Mar. 31, 2009, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=armOzfkwtCA4
[120] Pittman & Ivy, *supra* note __.
[121] SELIGMAN, *supra* note __ at 3 (citing historian John Brooks).
[122] The Federal Reserve Bank of St. Louis, A Timeline of Events and Policy Actions, available at http://timeline.stlouisfed.org/index.cfm?p=timeline
[123] Press Release, Freddie Mac Announces tougher subprime lending standards to help reduce the risk of future borrower default: Company Also to Develop Model Subprime Mortgages, Feb. 27, 2007.
[124] Timeline, *supra* note __.
[125] *Special Report: Subprime Lending: Measuring the Impact*, cited in Testimony of Vickie A. Tillman, Exec. V.P., S&P Credit Mkt. Serv. Before the Subcommittee on Capital Mkts, Ins. And Gov't Sponsored Enterprises, U.S. House of Rep., Sept. 27, 2007.
[126] Tillman Testimony, *supra* note __.
[127] See generally, WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET (2009).
[128] Pearlstein, *supra* note __.
[129] Timeline, *supra* note __.
[130] Timeline, *supra* note __; see also Countrywide Financial Corporation Press Release from which the quote originates.
[131] Timeline, *supra* note __.
[132] Timeline, *supra* note __.

Mainstream newspapers covered the brewing trouble at Countrywide and other aggressive mortgage originators stemming not only from subprime loans, but also adjustable rate mortgages.[134] The collective shareholder value lost by the stock declines at Washington Mutual, IndyMac Bancorp Inc. and Countrywide between the end of 2006 was estimated to be $24 billion. On October 10, 2007, the US Treasury Department and the Department of Housing and Urban Development launched HOPE NOW. This was an alliance of "credit and homeowners' counselors, mortgage servicers, and mortgage market participants" that was tasked at reaching out to at-risk borrowers and helping them stay in their homes.[135]

In January 2008, Bank of America announced a plan to buy Countrywide for $4 billion worth of BofA stock.[136] By Spring of 2008, it appeared that the crisis has spread beyond subprime mortgages. On March 5, Carlyle Capital Corporation announced that it was unable to meet additional collateral requirements of its repo counterparties. In this instance, the underlying was AAA rated debt issued by Fannie Mae and Freddie Mac (with implicit guarantee of the U.S. government).[137] Nonetheless, the counterparties wanted an additional $37 million cushion.[138] On March 24, 2008, the Fed announced would provide $29 billion in financing for the acquisition of the Bear Stearns Companies by J.P. Morgan Chase.

In March, the Fed also expanded its liquidity program, the Term Securities Lending Facility, to provide $200 billion in liquidity (in the form of US Treasury securities) in exchange for 28 days, instead of overnight, for mortgage related securities.[139] Throughout the crisis and bailout, the Fed continued to expand the liquidity program, by accepting a wider range of assets from a variety of counterparties and for longer terms.

By summer of 2008, Ambac and MBIA who insured CDOs were downgraded by S&P. IndyMac was closed by its regulator, the Office of Thrift Supervision and the FDIC took over the bank deposits and other assets. In July, the Fed authorized the NY Fed to extend credit to Fannie and Freddie if necessary.[140] Bush signed the Housing and Economic Recovery Act of 2008, which brought Fannie and Freddie under the supervision of FHFA and allows Treasury to buy their obligations.[141]

Little public attention was directed at these details, however, given the very dramatic and lengthy primary campaigns. The news cycle fixated on the high stakes Democratic nomination battle between Senators Hillary Clinton and Barack Obama. And, fresh on the scene, John McCain's Vice Presidential running mate, Governor Sarah Palin engaged the populace who worked through questions about surface versus substance. Meanwhile, very substantive economic problems were percolating.

The breakthrough events occurred over a few weeks in September 2008. Even a public distracted by the Presidential campaigns couldn't help but to turn its attention to the impending financial crisis. On September 7, government sponsored mortgage purchasers and securitizers, Fannie Mae and Freddie Mac were nationalized, brought under government conservatorship by the FHFA.[142] A week later, on September 15, BofA announced the acquisition of Merrill Lynch for $50 billion in stock.[143] On that same day, Lehman Brothers Holdings Inc. filed for protection under Chapter 11 of the Bankruptcy Code.[144] A day later, on September 16, the Fed authorized the Fed. Reserve Bank of NY to lend to AIG up to $85 billion. A large money market fund "broke the buck" due to holding of Lehman Bros. commercial paper and medium term notes.[145] The Treasury agreed to provide $50 billion to guarantee certain money market fund investments to help prevent a "run" on the funds.[146]

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[133] Timeline, *supra* note __.
[134] Michael Liedtke, High-risk Mortgages Become Toxic Mess, USA Today, Aug. 11, 2007 (printing AP story).
[135] Press Release, HOPE NOW Alliance Created to Help Distressed Homeowners: Treasury, HUD, mortgage servicers and counselors team up to reach out, explore solutions, Oct. 10, 2007, referred to in Timeline, *supra* note __.
[136] Timeline, *supra* note __.
[137] Press Release, Carlyle Capital Corp. Ltd. Issues Update on its Liquidity, Mar. 5, 2008.
[138] In a traditional government-backed repurchase ("govy repo") agreement, Party A gives Party C cash in exchange for the promise to pay it back with interest. Party C essentially "sells" Party A some government securities. Then, Party C is required to buy back these government securities at a higher rate. With a govy repo, if Party C is unable to buy back the securities, Party A can hold onto them or sell them. They are perceived as high quality, low risk.
[139] Timeline, *supra* note __ and Fed. Res. Board Press Release, Mar. 11, 2008.
[140] Timeline, *supra* note __
[141] Timeline, *supra* note __
[142] Timeline, *supra* note __
[143] Timeline, *supra* note __ and Press Release, *Bank of America Buys Merrill Lynch Creating Unique Financial Services Firm*, Sept. 15, 2008.
[144] Timeline, *supra* note __
[145] Timeline, *supra* note __
[146] Timeline, *supra* note __

On September 20, 2008, Secretary of the Treasury, Henry Paulson, provided Congress with draft legislation authorizing the purchase of "troubled assets."[147] Many expressed concern about the level of control Paulson would be given and the lack of accountability and oversight. Law Professor, John Macey characterized this as the largest transfer of power to the Administration from Congress that he'd ever witnessed.[148] For example, the Paulson proposal included that "Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency."[149] On September 21, Goldman Sachs and Morgan Stanley became bank holding companies[150] ending an era. Paulson and Bernanke memorably testified before the Senate Banking Committee, sounding the alarm that credit was frozen. Without an immediate $700 billion in government assistance, dire consequences would follow.

After first rejected the Paulson proposal, Congress worked through the conflict and in early October, President Bush signed the Emergency Economic Stabilization Act of 2008 (the "Bailout"). This authorized the purchase of $700 billion in troubled assets.[151] No sooner was the purchase trouble assets approved, than Secretary Paulson took a different course. In October, Treasury announced the use of $250 billion the TARP money for direct capital infusion into U.S. financial institutions. Nine such institutions declared they would take $125 billion.[152] Then, in November, Secretary Paulson announced that he no longer planned to use the TARP money to buy (illiquid mortgage-related) troubled assets.[153]

Eager to make use of government financing, the already struggling automakers paid a visit to Congress. Notoriously arriving on private jets, on November 18, the CEOs of the Big Three Auto companies asked Congress for TARP money.[154] On December 19, the Treasury loaned GM $13.4 billion in TARP money and Chrysler $4 billion.[155] More auto assistance followed, including support during the bankruptcy reorganizations of both GM and Chrysler.

With the goal of avoiding a full-fledged Depression, in February, President Obama signed the American Recovery and Reinvestment Act of 2009 (the "Stimulus Plan"). The President also announced a plan to help borrowers stay in their homes through either refinancing or modification. A meager $75 billion was directed through the Homeowner Stability Initiative.[156] The major banking regulators announce "stress tests". On February 26, the FDIC announced there were 252 "problem banks."[157] Thereafter, the FDIC continually reported an increasing number of troubled banks. It would later report that stress test results that of the 19 largest bank holding companies made public. Ten "failed".

In total, by March of 2009, the financial rescue plan commitment was nearly $13 trillion.[158] While this was equal to around $42,105 per person in the U.S,[159] the money was of course not directly handed to individuals. Moreover, the public concern over these expenditures rested first on the $700 billion "troubled asset" bailout from the fall of 2008. Then, attention switched to the $787 billion economic stimulus program from the winter of 2009. However, even taken together, these are a small portion of the overall rescue. If the credit crisis was a tsunami, the rapid responses and interventions were a whirlwind.

D. Double-Dipping: Enriching the Middlemen Before and After the Crash

[147] Timeline, *supra* note __
[148] Adam Davidson, *Bailout Seeks Broad New Powers for Treasury Chief*, MORNING EDITION, Sept. 23, 2008, available at http://www.npr.org/templates/story/story.php?storyId=94921462
[149] Davidson, *supra* note _
[150] Timeline, *supra* note __
[151] Timeline, *supra* note __
[152] Timeline, *supra* note __
[153] Timeline, *supra* note __
[154] Timeline, *supra* note __
[155] Timeline, *supra* note __
[156] Timeline, *supra* note __
[157] Timeline, *supra* note __
[158] Mark Pittman & Bob Ivy, *Financial Rescue Nears GDP as Pledges Top $12.8 Trillion*, BLOOMBERG, Mar. 31, 2009, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=armOzfkwtCA4
[159] Pittman & Ivy, *supra* note __.

Some justify market bubbles and accept excessive pay by suggesting that a "rising tide lifts all boats".[160] They embrace the belief that the high, high's of market expansions and the low, lows of collapses are felt evenly by all segments of society. However, recent evidence does not support this notion. During the "boom" period, while the economy expanded, the gains from this expansion were disproportionately captured by the top stratum of society. [161] Families with incomes of more than $398,900, or the top 1% collected around 23% of all income in 2007. This was up from around 10% in the 1950s through early 1980s. The sharp incline came between the early 1990s from around 13% to 23%.[162] Approximately 14,588 families, those earning more than $11.5 million, or the top .01% earned a more disproportionate share of the total income. These top families earned a steady 1 to 1.5% of the income in the 1940s through the 1980s. The huge jump came between the early 1990s when the top .01% earned 2%. Then by 2007, this small slice of the population earned 6%.[163]

The inverse proposition that, "a falling tide will strand all boats"[164] is equally suspect. Indeed, as the Berkshire Hathaway Chairman noted, some firms are more prepared to be buffeted by a storm than others. And, as we have seen with the governmental interventions, beginning in 2008 and through mid 2009, buckets to bailout out boats are not evenly distributed. After the hurricane, the big yachts were floating out at sea, while the rest of the boats and the harbor lay in ruins.[165] Indeed, out there in the yachts sit the clever bankers who arranged to receive stock option grants when the stock of the corporations who employed them had plummeted. By receiving options at the bottom, ten such executives had already seen a gain of $90 million by early September 2009.[166]

This was just one example of "double-dipping." The entire boom and bust has greater enriched those who caused the disaster. For example, Angelo Mozillo,[167] former CEO of Countrywide earned profits of at least $140 million in sales of Countrywide stock.[168] Mozillo later admitted that he was incapable of pricing these subprime CDOs. Jay Levine, a leader of the US arm of Royal Bank of Scotland, RBS Greenwich "earned more than $60 million during the three years before his departure at the end of 2007." [169] RBS Greenwich was a top issuer of mortgaged-backed securities, alongside Lehman Brothers and Bear Stearns. "At the height of the mortgage frenzy, [RBS Greenwich] generated more than $350 million in profit annually for RBS." The shareholders did not do so well. RBS was rescued by the British Government with a $30 billion bailout, due in part to tens of billions in losses from U.S. credit.[170]

Concerns about escalating CEO pay that is decoupled from long-term, sustainable performance was well documented in the news,[171] academic literature,[172] shareholder resolutions, shareholder advisory services, institutional investors and regulations, years before the GFC. Specific examples showed that irrational exuberance pays, or bubbles have beneficiaries. Between 1998 and 2001, 1,000 executives took home a total $66 billion. Of that $23 billion was paid to those at a mere 25 firms. This pattern was prevalent. Even bankruptcy did not deter executives from cashing out. Executives earned $3.3 billion at the twenty-five largest firms that filed between 2001-2003.[173] CEOs who were fired or resigned under pressure collectively received $1 billion in 2006, if one includes the

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[160] Then-Senator John F. Kennedy used this phrase to describe the interdependence of the economy. However, it has been more commonly appropriated to support trickle-down economics. See, Remarks of Senator John F. Kennedy at State Fair, Nashville, Tennessee, September 21, 1960.
[161] EMMANUEL SAEZ, *Striking it Richer:The Evolution of Top Incomes in the United States*
(Update with 2007 estimates), Table 1. Real Annual Income Growth by Groups, 1993-2007, http://elsa.berkeley.edu/~saez/saez-UStopincomes-2007.pdf
[162] SAEZ, *supra* note __, figure 2: Decomposing the Top Decile Income Share into 3 Groups, 1913- 2007.
[163] SAEZ, *supra* note __, figure 3: The Top .01% Income Share, 1913 – 2007.
[164] Nugent *supra* note __.
[165] In fact, this metaphor has a literal dimension. Many small and medium boats were abandoned and sunk when owners could no longer afford to pay slip fees and maintenance costs. This has polluted harbors and left wreckage in the water. See David Streitfeld, *Boats Too Costly to Keep Are Littering Coastlines*, N.Y.TIMES, Mar. 31, 2009.
[166] Steve Eder, *Bailed-out Bankers to Get Options Windfall: Study*, REUTERS, Sep. 2, 2009.
[167] No stranger to pay for failure, Mozillo was on the board at Home Depot when Robert Nardelli received an over $200 million departure payment after the company's stock price declined by by 8% during his six year tenure. Karen Jacobs, *Home Depot's Nardelli, Out after Year of Criticism*, REUTERS, Jan. 3, 2007.
[168] Bill Saporito, *Is Mozillo's Crime the Liar Loans – or the Lie?*, TIME, Jun. 4, 2009.
[169] Steven Pearlstein, *So You Just Squandered Millions . . . Take Another Whack at It*, WASH. POST., Sept. 2, 2009.
[170] Pearlstein, *supra* note __.
[171] Eric Dash, *Executive Pay; Has the Exit Sign Ever Looked So Good? What is the price of failure in corporate America in 2006?* N.Y. Times, Apr. 8, 2007 ().
[172] *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).
[173] PRINS *supra* note __, at 2.

$210 million paid to CEO Robert Nardelli for one day at Home Depot in January 2007.[174] In 2004, some have estimated that the top 25 managers of hedge funds earned more than all of the S&P 500 CEOs.[175]

However, even seasoned pay-watchers were stunned that in the midst of the Global Financial Crisis, bonuses totaling around $20 billion were paid to employees on Wall Street after firms had received at least half of the $700 billion in bailout money[176] plus many billions more in liquidity support.

Quite perversely, in 2009, the gap between pay and performance widened.[177] Lucian Bebchuk and Alma Cohen analyzed nine large financial institutions that received a total of $165 billion in TARP (bailout) money. They focused on earnings before compensation ("EBC"), or the "total pie to be divided between . . . the firm's employees and the shareholders." They found that for the years 2003-2006, aggregate compensation ran at between 52-62%.[178] In comparison, for the first half of 2009, aggregate compensation was approximately 74% of EBC.[179] Told in absolute (inflation adjusted) dollars, in 2006, EBC at the firms was $244 billion and aggregate compensation, $143 billion.[180] In 2009, (assuming the second half will mirror the first), ECB will be $211 billion and compensation $156 billion.[181]

For example, Merrill Lynch lost $27 billion in 2008. The US government gave BofA an extra $20 billion to help acquire, and thus rescue Merrill. In addition, the government agreed to guarantee $97 billion of BofA losses on Merrill's "troubled assets." Given this dramatic tax payer subsidized rescue, one might expect a reasonable people to express gratitude and humility. Yet, instead, in late December, just prior to the January 1 closing, Merrill paid $3.6 billion in employee bonuses.[182] This was at a failed firm, and bonuses were traditionally paid in January.[183] Many months later, the SEC reached a $33 million settlement with Merrill's new owner BofA, yet a federal judge challenged the agreement, refusing to bless it without further information. Judge Rakoff argued that both banks had "effectively lied to shareholders."[184] Shareholders approved the acquisition on December 5, but did not receive information about the planned bonuses, according to the SEC. BofA's attorney attempted to claim the money was paid from somewhere other than the ____ billion government bailout. However the judge concluded that the $3.6 billion in bonuses were paid by the taxpayers, as "money is money."[185]

Even after the public outcry in January of 2009 over the stealth Merrill bonuses, The American International Group ("AIG") took similar action. AIG had been at the epicenter of the quake and received more than $170 billion in taxpayer dollars. Yet, it announced in March of 2009 that it was planning $165 million in bonuses.[186] This was planned at the time that US government effectively owned 80% of AIG. Of particular note was that the bonuses were for "executives at A.I.G.'s financial products division, the unit that wrote trillions of dollars' worth of credit-default swaps that protected investors from defaults on bonds backed in many cases by subprime mortgages."[187] Put so succinctly, this was "the same unit whose shenanigans came perilously close to bringing the world's financial system to its knees."[188]

Some believe that the executive pay issue at AIG was a red herring. For example, Eliot Spitzer asked, "Why did Goldman have to get back 100 cents on the dollar? Didn't we already give Goldman a $25 billion cash infusion, and aren't they sitting on more than $100 billion in cash. . . there is a legitimate sense of outrage over the bonuses, the larger outrage should be the use of A.I.G. funding as a second bailout for the large investment

[174] Dash, *supra* note __.
[175] Davis, *supra* note __ at 207.
[176] Sheryl Gay Stolberg & Stephen Labaton, *Obama Calls Wall Street Bonuses "Shameful,"* N.Y. Times, Jan. 29, 2009.
[177] Lucian Bebchuk & Alma Cohen, *Guest Contribution: Back to the Good Times on Wall Street*, Wall St. J., Jul. 31, 2009, also available as adapted at http://blogs.law.harvard.edu/corpgov/2009/07/31/back-to-the-good-times-on-wall-street/
[178] Bebchuk & Cohen, *supra* note __.
[179] Bebchuk & Cohen, *supra* note __.
[180] Excluding State Street.
[181] Bebchuk & Cohen, *supra* note __.
[182] Louise Story, *Judge Attacks Merrill Pre-Merger Bonuses*, N.Y. TIMES, Aug. 10, 2009.
[183] *Former Merrill CEO Resigns from BofA*, MSNBC.COM, Jan. 23, 2009, available at http://www.msnbc.msn.com/id/28793175/
[184] Story, *supra* note __ .
[185] Story, *supra* note __ .
[186] Edmund Andrews & Peter Baker, *AIG Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 14, 2009.
[187] Andrews & Baker, *supra* note __.
[188] Joe Nocera, *The Problem with Flogging A.I.G.*, N.Y.TIMES, Mar. 21, 2009 (Nocera notes that "any nonfinancial company in A.I.G.'s straits would be in bankruptcy, and contracts would have to be renegotiated.")

houses."[189] However, on another level, this extremely important as many experts believe that there is clear correlation between skewed compensation incentives and the unreasonable risks that led to the crisis.[190]

The New York attorney general Cuomo reported that around 5,000 traders and bankers at financial firms that received government bailout money, earned more than $1 million each in 2008.[191] In addition, it surfaced in the summer of 2009 that Citigroup planned to pay trader Andrew Hall a $100 million bonus for an "aggressive year of bets in the oil market."[192] Meanwhile, Hall is participated in "a corner of the trading world that appears headed for its own infamy." Speculators like Hall created volatility in oil prices. Thus regulators are attempting to stop this activity. In the words of one journalist, "How do you hand $100 million to a guy who may have profited because gas hit $4 a gallon?"[193] Indeed, and how does one pay $100 million to an employee of Citigroup, the institution who received a $45 billion taxpayer-funded bailout?[194]

III. <u>The Crisis of Ideas</u>

> Berkshire Hathaway Vice Chairman, Charles Munger: "We want the sophisticated investor to protect himself, but we also want a system that identifies crooks and comes down like the wrath of God on them. We need both."
>
> Professor Joseph Grundfest: "And here I think what's intriguing is we have a failure of both."[195]

The Global Financial Crisis was not just a crisis of credit, but also a crisis of ideas. The GFC challenged the premises upon which the legal system had permitted the shadow banking system to grow. As noted in the introduction, the hands-off approach was premised upon a series of beliefs or expectations. The first was that corporate managers would not sacrifice long-term shareholder value for short-term gains. The second was that trading counterparties would monitor each other closely and discourage excessive risk. The third was that "sophisticated investors" had the ability to select and monitor "private" unregulated investment options, and if they were harmed it affected them only, not millions of underlying savers and the market at large. The catch-all fourth belief was that even if there were blips and bubbles, the market would quickly "heal itself" before causing any major disruption or harm to society.

When each of these beliefs proved untenable, a broader question arose: Do we serve the financial markets or do they serve us? Still, a great divide remains. Some would respond that "finance serves a public utility function" and that the role of financiers is to "ensure that money flows safely." While others would reply that finance should operate as a profit-seeking business. [196]

Representing the public utility position, some were calling for a temporary nationalization of the banks.[197] Others seemed to suggest a permanent takeover. Professor Nassim Nicholas Taleb commented that the bailouts represented the "worst of capitalism and socialism", in that we had "a situation in which profits were privatized and losses were socialized."[198] Damon Silvers, Deputy Chair of the Congressional Oversight Panel, observed that the stated purpose of the originally bailout:

> "was not to rescue Wall Street or make the world safe for derivatives traders. It was to stabilize the system Main Street depended on to allocate savings – the savings of families here and around the world – so that

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[189] Eliot Spitzer, *The Real AIG Scandal: It's Not the Bonuses. It's that AIG's Counterparties are Getting Paid Back in Full*, SLATE, Mar. 17, 2009, available at http://www.slate.com/id/2213942/
[190] Alan S. Blinder, *Crazy Compensation and the Crisis: We're All Paying Now Because Skewed Financial Incentives Led to Too Many Big Bets*, Opinion, WALL ST. J., May 28, 2009.
[191] Segal, *supra* note __.
[192] David Segal, *$100 Million Pay Day Poses Problems for Pay Czar*, N.Y. TIMES, Aug. 1, 2009.
[193] Segal, *supra* note __.
[194] David Wright & Mellody Hobson, *Can Obama Rein In Executive Pay?* ABCNEWS.COM, Aug. 14, 2009, available at http://www.abcnews.go.com/Business/MellodyHobson/story?id=8326957&page=1
[195] *Legal Matters with Charles T. Munger*, STANFORD LAWYER, Spring 2009 (interview of Charles Munger by Joseph Grundfest, hereinafter "Munger Interview").
[196] TETT, supra note __.
[197] Paul Krugman, *Banking on the Brink*, N.Y.TIMES, Feb. 22, 2009.
[198] Svenja O'Donnell & Francine Lacqua, *Taleb Says Nationalize the Banks, You Can't Trust Them*, BLOOMBERG.COM, Jan. 29, 2009.

> other families could finance purchases, and so that employers could finance their operations on terms that were affordable and fair to both lender and borrower." [199]

Regulators echoed sentiment that the financial markets ultimately serve the people. FDIC Chair Sheila Bair noted that the capital infusions were needed "to avert a more pronounced breakdown of the credit system."[200] Fed Chairman Ben Bernanke answered questions in a town hall style meeting televised by public television. Asked by an audience member why the Fed did not let the large firms fall and make room for small business to thrive. Bernanke responded, ""it wasn't to help the big firms that we intervened . . .When the elephant falls down, all the grass gets crushed as well."[201] Indeed the promise of the bailout was egalitarian.

Politicians harnessed the power of this ideological crisis. Then Senator and Presidential candidate, Barack Obama declared this the "a final verdict on eight years of failed economic policies promoted by George Bush, supported by Senator McCain, a theory that basically says that we can shred regulations and consumer protections and give more and more to the most, and somehow prosperity will trickle down."[202] Senator Obama did not mention the fact that much of the significant deregulation occurred during Bill Clinton's years in office. In contrast, President George W. Bush justified his decisions to nationalize AIG, bail out the GSEs and banks with more than $700 billion. He said during an interview with a cable news network, "I've abandoned free-market principles to save the free-market system."[203]

Alan Greenspan, once a proponent of private ordering instead of government regulation, also pinpointed the cause of the crisis as a failed ideological construct:

> The whole intellectual edifice, however, collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today, in my judgment. . . those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance. If it fails, as occurred this year, market stability is undermined."[204]

Stated eloquently by the Congressional Oversight Panel, "As asset prices deflated, so too did the theory that had increasingly guided American financial regulation over the previous three decades – namely that private markets and private financial institutions could largely be trusted to regulated themselves."[205]The notion that counterparties can through the private markets control risky behavior was belied by the fact that "tens of billions of dollars of taxpayers' money has been funneled to A.I.G.'s counterparties — at 100 cents on the dollar."[206]

Another idea destined for the dust bin of history was that "sophisticated investors" had the ability to protect themselves and those for whom they act as fiduciaries. Thus, government regulation (in the form of disclosures and operational controls) would be unnecessary for "private" investment pools to which they directed their own funds and the funds of clients. Regarding subprime mortgages, Greenspan reflected that "To the most sophisticated investors in the world, they were wrongly viewed as a 'steal.'"[207] The reliance upon sophisticated investors will be covered in greater detail below.

It must be noted, however, that this ideological tension between the role of the markets and the financial system is not new. Just after the Depression, in the late 1930s, John Maynard Keynes proclaimed that:

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[199] Opening Remarks of Damon A. Silvers, Deputy Chair, Congressional Oversight Panel, Hearing on Small Business Lending in Wisconsin, Apr. 29, 2009, available at http://cop.senate.gov/documents/statement-042909-silvers.pdf

[200] Nick Grabbe, *FDIC Chief Sheila Bair Tells UMass Crowd that Obama Plans Should Pay Off*, DAILY HAMPSHIRE GAZETTE, Mar. 28, 2009.

[201] Bernanke Live: Fed Chairman Faces PBS Viewers, W.S.J. Jul. 26, 2009, available at http://blogs.wsj.com/economics/2009/07/26/bernanke-live-fed-chairman-faces-pbs-viewers/

[202] James Freeman, Spitzer and Sarbox were Deregulation?, Wall St. J., October 31, 2008.

[203] Bush Weighs Options to Help Automakers, BOSTON.COM, Dec. 17, 2008 (Bloomberg news story), available at http://www.boston.com/business/articles/2008/12/17/bush_weighs_options_to_help_automakers/

[204] Testimony of Dr. Alan Greenspan, Committee of Government Oversight and Reform (October 23, 2008) at 2.

[205] CONG. OVERSIGHT PANEL, SPECIAL REP'T ON REG. REFORM 6 (January 2009) (This report was submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343).

[206] Nocera, *supra* note __.

[207] Greenspan testimony *supra* note __ at 2-3.

> "When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism – which is not surprising, if I am right in thinking that the best brains of Wall Street have in fact been directed toward a different object."[208]

Indeed, crashes and panics bring about the debate afresh. After a collapse, arguments favoring the public utility role and denouncing excessive speculation arise. And, with the help of public outcry and business cooperation, tighter regulation of the risky behavior ensues.

The paradox seems to be, however, that when regulation is successful, the public becomes complacent and business suggests that it no longer needs to be externally controlled. This is a very odd argument, though it has been successful, when pronounced by a charismatic leader. By analogy, the idea seems to be that after building a system of dams, the river argues that it now no longer needs the dams. This paradox was explained by the head of the Congressional Oversight Panel.

> "We go fifty years without a financial panic without a crisis. No banks failing . . . Then what happens is we say regulation is a pain, it's expensive we don't need it so we start pulling the threads out of the regulatory fabric and what's the first thing we get the S&L Crisis. Seven hundred financial institutions fail. Ten years later . . . we get Long-Term Capital Management when we learn that when something collapses one place in the world it collapses everywhere else. Early 2000s we get Enron which tells us the books are dirty. And what is our repeated response, we just keep pulling the threads out of the regulatory fabric."[209]

These philosophical questions intrigue those well outside of the private sector. Even Pope Benedict XVI weighed in with an encyclical entitled Caritas in Veritae (Charity in Truth).[210]

> "Finance, therefore — through the renewed structures and operating methods that have to be designed after its misuse, which wreaked such havoc on the real economy — now needs to go back to being an instrument directed towards improved wealth creation and development. . . Financiers must rediscover the genuinely ethical foundation of their activity, so as not to abuse the sophisticated instruments which can serve to betray the interests of savers."

Most broadly, as one journalist stated, "At stake are competing visions of the U.S. economy: One would be restricted by rules but less prone to bubbles; the other would provide less restraint but also less protection against bubbles that can pop."[211]

IV. Gatekeepers and Enablers

An unhealthy dependency upon credit and speculation brought about the global financial Crisis of 2008 ("GFC"). At all levels of society, individuals and businesses borrowed with unrealistic expectations of future prosperity. Many believed they had the ability to fully pay back principal and interest. Others expected home and other values to rise, so they might sell and pay off their loans, in the event that their income could not keep up with debt service and other expenses. Still others did not have the capacity to think much at all beyond the easy money that credit or leveraged-investments seem to offer.

In particular, large institutional investors who invest the savings of millions of Americans have been pressured to achieve steady returns in order to meet various mandates such pension funds, some which individually needed to make billions in scheduled payments annually to retirees. They have learned, though that following what

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[208] JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY (1936).
[209] *Interview with Elizabeth Warren*, THE DAILY SHOW, Apr. 15, 2009, available at http://www.thedailyshow.com/watch/wed-april-15-2009/elizabeth-warren-pt--1
[210] Encyclical Letter, Caritas in Veritae, of the Supreme Pontiff, Pope Benedict XVI to the Bishops, Priests and Deacons, Men and Women Religious, the Lay Faithful and All People of Good Will on Integral Human Development in Charity and Truth, available at http://www.vatican.va/holy_father/benedict_xvi/encyclicals/documents/hf_ben-xvi_enc_20090629_caritas-in-veritate_en.html
[211] Gary Fields, *Vermont Mortgage Laws Shut the Door on Bust -- and Boom*, Aug. 18, 2009.

promised to be safe, high yields, but which depended upon short-term highly speculative strategies rapidly erased their gains. These institutional investors who hold investment for the long term as "universal owners"[212] are dependent upon the strength of the economy should consider these changes necessary for the overall performance of their portfolios.[213]

Common sense and past experience should have prevented smart, sophisticated individuals from participating in this credit bubble. However, as with the internet bubble, when experts claimed fundamentals like price to earnings rations no longer mattered, with the credit bubble, experts encouraged us to believe that credit risk had been contained through complex financial engineering.

With the benefit of hindsight, we can now see that credit "insurance" did not dilute, but instead concentrated and amplified the risk associated with excessive borrowing. Whether the excess was unreasonable loan-to-income ratios for home mortgages, excessive borrowing-to-equity ratios, or a form of economic leverage through derivatives, it led to the same crisis.

As also noted above, in remarks to Congress, Alan Greenspan marveled after the September crisis that one would have expected that in the interest of corporate profits and protecting shareholders, managers would have avoided self-destructive behavior. This presumption, this intellectual foundation was, unfortunately a poor one. Greenspan informed the Congress, "those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance. If it fails, as occurred this year, market stability is undermined."[214]

It is worth examining, then if private gatekeepers, such as corporate executives, trading counterparties and sophisticated investors cannot protect their self-interests, and public gatekeepers (the SEC and other regulators) are also often conflicted, underfunded, without necessary mandate or expertise, then what mechanism can be put in place to stand between issuers and investors? How might we protect investors and the markets? Prior to answering those questions, this section will examine out some of the gatekeeper theory upon which Greenspan based his comments, offer up a different framework to understand this crisis, that of enabling dependency.

A. Corporate Governance and Gatekeepers

The term "corporate governance" typically is used to describe the power balance between the three primary corporate constituencies, the managers, the board of directors and the owners of publicly traded corporations.[215] Corporate governance can also refer to the responsibility of corporations to society at large.[216]

1. The Separation of Ownership from Control and the Age of Intermediation

The power struggle between owners and managers emerged from an early 20th Century shift in ownership in the U.S. In the 19th Century, business ownership had been more concentrated. With industry's need to raise more capital, a wider shareholder base had to be created. Due to this diffusion of share ownership, corporate managers had control of owners' capital.[217] Owners were numerous and distant. "Persons other than those who [had] ventured their wealth" were directing industry.[218] From this separation of ownership from control arose the agency problem, whereby managers could not always be trusted to act in the interests of owners. The use the securities laws to protect owners or shield managers and directors is often part of the corporate governance area as well.[219]

[212] For an explanation of the term "universal owner," *see*, JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC xv (2000) and ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 268-270 (1995).
[213] HAWLEY & WILLIAMS *supra* note __ . ("If they can't sell, they must care" at 21.
[214] Testimony of Dr. Alan Greenspan, Committee of Government Oversight and Reform (October 23, 2008) at 2.
[215] *See generally* ROBERT A. G. MONKS & NELL MINOW, CORPORATE GOVERNANCE (2d ed. 2001).
[216] THOMAS CLARKE, THEORIES OF CORPORATE GOVERNANCE: THE PHILOSOPHICAL FOUNDATIONS OF CORPORATION GOVERNANCE 1–2 (2004).
[217] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Transaction 2d ed. 1991) (1932).
218. *Id*. at 4.
[219] Robert Thompson & Hilary Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. R. (2003).

In some (but not all) respects, the Berle & Means framework has become outdated. We are no longer in a stage of managerial capitalism but an Age of Intermediation.[220] This concept will be discussed later in the section providing a background on hedge funds.

2. Gatekeepers

Leading corporate governance expert, Professor John Coffee wrote expansively on the role of another "player" in corporate governance, the gatekeeper. [221] Coffee proposes that "corporate governance does not work, nor can management be held accountable, in the absence of a system that makes gatekeepers reasonably faithful to the interests of investors."[222] In his view, the current system of corporate governance, including honest securities offerings, depends upon the vigilance of private individuals. Yet, he notes that private gatekeepers failed in their duties during the accounting Enron, Worldcom and other accounting scandals of the late 1990s-early 2000s.

Coffee describes a gatekeeper as (a) an outsider or otherwise independent; (b) functions in a monitoring role and (c) has the power to screen out, rate or grade another's "compliance with standards or procedures." In other words, a gatekeeper is someone who has the ability to withhold consent and by doing so can prevent bad acts. [223] In the context of corporate law, a gatekeeper stands between the issuer (or corporate manager) and the investor. The gatekeeper should block certain activities, such as securities offerings and other financial disclosures if they fail to meet certain standards. If the gatekeeper blocks the issuer's or manager's ability to make these disclosures, then access to investor funding is also blocked.

While there are public gatekeepers such as the the Securities and Exchange Commission, Coffee's emphasis is on the role of private gatekeepers. This would include auditing firms, attorney, securities analysts and national recognized statistical ratings organizations (rating agencies or NRSROs).[224] While one might expect these gatekeepers to act as effective watchdogs, alerting shareholders when there are compliance problems, Coffee noted that during the accounting scandals of the late 1990s and early 2000s, these watchdogs failed to bark or were not even in the neighborhood. "If there is no watchdog, it cannot bark when the thief comes in the night."[225] He posited that a few factors lead to the silence of gatekeepers. These include conflicts of interest, the disincentives to aid and abet fraud were diminished, and the value of reputational capital is not as significant as in past periods and the effect of market bubbles.

Conflict-of-interest is the greatest challenge according to Coffee. "Although many problems surround the performance of gatekeepers, one problem overshadows all others: typically, the party paying the gatekeeper will be the party that the gatekeeper is expected to monitor."[226] Conflicts of interest made loose standards profitable. Some accounting firms earned roughly half of their revenue for consulting services. The need to "cross-sell" consulting and public accounting practices encouraged questionable accounting treatments at Enron, for example. In addition, due to legal changes, the disincentives to aid and abet fraud were diminished. Furthermore, he noted that the value of reputational capital was not as significant as in past periods.[227]

Finally, he observed the effect of market bubbles. "[F]und managers tend to herd. In part this tendency exists because fund managers and analysts find it more damaging to their careers to be individually wrong than collectively wrong. In part also, such a tendency is a corollary[228] of a stock market bubble. . . . If the fund manager believes that the 'irrational exuberance' of the market is likely to carry the stock price of Enron up another 20 percent, then the fund manager who sells Enron will underperform the market and appear less successful than his competitors. As a result, capital will flow out of the fund into the funds managed by rivals."[229]

[220] *See generally*, Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. (2009).
[221] JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006).
[222] COFFEE *supra* note __ at 17-18.
[223] Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L.ECON. & OG. 53 (1986).
[224] COFFEE *supra* note __ at 2.
[225] COFFEE *supra* note __ at 34.
[226] COFFEE *supra* note __ at 3.
[227] Gatekeepers are trusted by investors, in theory due to reputational capital. And, "gatekeepers should be less willing than their principals to violate the law. Hence, by focusing on the gatekeeper, law enforcement wisely focuses on the weakest link in the chain and may be able to interdict misconduct, even when it cannot effectively deter the principal." COFFEE *supra* note __ at 5.
[228] COFFEE *supra* note __ 32.
[229] COFFEE *supra* note __ 32.

Coffee found that the most successful gatekeepers seemed to be those whose incentive to find the "truth" was greater than the stream of payments associated with plausible deniability.[230]In emphasizing the importance of impartial gatekeepers and not just legally required disclosure, Coffee noted that disclosure is "the classic answer of corporate law to conflicts of interest." Yet the unintended consequences affect the discloser and the recipients of information, according research done by social psychologists.[231] Evidence suggests that when investors receive risk disclosure they believe this indicates a sort of honesty and fair play and then their guard is down. Similarly, when an issuer makes the disclosure, it now feels it has done all it needs to do and can aggressively pursue its self interests.

Coffee himself seems to hold out little hope for making private gatekeepers more accountable: "The sad irony is that the more we strengthen litigation remedies to make professionals more accountable, the more we will see them respond by seeking narrow hyper technical rules that protect them from exercising judgment."[232]

He describes the paradox that: "[A]bsent a litigation threat, professionals acquiesce in dubious and risky practices that their 'client' wants; but once subjected to an adequate litigation threat, professionals insist upon narrow duties, hopelessly specific safe harbors, and a rule-based system that often seems devoid of meaningful principles. In the former environment, they are unaccountable; in the latter, they become useless."[233]

However, as described below, one can find a way out of this morass. If one acknowledges that both disclosure and gatekeepers are important but not sufficient, then, the logical recommendation would be substantive investment and operational restrictions. Not only is this recommendation sensible, but it was also codified in the 1940 Act regulating mutual funds.

B. Enabling Exuberance

A helpful framework emerges by linking the enabling behavior from co-dependency theory to the four legal acts or omissions identified in this paper. Excessive borrowing and speculation can be considered an addiction or dependency. Individuals, investment vehicles, financial institutions and other businesses might be seen at different moments as credit abusers or gamblers. As described in more detail below, this credit abuse and gambling addiction is "enabled" through laws that (1) help the behavior persist; (2) makes it possible for the abuser to avoid the consequences of the behavior; (3) create an atmosphere of fear; and (4) leave the abuser ungrateful and unappreciative.

1. Enabling and Co-dependency

An enabler helps further another person's self-destructive, addictive behavior, protects the abuser from suffering consequences and denies both the abuse and the harm caused to others. The enabler takes these actions due to his or her own dependency upon the abuser. In other words, an enabler helps another "persist in self-destructive behavior (as substance abuse) by providing excuses or by making it possible to avoid the consequences of such behavior."[234]

This usage emerged at the intersection of the "family therapy and chemical dependency treatment professions"[235] as those who observed of the behavior of spouses, family members and others close to those suffering from alcoholism and other substance abuse. The term used to describe the relationship between the close friend or relation and the substance abuser, codependence was popularized in the mid 1980s through the publication of a book that sold millions of copies in the U.S. alone.[236] One expert observed that "*Enabling* is therapeutic jargon that means a destructive form of helping. Any acts that help an alcoholic continue drinking, prevent the alcoholic from suffering consequences, or in any way make it easier for an alcoholic to continue drinking are considered enabling behaviors."[237] Of particular note is the behavior of the substance abuser after a "rescue" by an enabler.

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[230] For example, he noted that it was the short-selling analyst who pushed Fortune magazine to run the Enron article that helped lead to the firm's ultimate demise. This helped expose the multibillion in off-balance sheet entities. Somehow the accountants and lawyers looked the other way.
[231] Daylian M. Cain, George Loewenstein & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUDIES 1 (2005).
[232] COFFEE *supra* note __ at 370.
[233] COFFEE *supra* note __ at 371.
[234] http://www.merriam-webster.com/dictionary/enabler
[235] RICHARD J. FRANCES & SHELDON IRVIN MILLER, CLINICAL TEXTBOOK OF ADDICTIVE DISORDERS, SECOND EDITION 514 (1998).
[236] MELODY BEATTIE, CODEPENDENT NO MORE: HOW TO STOP CONTROLLING OTHERS AND START CARING FOR YOURSELF (1986) (the term enabling is used synonymously in this book with "rescuer" and "caretaker.")
[237] BEATTIE, *supra* note _ at __.

"[T]his victim, the poor person we've rescued, is not grateful for our help. He or she is not appreciative enough of the sacrifice we have made. The victim is not behaving the way he or she should. This person is not even taking our advice. . . "[238] Some suggest that the term "enabling" has been replaced by the term "codependence" given more empathetic connotation, given the genuine suffering experienced by those close to abusers.[239]

The circumstances that bring about enabling include erratic behavior on the part of the addict which leaves others in a state of fear. "The cost of continually living in fear is high. Many co-dependants endure persistent feelings of anxiety and dread, coming to believe that anything good in their lives is in continuous and immediate danger of destruction." [240] Family members continually try to "protect the user from the consequences of his or her behavior, partly because those consequences – loss of life, job, place in the community are feared to be too horrible to endure . . .Responsibility shifts from the [addict] toward the most caring and responsible members of the family; the chief enablers and family heroes."[241]

By analogy, we have created Legal Enablers that further an unhealthy dependency on excessive borrowing or leverage and speculation. Enablers have protected those who engage in these risky practices from suffering economic and legal consequences. In addition, Enablers deny redress for the harm caused to the most vulnerable victims of this credit and gambling. The people we bailed out is not grateful of our help or sacrifice. Responsibility shifted from those who overleveraged to the public taxpayers and investors. One investment consultant noted that "AIG's financial-products division went heavily into the business of speculation, and its gambling debts are what taxpayers are paying off right now."[242]

2. Credit and Gambling Addiction

It is well-established that individuals can be addicted to or dependent upon debt[243] and gambling.[244] Euphoria, exuberance or a high can result from these practices. This mood elevation can temporarily mask other underlying troubles. However, the abusive behavior can create its own problems, threatening both the addict and interconnected family, friends and co-workers.

Even for those who are not addicted to debt, but merely dependent upon it to make up the gap between income and increased expenses, excess has dire consequences. Consumers have since the mid-20th Century advent of universal revolving credit cards[245] suffered from this disease. Credit card issuing banks act as enablers. "If you set out to hang yourself, the banks and credit card companies are more than willing to give you the rope."[246] Indeed, credit card issuers were willing to extend credit to riskier and riskier borrowers, even when they knew these borrowers were likely to default or go into bankruptcy, because the late fees, increased interest rate payments and other charges were extremely profitable.[247] When bankruptcy law expert, Professor Elizabeth Warren met with Citigroup, she explained that the bank could cut its charge-off losses in half if it would cease lending to people who clearly could not afford to pay them back. A Citigroup executive dismissed her suggestion, revealing that those unqualified borrowers who were destined for default were "the heart of our profits. That's where we make all of our money."[248] In this way credit card issuers were dependent upon consumer credit dependence.

Indeed, the entire economy was heavily dependent upon excessive consumer spending. Spending requires money, but with declining real wages money had to be borrowed. Excessive borrowing, then required financial engineering to provide the comfort, or illusion that the risk of default would decrease even as consumers' level of debt to income increased. "Excessive, unsustainable leverage was present throughout our society in the bubble – not just home mortgages or credit cards, but leveraged buyouts of companies large and small, and hidden in

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238 BEATTIE, *supra* note _ at __.
239 FRANCES & MILLER, *supra* note __ *at* __.
240 BRUCE CARRUTH & WARNER MENDENHALL, CO-DEPENDENCY: ISSUES IN TREATMENT AND RECOVERY (1989).
241 CARRUTH & WARNER at 42.
242 Ng, supra note __.
243 *See generally*, History of Debtors Anonymous ("the act of debting itself was the threshold of this disease) available at http://www.debtorsanonymous.org/about/history.htm
244 *See generally*, Gamblers Anonymous website, available at http://www.gamblersanonymous.org/about.html
245 STUART VYSE, GOING BROKER: WHY AMERICANS CAN'T HOLD ON TO THEIR MONEY 98 (2008) (The first third-party credit card, Diners Club was offered in around 1949. The first "truly universal revolving credit card" was BankAmericard, offered by Bank of America in 1958).
246 VYSE, *supra* note __ at 2.
247 SCURLOCK, *supra* note _ at 164.
248 SCURLOCK, *supra* note _ at 164.

complex capital structures and hedge funds. . . If we dismantle or outsource our real economy, cheap credit from our foreign trading partners will not substitute for what we have lost for long."[249]

Additionally, it is also well-documented that in terms of business enterprises, financial institutions and financial systems, excessive leverage and speculation can produce temporary highs, also masking underlying troubles. It is significant that language around credit access evokes alcohol abuse. As former Fed Chairman, William McChesney Martin is often quoted as saying, "You have to take away the punch bowl when the party is warming up."[250]

However, the abuse is unsustainable and ultimately results in a self-destructive crash, threatening the institutions engaged in this behavior and those interconnected counterparties, suppliers, customers, shareholders and so on. In the context of the Global Financial Crisis, in the words of an experienced money manager, "Leverage kills. People forgot."[251]

Leverage is the steroid of finance. Both logic and history show the inevitable result of over-leverage in the economy. When the collateral that secures loans declines, a rapid acceleration of defaults and widespread loss occurs. Yet, borrowing is an important means for businesses (and individual) to finance operations and expansion and to allocate resources to promising enterprises. Accordingly, we had developed laws and empowered regulators to control the amount of debt particular types of entities can amass. In addition, we have developed mechanisms for swiftly, systematically and fairly unwinding (and sometimes restructuring) forms that become insolvent. However, we only applied those laws to certain parts of the financial system, and also allowed for many off-balance sheet tricks to make regulated firms look less leveraged.

> " Federal bank regulators impose minimum risk-based capital and leverage ratios on banks and thrifts and supervise the capital adequacy of such firms through on-site examinations and off-site monitoring. Bank holding companies are subject to similar capital requirements as banks, but thrift holding companies are not. The Securities and Exchange Commission uses its net capital rule to limit broker-dealer leverage and used to require certain broker-dealer holding companies to report risk-based capital ratios and meet certain liquidity requirements. Other important market participants, such as hedge funds, use leverage. Hedge funds typically are not subject to regulatory capital requirements, but market discipline, supplemented by regulatory oversight of institutions that transact with them, can serve to constrain their leverage."[252]

a. <u>Denial of the Past</u>

. "For protecting people from the cupidity of others and their own, history is highly utilitarian."[253]

Leverage kills. People forget and also choose not to remember. With little effort, one can open nearly any book about market crashes or the Great Depression and see the affects of excessive leverage and speculation. Moreover, prior to the Global Financial Crisis, concerns were raised for more than 10 years, specifically related to excessive leverage and private investment pools. It seems implausible, given the repeated pattern of cause and effect that we would forget. Fortunately, historians remember that: "All major panics follow the same basic outline: asset bubble, massive leverage (borrowing to buy the rising asset), bursting bubble (asset price declines rapidly), defaults on loans, asymmetric information and uncertainty, reduced lending, declined economic activity, unemployment, more defaults."[254]

Historically, high levels of borrowing to purchase overvalued assets has played a part in many previous financial and even regional crises. In 1877, the New York Times reported a phenomenon quite similar to the present situation. Mortgages in the West (at the time Illinois) were collapsing. Millions of dollars of "Eastern money" had

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[249] Silvers, *supra* note __.
[250] Federal Reserve Chairman, William McChesney Martin, quoted in Remarks by Governor Edward M. Gramlich Before the Wharton Public Policy Forum Series, April 22, 1999.
[251] Remarks made during a panel at the Yale Governance Forum, June 11, 2009 (the author attended this conference, however, due to Chatham House Rules, whereby neither the identity of the affiliation of a speaker may be revealed, this quote is not attributed).
[252] GAO REP'T, *supra* note __ at 2.
[253] JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929 (1955).
[254] Historian Robert Wright, cited in the SPECIAL REP'T ON REG. REFORM (referencing Andrea Young, *What Economic Historians Think About the Meltdown*, HISTORY NEWS NETWORK, Oct. 20, 2008.)

been lost.[255] Depreciation in real estate values led to the "ruinous impairment of securities based upon it."[256] There was a practice of "obtaining by way of mortgage more than the mortgaged property ought really to be valued at."[257] Foreclosure sales in Chicago were yielding between a quarter and a fifth of what had been the property values.[258] The article noted that:

> "[T]he suspicion arises that the . . . investor is the victim of overvaluation that would be all but impossible without a certain degree of collusion between the agent acting for the mortgagee and the lawyer or agent acting for the mortgagor."[259]

The mortgagee (investors) from the East depended upon the "integrity and sagacity of the persons in Chicago through whom the loan was negotiated."[260] As is the practice today, these mortgage loans were sold. At the time, some were sold even without any guarantees by the seller that the interest or principal would be paid. Companies arose in New York and Boston which would sell these mortgages and provide a guarantee to the investors. However, given the aggregate liabilities of these operators relative to their capital, these guarantees were not meaningful. "A capital of one million, for example, cannot be regarded as a perfectly valid guarantee of ten millions."[261]As to be expected, these "agents" often became insolvent. One such agent went to bankruptcy court seeking discharge from around $1.8 million owed to "Eastern investors, some of the heaviest being shrewd citizens of this State, and another a Hartford life insurance company much addicted to the pursuit of Western securities."[262]

In 1927, many were anxious about the "stock market gamblers" being supplied with loans from member banks. This was thought to drain national resources from legitimate enterprises.[263] The Federal Reserve expressed its concerns about member banks' borrowing "for the purpose of making speculative loans."[264] When President Hoover took office in early March of 1929, he requested that the Fed act to reduce credit for speculative loans. Yet, he did not act forcefully when they failed to act.

Excessive borrowing was again a topic in the 1930s while examining the role of investment pools (known as "investment trusts") in the Crash. The "abuse of leverage was a primary concern that led to enactment of the Investment Company Act."[265] In the [preamble to the] 1940 Act, Congress expressed concerns about the role of "excessive borrowing and the issuance of excessive amounts of senior securities" in that this would "increase unduly the speculative character of their junior securities" and "inadequate assets or reserves."[266] A "senior security" is defined by the SEC to be "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness."[267]

The 1940 Act is the law that governs investment companies (including mutual funds). It will be discussed in greater detail below. The section of that law that restricts the issue or sale of senior securities,[268] was designed to protect both the senior securities holders and the equity or junior securities. The former was abused in that the sponsors often owned a small equity, voting stake in the firm and then borrowed extraordinary amounts by issuing senior debt securities. It was a challenge for senior security holders to calculate their expected return given the "multiple classes" and "pyramiding" of senior securities.[269] Equity holders had the right to redeem their stock and this would diminish the equity cushion that was designed to protect the interests of senior securities holders.[270]

[255] *Collapse of Western Mortgages*, N.Y. TIMES, November 11, 1877.
[256] *Id.*
[257] *Id.*
[258] *Id.*
[259] *Id.*
[260] *Id.*
[261] *Id.*
[262] *Id.*
[263] SELIGMAN, *supra*, note __ at 7, (quoting an article by Virginia Senator Carter Class.)
[264] SELIGMAN, *supra*, note __ at 4.
[265] Derivatives Memo, *supra* note __ at 51 (referencing the SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 707, 75th Cong., 3d Sess. Pt. 1 (1939); the SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 70, 76th Cong., 1st Sess. Pt. 2 (1939); the SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 279, 76th Cong., 1st Sess. Pt. 3 (1939) [hereinafter INVESTMENT TRUST STUDY, (Pt 1 – 3, respectively).
[266] 15 U.S.C. §80a-1(b)(7) and (b)(8).
[267] Securities Trading Practices of Registered Investment Companies: General Statement of Policy, Investment Company Act Release No. 10666 (April 18, 1979) (hereinafter, Release 10666), available at http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf
[268] Section 18(f) of the 1940 Act. Section 18(a) placed some restrictions on closed end funds as well.
[269] Derivatives Memo, *supra* note __ at 54, referencing INVESTMENT TRUST STUDY PT.3, *supra* note __, at 1665, 1674-75.
[270] Derivatives Memo, *supra* note __, referencing the INVESTMENT TRUST STUDY, *supra* note __.

Excessive leverage also put the public equity holders of funds at risk as it created volatility. "[t]he leverage of the senior-junior capital structure magnified the losses suffered by common stockholders."[271]

Leverage and the use of derivatives by investment pools was of great concern in the early 1990s. In June of 1994, the Congressional Committee on Energy and Commerce requested a comprehensive study concerning mutual funds' use of derivatives be performed by the Commission. [272] By September of that year, Chairman Levitt produced a lengthy memo from the Division of Investment Management. The memo sent out to examine whether the laws and regulations governing the use of derivatives by mutual funds were adequate. Included within this study are a series of questions and answers related to the interrelationship between the use of derivatives and the limitations on the use of leverage by investment companies.[273] Also included is a discussion of liquidity problems associated with "exotic derivatives."[274] The term derivative was broadly defined for purposes of the study. It included the more traditional concept of "an instrument whose value is based upon, or derived from some underlying index, reference rate . . . security, commodity, or other asset." [275] It also included "those instruments that are created by separating other financial instruments into constituent pieces, e.g. mortgage derivatives."[276]

Derivatives can involve leverage as they can create an obligation or debt to a third party which is greater than the amount of the initial investment. This might include put options, futures and forward contracts by way of example.[277]

Another instrument can create the economic equivalent of leverage because its price is closely tied to certain market fluctuations, like interest rate or stock price changes. This might include a leveraged inverse floating rate bond.[278] In the Commission's view, the leverage created by derivatives subjects the fund and its shareholders to increased volatility. They became exposed to gains and losses that well exceed the initial investment. Other derivatives that create economic leverage had the same magnifying effect.[279] Accordingly, the Commission applied Section 18 of the 1940 Act to those derivatives that created indebtedness leverage, including futures, forward contracts and written options.[280] Mutual funds are required to "cover" the debt obligations created by these instruments. The method for covering is to hold segregated accounts of cash, U.S. Government Securities or highly rated debt equal to the value of the obligation[281] (but not the full notional amount). As an alternative, of course, holding the underlying instrument of other offsetting instrument would also suffice. It is worth noting that the Commission had not at the time of the report required cover for derivatives that create "economic leverage."[282]

As a result of this study, the SEC put out a release known as "ten triple six" providing guidelines and limits by mutual funds and other investment companies on the use of leverage. In practice, a mutual fund may not take on debt of more than 33 1/3 percent of its assets.[283] In addition, only 15% of a mutual fund's net assets can be in illiquid securities (or 10% for a money market fund).

Given this close attention paid to leverage ratios generally, and with investment pools specifically, it's a marvel that hedge funds slip around any such restrictions, particularly after the collapse of Long-term Capital Management.

b. <u>Leverage, Gambling and the GFC</u>

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[271] Derivatives Memo, *supra* note __, at 56 (also the authority of the Commission to regulate short selling and purchases on margin are based upon related concerns).
[272] Memorandum from the Division of Investment Management to Chairman Levitt, Regarding Mutual Funds and Derivative Instruments (September 26, 1994) (referred to herein as "Derivatives Memo").
[273] Derivatives Memo, *supra* note __ at 51 – 65.
[274] Derivatives Memo, *supra* note __ at 45 – 51.
[275] Derivatives Memo, *supra* note __ at 4 (referencing the GROUP OF THIRTY GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 2 (July 1993).
[276] Derivatives Memo, *supra* note __ at 4 (referencing James K. Glassman, *Mortgages, and Governments, Can Get Sliced and Diced*, WASH. POST, Sept. 7, 1994, at F1.)
[277] Derivatives Memo, *supra* note __ at 57.
[278] Derivatives Memo, *supra* note __ at 58.
[279] Derivatives Memo, *supra* note __ at 58.
[280] Release 10666, supra note __.
[281] Release 10666, *supra* note __.
[282] Derivatives Memo, *supra* note __ at 60.
[283] President's Working Group on Hedge Funds, supra note __ at A-2.

Well before the crisis, in the summer of 2003, two senior economists from the Bank of International Settlements warned that new financial innovations made us "more vulnerable to boom and bust cycles."[284] Notwithstanding concerns about leverage, in 2004, the SEC changed its practice of controlling the amount of debt brokerages could have relative to their equity.[285] This placed pressure on brokerages to increase leverage so as to improve earnings. In 2005, a former banker who had structured credit derivatives worried about the "euphoria" around structured finance and questions whether a "state of irrational exuberance" might be developing. Another banker agreed that the "buzz about credit derivative products" was the "hedge funds getting into it without the requisite abilities."[286] Indeed both the leverage and complexity of this instruments suggested that even sophisticated investors were speculating and chasing yield without an appreciation of the risks involved.[287]

In 2006, FDIC Chair, Sheila Bair expressed concern about the relationship between leverage and systemic risk, proclaiming that "the leverage ratio—a simple tangible capital to assets measure—is a critically important component of our regulatory capital regime."[288] Also, Timothy Geithner, then the president of the New York Federal Reserve addressed the New York Bankers' Association expressing concern about leverage:

"[C]onfidence in the overall resilience of the financial system needs to be tempered by the realization that there is much we still do not know about the likely sources and consequences of future stress to the system . . .[and]. . . The proliferation of new forms of derivatives and structured financial products has changed the nature of leverage in the financial system. The addition of leverage imbedded in financial instruments to balance-sheet leverage has made this source of potential risk harder to assess."[289]

Just before the Global Financial Crisis, the leverage (ratio of borrowing to capital) at major regulated and unregulated financial entities was extremely high. The greatest leverage were broker-dealers and hedge funds at 27 to 1. Next in line were the mortgage Government Sponsored Enterprises such as Fannie Mae and Freddie Mac with 23.5 to 1.5. At the other end of the spectrum were commercial banks (9.8 to 1) and savings banks (8.7 to 1).[290]

However, prior to the crash, the majority view at the Fed in Washington and the Treasury was that financial engineering through credit derivatives and CDOs had dispersed risk.[291]

There are, however, divergent opinions from experts on the role of leverage in the GFC. According to the GAO report:

> "Some studies suggested that leverage steadily increased in the financial sector before the crisis, and deleveraging by financial institutions may have contributed to the crisis. First, the studies suggested that deleveraging by selling financial assets could cause prices to spiral downward during times of market stress. Second, the studies suggested that deleveraging by restricting new lending could slow economic growth. However, other theories also provide possible explanations for the sharp price declines observed in certain assets. As the crisis is complex, no single theory is likely to fully explain what occurred or rule out other explanations. Regulators and market participants we interviewed had mixed views about the effects of deleveraging. Some officials told us that they generally have not seen asset sales leading to downward price spirals, but others said that asset sales have led to such spirals."[292]

Nonetheless, the GAO still concluded "The financial crisis has revealed limitations in existing regulatory approaches that restrict leverage."[293]

Derivatives trading, with no central clearing, brought back the bucket shop, because you could make bets without having any interest in the basic security, and people did make such bets in the billions and billions of

[284] TETT, *supra* note __ at 153, citing Claudio Borio & William White, *Whither Monetary and Financial Stability?* Paper presented to Reserve Bank of Kansas City Economic Symposium, Jackson Hoke, Wyoming, Aug. 30, 2003.
[285] TETT, *supra* note __ at 134, referring to the SEC ____
[286] TETT, *supra* note __ at 129, referring to comments made by Terri Duhon and Cynthia McNulty at a conference in Nice in Apr. 2005.
[287] TETT, *supra* note __ at 130.
[288] Federal Deposit Insurance Corporation, Remarks by Sheila C. Bair, Chairman before the Conference on International Financial Instability: Cross-Border Banking and National Regulation, Federal Reserve Bank of Chicago and the International Association of Deposit Insurers (October 5, 2006), available at http://www.fdic.gov/news/news/speeches/archives/2006/chairman/spoct0606.html and cited in SPECIAL REP'T ON REG. REFORM *infra* note __ at 26.
[289] Tett, supra note __ citing Timothy Geithner Remarks at the New York Bankers Association Financial Services Forum Chairman's Reception, New York City, Apr. 5, 2006.
[290] SPECIAL REP'T ON REG. REFORM , *supra* note __ at 24.
[291] TETT, *supra* note __ at 152.
[292] GAO REP'T, *supra* note __ at 2.
[293] GAO REP'T, *supra* note __ at 49.

dollars. Some of the most admired people in finance—including Alan Greenspan— argued that derivatives trading, substituting for the old bucket shop, was a great contribution to modern economic civilization." [294] In other words, "the securities market function better as a gambling casino with vast profits for the people who were croupiers."[295] The C.O.P. declared that: "Without clear and effective rules in place, productive financial activity can degenerate into unproductive gambling, while sophisticated financial transactions, as well as more ordinary consumer credit transactions, can give way to swindles and fraud."[296] And, corporate governance experts wondered whether we desired "to go back to an era when banks were banks and not casinos."[297]

V. Stop Enabling : Regulate Private Investment Pools: Pool Safety

This paper recommends that we eliminate the loopholes that allow unregistered investment pools broad discretion to, for example, operate without transparency or supervision, to engage in self-dealing or related-party transactions, to inaccurately value and inadequately protect assets and to take on excessive leverage and illiquid portfolio securities. Instead, a 1940-Act "lite" regime should apply to investment pools regardless of whether they are ostensibly offered privately to "sophisticated investors." So long as these pools have control over the retirement savings of ordinary Americans they should be made safe. And, so long as these pools have the ability individually or collectively to create systemic risk, they should also be subject to substantive 1940 Act regulations.

A. Role of Private Investment Pools in the Global Financial Crisis

Private investment pools played a central role in the GFC. Mortgage-backed securities themselves are private investment pools, exempt from the 1940 Act. It is well-documented that the GFC started in the sub-prime mortgage market. While it is clear that the 1940 Act could not and should not on a wholesale basis apply to these pools, it would make sense to apply some safer limits on "economic leverage" for CDOs. The Securities and Exchange Commission briefly addressed the theretofore safe record of these securitization vehicles in its comprehensive report on the state of the Investment Company Act.[298] That being said, the focus of this section of the paper is on another type of "private" investment pool, the hedge fund.

The debate over whether hedge funds caused the GFC reminds one of a stanza from a T.S. Eliot poem, "Streets that follow like a tedious argument/Of insidious intent."[299] Many who either work in the hedge fund industry or are paid in some way by the hedge fund generally deny the connection and also resist regulation. If they are open to regulation, it is very mild disclosure obligations which will not remedy the problem.

That said, hedge funds did play an important role. As noted in the sections above, hedge funds were willing buyers of the toxic waste "equity" tranche of subprime mortgage-backed CDOs. In addition, they were big players in the credit default swap market. The collapse of the two Bearn Stearns hedge funds signaled a transformation of the subprime crisis into a much larger credit problem. Moreover, given the opacity of hedge funds, it is still difficult to discern the magnitude of their involvement.

However, whether they were the prime cause of the crash is beside the point. Unregulated hedge funds are a problem due to the harm they can cause to investors and the markets because they cannot withstand market turmoil. Even if they were not the sole or primary contributor to the GFC, they help to magnify the damage done and harm their own investors. In terms of defining the systemic risk, many acknowledge that hedge funds are like banks, that generate tremendous negative externalities when the fail. Yet, hedge funds are even more prone to such effects because:

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[294] Munger Interview, supra note __.
[295] Munger Interview, supra note __.
[296], SPECIAL REP'T ON REG. REFORM , *supra* note __ at 2.
[297] Remarks made during a panel at the Yale Governance Forum, June 11, 2009 (the author attended this conference, however, due to Chatham House Rules, whereby neither the identity of the affiliation of a speaker may be revealed, this quote is not attributed).
[298] DIV. OF INV. MGMT., U.S. SEC & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION __ (1992).
[299] T.S. ELIOT, *The Love Song of J. Alfred Prufrock* in PRUFROCK AND OTHER OBSERVATIONS (1917).

> "unlike banks, hedge funds can decide to withdraw liquidity at a moment's notice, and while this may be benign if it occurs rarely and randomly, a coordinated withdrawal of liquidity among an entire sector of hedge funds could have disastrous consequences for the viability of the financial system if it occurs in the wrong time and in the wrong sector."[300]

In addition, the techniques used by these pools were the cause of this crisis and earlier meltdowns and crashes. Restricting a dangerous behavior makes sense regardless of who the market player is. Excessive leverage was a chief contributor to the collapse and we know that hedge funds have no leverage restrictions. We also know that they represent over a trillion dollars in assets. While some declare that because regulated banks and investment houses were bigger contributors to the GFC, hedge funds deserve to maintain a special place in the shadows of the banking system. This simply does not follow. The need to regulate hedge funds arose prior to the GFC. Moreover, it relates to the techniques that hedge funds are permitted to employ. Finally, the industry has all but conceded that regulation is on its way. The battle grounds now are around whether that regulation will be more than a minor registration and disclosure requirement under the Investment Advisers Act of 1940, or something with real value to protect investors and the market.

The GAO noted that in order to "ensure financial stability," many financial institutions that use leverage are regulated, hedge funds are not. The justification is that "market discipline, supplemented by regulatory oversight of institutions that transact with them, can serve to constrain their leverage."[301]In this last sentence, the GAO suggests that leverage can be constrained by institutions like counterparties who trade with them, prime brokers who lend to them and by the market generally.

Many disagree. Given the meltdowns of Long-Term Capital Management (discussed below) as well as others, it's clear that counterparties are not good watchdogs. Additionally, prime brokers do not have complete information about the total debt incurred by hedge funds they to whom they lend. Most importantly, the entire exemption for hedge funds depends upon the ability of "sophisticated investors" to select and monitor investments. As discussed below, this has not happened.

Finally, assuming that the market can somehow arrive at the right level of leverage, then the belt-and-suspenders approach of government oversight should not be a problem for the industry. However, as discussed in the "crisis of ideas" section above, this intellectual edifice supported by the "central pillar" of "counterparty surveillance" has collapsed.[302]

B. Hedge fund background

The term "hedge fund" is used to describe "an investment vehicle that pools capital from a number of investors and invests in securities and other instruments."[303] Hedge funds based in the U.S. are commonly organized at Delaware limited partnerships. This general partner, often a limited liability company ("LLC"), acts as the hedge fund manager.[304] Sometimes the general partner contracts with a third party to act as the investment adviser (or sub-adviser) to the fund. The limited partnership interests are considered "securities."[305] Some hedge funds are organized as LLCs, with one of the LLC members acting as a managing member.[306] Another popular way to organize a hedge fund is through a "master-feeder" structure. Investors purchase interests in a feeder fund and that fund invests its assets into an underlying or "master" fund. Typically the underlying fund is located outside the U.S. to minimize taxation. Other feeder funds also invest assets into the master fund. This should not be confused with another variant, the fund-of-hedge fund structure. With this the fund-of-hedge fund form, the investor buys shares in a hedge fund that then invests in roughly 25 – 50 separate hedge funds.[307]

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[300] ANDREW W. LO, HEDGE FUNDS: AN ANALYTIC PERSPECTIVE 302 (2008).
[301] GAO REP'T, *supra* note __ at 2.
[302] Testimony of Dr. Alan Greenspan, Committee of Government Oversight and Reform (October 23, 2008) at 2.
[303] THOMAS P. LEMKE, GERALD T. LINS, KATHRYN L. HOENIG & PATRICIA S. RUBE, HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE 1 (2008-2009).
[304] LEMKE et al, *supra* note __ at 14 - 15.
[305] LEMKE et al, *supra* note __ at 15.
[306] LEMKE et al, *supra* note __ at 18.
[307] LEMKE et al, *supra* note __ at 255.

Conceptually, a hedge fund is quite similar to a mutual fund. Both are types of "investment companies," meaning they sell securities to investors, pool the proceeds of those sales and invest in other securities. However, hedge funds have escaped regulation due to the character of their investors and the "private" way they are sold. A mutual fund is an open-ended investment company, meaning, it issues shares constantly and existing shareholders can redeem their shares in exchange for cash on demand within at least 7 days.[308] In addition, mutual funds are typically organized as state law business trusts or corporation, not partnerships.

Records indicated that the first hedge fund was operated by Alfred Jones in 1949. This fund had a mere $100,000 in assets.[309] Jones was thought to be the first to run a balanced portfolio.[310] Seeking a market-neutral portfolio, he took long positions in undervalued stocks and short positions[311] in overvalued stocks. He hoped that events that lifted or deflated the equity markets would not damage the value of his assets as his short and long positions would respond inversely. At that time and into the early 1950s, the hedge fund concept was fairly limited. The term was used to describe an equity fund like Jones' that engaged in basic hedging practices.[312] Even into the early 1990s, many hedge fund investors sought a conservative absolute return that would not necessarily mimic the market overall, but would also not decline in concert during poor performance of the broader market.[313]

Since the 1950s however, the term "hedge fund" has become quite elastic. Increasingly, it was used to mean any type of "unregistered, privately-offered, managed pools of capital, general excluding, in particular, funds principally involved in venture capital or similar private equity investments."[314] In other words, a hedge fund became defined in the negative, not the positive. It was a "catch-all." Indeed, there is much confusion today over this concept. The term "hedge fund" refers to a structure not an investment style. In short, "there is no such thing as a well defined hedge fund strategy or approach to investing."[315] However, approximately 30-40% of the hedge fund "business" is said to employ the long-short strategy.[316]

While hedge funds employ a variety of investment strategies, there are some common characteristics. Most hedge funds generally seek absolute returns, in that they are often designed to generate profits in all market conditions as opposed to being measured relative to a benchmark index.[317] Most hedge funds use leverage. Leverage can be achieved through a variety of modes including short selling, buying securities on margin, borrowing, selling securities through repurchase agreements and investing in derivatives.[318]

Where hedge funds differ is in strategies. By way of illustration, these strategies can include the "long-short" approach like the Jones fund, long only, or short-bias. A hedge fund might focus on a particular industry or sector, such as energy. Some focus on emerging market debt or equities. Some hedge funds capture arbitrage opportunities, such as fixed-income arbitrage, convertible bond arbitrage and event-driven arbitrage. A growing number of hedge funds, sometimes referred to as "vulture funds" focus on purchasing the debt or equity of corporations under extreme economic distress.[319]

Almost sixty years after the first hedge fund launched, at its peak, hedge fund assets were thought to be at $1.9 trillion.[320] There were only about 215 hedge funds in 1968 and possibly 3,000 by the 1990s.[321] Over 16 years,

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[308] The fund must settle the transaction in no more than 7 days, though they typically settle T+1. There are also closed-ended investment companies that issue shares in a primary offering but then not after. The shares are then traded on the secondary market, typically through listing on an exchange. From a legal perspective, the only thing that distinguishes a hedge fund from a mutual fund or closed-end investment company is that generally, neither the hedge fund itself nor its manager are registered under the federal securities laws. (While some do register, they are rare and will be discussed below). This legal distinction also impacts the ability for hedge funds to pursue a wide variety of investment strategies not available to mutual funds or other registered investment companies. For more details on mutual fund structure and regulation, see Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. Issue 3 (2009).
[309] Aguilar Speech, supra note __.
[310] ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 25 (2000).
[311] A long position means buying the stock outright and holding it. A short position involves borrowing shares of stock in a company and then selling them, then buying them back (hopefully at a lower price) and returning them to the original owner. It is a way of betting that the price will go down and capturing the difference. Naked shorting is similar, except that one does not actually borrow the stock.
[312] SEC Chairman, William H. Donaldson, Testimony Concerning the Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk, Before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, May 22, 2003 (hereinafter, "Donaldson Testimony").
[313] LOWENSTEIN, *supra* note _ at 25.
[314] Donaldson Testimony, *supra* note __.
[315] Stephen J. Brown, *The Role of Hedge Funds in Financial Crisis*, FINANCE AND MARKETS MONITOR (Oct. 2008).
[316] Brown, *supra* note __.
[317] LEMKE et al, *supra* note __ at 2.
[318] LEMKE et al, *supra* note __ at 2.
[319] LEMKE et al, *supra* note __ at 2 -6.
[320] Lattman & Stasburg, supra note __

hedge funds experienced a 3,000% growth rate.[322] SEC Commissioner Luis A. Aguilar noted that "it is believed that the industry managed around $38 billion in 1990, $625 billion in 2002, and reached $1.9 trillion at the end of 2007, although that amount may have decreased to $1.3 trillion at the end of 2008."[323] Hedge funds were said to have made 30%of all US fixed income trades, which included 85% of distressed debt and 80% of certain credit derivative trades.[324]

Much as the managers may say they are in it for the long haul, "the typical hedge fund has a half life of five years or less."[325] The conclusion some draw from this observation is that managers have only one shot to get it right and will not be excessive risk takers. However, it is equally likely that given the odds of failing due to events beyond their control, managers will take all kinds of risk. Or, one might conclude, regardless of how hard they try or the risks they take, the 2 and 20 payment and high water mark structure encourages making fast money.

Not all hedge funds use leverage, and many hedge funds have positive effects on the market. Some activist hedge funds can improve long-term shareholder value.[326] Some pressure entrenched management. They also have the potential to mitigate risk and perform better than the market index during bear markets. However, one does not need to overlook the benefits of some hedge funds to recognize the dangers others have, do and can cause due to their unlimited investment options. In other words, some people are good, but that does not suggest we should abandon laws that prohibit socially undesirable actions like theft or violent crimes.

Many hedge funds have been found or suspected to have engaged in insider trading, front running, market timing. They also meet 4 of the 8 areas identified in the COP Special Report on Regulatory Reform as "most urgently in need of reform." [327] They appear to "pose systemic risk," have the ability and practice of using "excessive leverage," are a part of the "shadow banking system," employ pay structures that encourage "excessive risk taking," Hedge funds and systemic risk will be discussed in more detail below.

Many hedge funds will not survive the crisis. Hedge funds were already, on average down by 5% by the time the Bush Administration began the bailout proposals.[328] In the nine months ending on June 30, 2009 $300 billion was withdrawn by hedge fund investors. [329] At a single hedge fund run by Cerberus, in August 2009, investors withdrew $5.5 billion around 71% of the fund's assets. Of these those run by well-known managers Atticus Capital LP, Pequot Capital Management and Cantillon Capital Management closed down.[330]

C. Hedge Fund Ownership

In order to identify who owns hedge funds, one first needs to be clear on what is meant by "ownership." When an institution purchases interests in a hedge fund, it becomes the "owner." However, the institution is not the ultimate investor whose savings or retirement benefits are at risk. The law around hedge funds ignores this reality. Instead, it does not "count" the ultimate investors. It generally counts only the institutions who manage other people's money. While this will be discussed in greater detail regarding the securities laws loopholes for hedge funds, it is introduced here. It is important to keep in mind, whenever institutional owners are mentioned that there are millions of people not counted behind those institutions.

This is easy to illustrate by first using a familiar example, the mutual fund. Thereafter, the more complex example, the hedge fund can be explained. In the U.S. more than 90 million individuals, or half of all households own mutual funds.[331] They may be direct retail investors in the funds. Or, they may be indirect investors, such as through their 401k plan. Mutual funds are essentially shell entities that take money from investors and direct it to the capital markets by buying up securities. They constantly offer shares to the public and redeem them on demand.

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[321] LOWENSTEIN, *supra* note _ at 26.
[322] William Klunk, Actuary Domestic Policy Division, Pension Funds Investing in Hedge Funds, CRS Report to Congress, June 15, 2007.
323 Aguilar Speech, supra note __.
[324] John P. Hunt, *Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports – Raising the Bar but Missing Risks*, Berkeley Law working paper, June 2008.
[325] Brown, *supra* note __.
[326] See, e.g. Alon Brav, Wei Jiang, Randall Thomas & Frank Partnoy, *Hedge Fund Activism, Corporate Governance and Firm Performance*, 63. J. FIN. 1789 (2008).
[327] SPECIAL REP'T ON REG. REFORM, *supra* note __ at 4.
[328] Landon Thomas Jr., *In Newest Crisis, Hedge Funds Face Chaos*, N. Y. TIMES, Sept. 21, 2008.
[329] Peter Lattman & Jenny Stasburg, *Clients Flee Cerberus, Fallen Fund Titan*, WALL ST. J., Aug. 29, 2009.
[330] Lattman & Stasburg, supra note __ (Though they were ostensibly "privately" offered, some are described as having "big names").
[331] INV. CO. INST., 2009 INVESTMENT COMPANY FACT BOOK 15 (49th ed. 2009).

Collectively, US mutual funds have more than $10 trillion in assets.[332] These assets include, for example, U.S. stocks, mortgage-backed securities, municipal securities, short-term commercial paper and many other equity and debt instruments, depending upon the particular fund's investment mandate. When a person buys shares in a mutual fund, and that fund turns around and buys common stock of corporation XYZ, the mutual fund is the legal owner of the common stock. Thus, the person who puts his or her money at risk, who depends upon the financial performance of that underlying corporation is not the legal owner. The fund is a middleman or intermediary. Taking this a step further, if a person participates in a 401k plan and selects a mutual fund for investment, when that mutual fund buys common stock of corporation XYZ, it is the retirement plan that is the owner of the mutual fund and the mutual fund is the owner of the corporation. Thus, the ultimate investor is not a legal "owner" of either investment. Both the plan and the mutual fund, two shell entities are owners. The entities who have are legal "owners" are not the "true owners" are those with their savings at risk.

In the context of hedge funds, the story is similar, but a little more complicated. At the peak, hedge funds had $1.9 trillion in assets and presently around $1.5 trillion.[333] While this may seem small relative to the mutual fund industry worldwide, it is worth noting that US mutual fund assets were at that same level in the early 1990s. While there are more than 18,000 hedge fund across the globe, 75% of the assets are managed by approximately 200 firms, each with more than $1 billion under management.[334]

It is clear that "In recent years, [hedge fund] growth has been fueled in part by institutional investors, such as endowments, foundations, insurance companies, and pension plans."[335] According to a 2005 study conducted by the Bank of New York, and Casey Quirk & Associates, it was estimated that by 2008, institutions would invest over $300 billion in hedge funds. It is not clear whether this figure represents their initial capital contribution of their share of the total assets. Of this institutional money, around 40% came from pension funds.[336]

A 2006 report to Congress reported that almost a quarter of all pension funds were invested in hedge funds. The average amount of pension fund assets dedicated to them was 2.1%.[337]

Lured by the attractive returns and pressured to achieve absolute returns[338] in order to finance the retirements of an increasing number of retirees, some pension funds had 20 – 39% of plan assets invested in hedge funds.[339] Given the challenges of its underfunded pension liability, it is not surprising that, General Motors was one of the first corporations to invest its pension plan in hedge funds. GM had to pay out over $6.5 billion per year to retirees, necessitated a 7% annual return to avoid drawing down principal.[340] These funds represent the employees' deferred wages and future retirement security. At the time, concerns were raised by " consultants and academics [who] question whether hedge funds, with risks that are hard to measure, are appropriate for pension funds, whose sole purpose, by law, is to pay out predetermined benefits to retired workers."[341] Some suggested that it was inappropriate for funds that have to pay retirees on a specific schedule lock up assets in hedge funds that could suspend withdrawals.[342] Notwithstanding the growing commitments to hedge funds by pension plans, ERISA did not require plan sponsors to reveal to beneficiaries how many hedge funds and the amount of total assets invested in hedge funds.[343]

D. <u>The Regulation Hedge Funds Slipped Through</u>

Generally speaking, hedge funds are investment pools that slipped through certain New Deal legislation: the Securities Act of 1933 (the "1933 Act"), The Securities Act of 1934 (the "1934 Act"), the Investment Company Act of 1940 (the "1940 Act") and the Investment Advisers Act of 1940 (the "Adviser's Act"). In addition these

[332] *Id.*
[333] Managed Fund Association, FAQ, available at http://www.managedfunds.org/hf-hf-adviser-faqs.asp
[334] M.F.A., supra note __
[335] Aguilar Speech, supra note __.
[336] Riva D. Atlas & Mary Williams Walsh, *Pension Officers Putting Billions into Hedge Funds*, N.Y. TIMES, Nov. 27, 2005.
[337] William Klunk, Actuary Domestic Policy Division, Pension Funds Investing in Hedge Funds, CRS Report to Congress, June 15, 2007.
[338] Fiona Stewart, *Pension Fund Investment in Hedge Funds*, OECD Working Papers on Insurance and Private Pensions (2007).
[339] Atlas & Walsh, supra note __.
[340] Id.
[341] Id.
[342] Id.
[343] Klunk, supra note __.

loopholes were later expanded to encourage their growth. Prior to explaining how the loopholes operate, it's important to provide the historical context for these laws as well as their content. In other words, revisiting the reasons for the laws and the premises upon which hedge funds escaped them is useful. From there it is possible to make the case that if those premises have eroded, regulation is indeed necessary and the loopholes should be sewn shut.

1933 Act and associated regulations, governs the initial offering and sale of securities. The 1933 Act provided some very basic protections. Essentially, it sought three things (1) registration: with the government of all securities, (2) disclosure: control over the content and manner of disclosing an offering of securities and (3) liability: creation of criminal and civil liability[344] based upon materially false or misleading statements in registration statements.[345]

The 1934 Act focused upon the secondary market in securities. It was designed to regulate the stock exchanges, prevent market manipulation and to place "curbs on excessive speculations."[346] It requires publicly-traded firms to make ongoing disclosure and prohibits manipulative and misleading conduct.

The 1940 Act regulated the offering, sale and operations of investment companies. Unlike the 1933 and 1934 Acts which focused upon truthful and complete disclosure, the 1940 Act was far more comprehensive. It applied to investment companies where there had been tremendous abuses.[347] It recognized that investment companies were very different from ordinary corporations ("operating companies") that made a product or service for public consumption. The main business of investment companies was collecting savings from the public and investing in securities. Given that the operators of investment companies were often the same institutions that "manufactured" and traded securities, there were tremendous temptations for self-dealing, front-running, excessive leverage and fraud. It recognized that with these pools, it was not enough to mandate disclosure. Thus the 1940 Act imposed very detailed investment and operational restrictions upon mutual funds (as well as "closed-end" investment companies). The Advisers Act regulated the conduct of and fees charged by money managers or advisers.

1. <u>1933 and 1934 Acts</u>

> The 1933 Act codified the "right of prospective investors to demand that any business organization which seeks their savings must provide them with such information as may be adequate for the evaluation of investment opportunities."[348]
>
> "Let the seller also beware"[349] FDR, 1933

The 1929 Crash catalyzed public awareness that "promoters, officers, directors and principal stockholders of many corporations had been faithless in the discharge of their fiduciary duties"[350] of loyalty and care. However, well before 1929, made reformers introduced federal legislation to protect investors from unscrupulous underwriters[351] or sellers of securities. In 1900, the United States Industrial Commission made suggestions that investors receive disclosure of "details of the organization that might be of material consequence to the intelligent investor."[352] The USIC also recommended that prospectus liability attach for failure to disclose the facts or for making untrue statements. In 1903, a Bureau of Corporations was established within the fledgling Department of

[344] Including monetary damages and a right of recission.
[345] CHERRINGTON, *supra* note _ at 67.
[346] *Roosevelt Signs*, *supra* note __ .
[347] *See* generally, Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. fn 99 – 112 (2009).
[348] CHERRINGTON, *supra* note at ix.
[349] *National Affairs: Caveat Venditor*, TIME, April 10, 1933.
[350] CHERRINGTON, *supra* note _ at 1.
[351] An underwriter of a securities offering, typically guarantees to advance the issuing company money. The underwriter then takes on the risk of selling the securities to the public. In exchange for fronting the money and taking on the risk of being left with an inventory of unsellable or slow to sell securities, the underwriter receives a premium. Thus the amount paid by the underwriter to the issuing company is less than the total predicted value of the stock sale. Additionally, when the public offering price is too low underwriters can give favorite customers a piece of the offering. Customers can quickly "flip" or sell the stock if it begins to rise quickly on the secondary market.
[352] CHERRINGTON, *supra* note _ at 38.

Commerce. It strove to end state-by-state incorporation and to require the largest publicly traded corporations to become federally chartered.[353]

Thereafter, the Commissioner of Corporations sought to prohibit “misleading or dishonest financial statements”[354] This was thought to be one of the “principal evils of the corporate form of organization.” President Taft asked Congress to federalize corporate law “to prevent the recurrence under the national auspices of those abuses which have arisen under state control.”[355] The Federal Trade Commission reported in 1920 many efforts “to stop the sale of worthless securities.”

Failed legislation included a bill introduced by Congressman Taylor which required registration of securities with the Treasury department. It also provided for liability for damages against anyone who signed the registration statement. His intention was to “compel the stock shark faker to make a truthful statement of what he has and who he is, and all about his scheme, so that any intelligent person may know that he is a swindler and is selling clear blue sky.”[356] Opponents complained that such disclosure would “place an excessive burden on honest corporations and investment banks.” They also did not want to hire outside accountants to verify the financial statements. The bill died in committee.

Sentiment changed, though after the boom and bust. In 1920 through 1928, the listed stocks on the NYSE doubled in value. This aligned with corporate profits which had risen by 80%. However, at the end of Calvin Coolidge’s presidency, between March of 1928 through August of 1929, “the market began to exhibit a manic quality.”[357] Stocks then again, doubled in value in that eighteen month period.[358] With the Great Crash, between September 1, 1929 and July 1, 1932, listed stocks on the NYSE lost 83% of their value, going from $90 to $16 billion.[359] In 1933, an expert from the Department of Commerce who testified at House hearings, revealed that of the $50 billion in securities sold during the past thirteen years, half or $25 billion were “undesirable or worthless.”[360]

In 1932, the President told Congress that legislation needed to be passed that shifted the paradigm that caveat emptor was not sufficient but “that the seller should also beware.”[361]To create the federal securities laws, it was necessary to transform public sentiment. The Congressional “Pecora Hearings” held between 1932 and 1934 aided that effort. During those hearings, attention was drawn to the “salary levels and income tax returns of the financiers” appearing before the committee.[362] It was Pecora’s view that “extravagant incentive salary arrangements [at National City] had encouraged bank officers to engaged in unsound security-selling and unsound banking practices.”[363]

Taking advantage of the populist dissatisfaction, President Roosevelt sent a message to Congress recommending legislation to regulate the offering of securities:

> "The public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities. . . . There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. This proposal adds to the ancient rule of caveat emptor ['Let the buyer beware'] the further doctrine: 'Let the seller also beware' [caveat venditor]. It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence."[364]

On May 27, 1933, President Roosevelt signed the Rayburn-Fletcher Securities Bill.[365] Hailed as a law that was “designed to protect the investing public by means of publicity concerning stock issues,”[366] it was initially

[353] COFFEE *supra* note __ at 119.
[354] CHERRINGTON, *supra* note _ at 39.
[355] CHERRINGTON, *supra* note _ at 41.
[356] CHERRINGTON, *supra* note _ at 44, citing the Hearings on H.R. 188, 66th Congress, 1st Session p. 13.
[357] SELIGMAN, *supra,* note __ at 2.
[358] SELIGMAN, *supra,* note __ at 2.
[359] SELIGMAN, *supra* note __ at 1.
[360] *Caveat Venditor*, supra note __.
[361] CHERRINGTON, *supra* note _ at 58.
[362] SELIGMAN, *supra,* note __ at 2.
[363] SELIGMAN, *supra,* note __ at 26.
[364] *Caveat Venditor*, supra note __.
[365] *Roosevelt Signs the Securities Bill,* N.Y. TIMES, May 27, 1933.
[366] *Roosevelt Signs*, *supra* note __ .

"unwelcome to a great many persons."[367] Upon signing the law, the President proclaimed that "this measure at last translates some elementary standards of right and wrong into law."[368]

Roosevelt viewed the 1933 Act as going beyond merely investor protection. He perceived it as protecting markets so they could serve society. He announced that "[T]he merchandising of securities is really traffic in the economic and social welfare of our people."[369] He went on to declare that "If the country is to flourish, capital must be invested in enterprise. But those who seek to draw upon other people's money must be wholly candid regarding the facts upon which the investor's judgment is asked."[370] He saw the law as putting an end to "private exploitation of the public's money."[371] This was in his view a "permanent addition to our regulatory legislation."[372]In addition, he saw the disclosures required in the 1933 Act as a way to prevent "the approach of economic depressions and the taking of steps to prevent them."[373]

The Federal Trade Commission initially had the "primary duty to guard the investing public against tricksters in the stock market."[374] Because the Securities and Exchange Commission took over this role after the 1934 was enacted,, to avoid confusion, hereafter, the Commission shall be referred to as the "Commission." The law required underwriters to register with the Commission prior to selling stocks or bonds. Registration statements had to be filed at least 20 days in advance to give the expert accountants on staff at the Commission time to review the filing. Acting as a gatekeeper, the Commission could either approve or deny the security from being offered to the public.[375] The registration statement was open to public inspection. Information required in the registration statement included the name of the issuer, it officers, identity of principal stockholders and other important information. For example, the names and addresses of persons holding 10% of any class of stock of the issuer had to be disclosed. Payments made in the prior year to officers or directors in excess of $25,000 was included. Also, the as the maximum aggregate price had to be included.[376]

While prospective investors could be given a prospectus (or offering document), it also needed to be filed with the Commission. The prospectus did not need to contain all of the information included within the registration statement, however, it could not omit any material information that would make other claims in the document misleading. Even radio advertisements had to be filed five days before broadcast with the Commission and were required to contain certain basic information such as the price of the stock and the date of the stock offering.

The Commission was careful to caution the public that in accepting a registration statement, it was not endorsing the offering or even suggesting that the information contain therein was accurate or truthful.[377] Indeed, the former Commission chairman, Huston Thompson, remarked that "Speculative securities may still be offered and the public is as free to buy them as ever."[378]

Private offerings were exempted at the start. A problem arose however because the law did not "establish criteria for distinguishing between private and public offers."[379] Many took advantage of this exemption. "The volume has been large and because it has been impossible to differentiate sharply between public and private sales, it may be that in some instances there has been a 'circumvention of the spirit of the securities law.'"[380] "The expert engineer or accountant or financial analyst may not be deceived by a statement of prospectus, but if the average investor is likely to be deceived, a refusal or stop order is appropriate."[381]Ways to deceive "the uninitiated investors" included "the use of 'meaningless high sounding and pseudoscientific phrases designed principally to impress the uninformed."[382]

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[367]HOMER CHERRINGTON, THE INVESTOR AND THE SECURITIES ACT ix (1942) (However by the early 1940s, it had "won almost universal acceptance.")
[368] *Roosevelt Signs*, *supra* note __ .
[369] *Roosevelt Signs*, *supra* note __ .
[370] *Roosevelt Signs*, *supra* note __ .
[371] *Roosevelt Signs*, *supra* note __ .
[372] *Roosevelt Signs*, *supra* note __ .
[373] *Roosevelt Signs*, *supra* note __ .
[374] *Securities Rules Issued Under Act*, N.Y. TIMES, July 7, 1933.
[375] *Securities Rules Issued*, *supra* note __.
[376] *Securities Rules Issued*, *supra* note __.
[377] *Securities Rules Issued*, *supra* note __.
[378] *Roosevelt Signs*, *supra* note __ .
[379] CHERRINGTON, *supra* note _ at 109.
[380] CHERRINGTON, *supra* note _ at 114, citing T.C. Blaisdell, Director of Monopoly Study for the Securities and exchange Commission, *Spectator*, September 15, 1938.
[381] CHERRINGTON, *supra* note _ at 132-3.
[382] CHERRINGTON, *supra* note _ at 133, citing Income Estates of America Inc. I. at 291.

Thus the securities division of the Commission chose to provide guidance. In a letter to the Corporation Trust Company concerning the meaning of the words "public offering," the Commission stated that "an offer made to not more than a small, insignificant number of persons, say twenty-five or so, would not appear to be a 'public offering' within the meaning of the Securities Act."[383] In addition, "some issuers, not wishing to comply with the Securities Act, had developed the policy of offering their securities to small groups of large investors – chiefly insurance companies." [384] It was recognized that "If . . . an issuer goes directly to large investors, without utilizing the instrumentalities of public distribution, it may be supposed that the intent is to effect [sic] a private sale."[385] The Securities Act gave " investors now have access to information about certain issuers" that might not otherwise have been available. Even without that, though, he noted that "the institutional investor is skilled in the art of investment and needs but little of the help of the Securities and Exchange Commission in getting information about issuers."[386]

In less than a year, pressure mounted for an amendment to the 1933 Act. Franklin Roosevelt resisted calls to weaken the law. However, he expressed willingness to clarify points of confusion.[387] The objections or "protests" were to the provisions of the 1933 Act which held directors and officers liable (in civil court) for misstatements.[388] The President made clear that he supported legitimate business and did not want ambiguity in the law to "frighten business away from the flotation of securities."[389] Apparently, businessmen were afraid that the strict liability imposed on issuers would "penalize them almost ruinously for honest mistakes."[390]As a result, in 1934, those subject to the law, other than the issuer, had a new affirmative defense. The underwriter must make a reasonable investigation of the registration statement.

2. <u>The 1940 Act</u>

Investment companies regulated under the 1940 Act are subject to a comprehensive regulatory scheme. Everything from offering, advertising and sales to investment strategy, operations and governance are covered in that law and related regulations. For example, mutual funds managers are overseen by a board of directors or trustees, the majority of whom are independent. By law, this board negotiates the management contract between the fund (a shell entity) and the manager (the mutual adviser such as Fidelity, Vanguard, T. Rowe Price). The board also is required to establish and review certain policies, including overseeing the use of leverage and derivatives.

In addition to governance controls, under the 1940 Act, mutual funds are subject to detailed investment restrictions. As noted above, they are restricted in the use of leverage. Each fund must limit the amount of illiquid securities in their portfolio to no more than 15% of net assets (with money market funds limited to 10%). They are also restricted regarding the level of investment in financial institutions and in other investment pools.[391] Mutual funds are usually required to diversify holdings so that at least 75% of its assets are spread across a variety of investments, with no single such investment accounting for more than 5% of the fund's total assets.[392]

Most importantly, there are strict prohibitions on transactions between the mutual fund (shell) and its affiliates (such as the manager and other related parties). Similarly, there are prohibitions on transactions between funds managed by the same adviser. A concern underlying these prohibitions are favoring the adviser over the mutual fund investors and allocated better trades to a favored fund, or conversely dumping poor securities into a disfavored fund. Exemptions to these affiliated transactions prohibition typically must be granted upon application to the SEC. Mutual funds must value their shares on a daily basis.

In addition, the advertising and marketing of mutual funds is highly regulated due to a combination of obligations from the 1933, 1934, 1940 Act and Advisers Act.[393]

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[383] CHERRINGTON, *supra* note _ at 109, referencing the S.E.C. Letter to the Corporation Trust Company, April 27, 1934.
[384] CHERRINGTON, *supra* note _ at 110.
[385] CHERRINGTON, *supra* note _ at 112.
[386] CHERRINGTON, *supra* note _ at 115
[387] *Roosevelt Bars Easing Stock Law*, N.Y. TIMES, December 14, 1933.
[388] *Roosevelt Bars*, *supra* note __.
[389] *Roosevelt Bars*, *supra* note __.
[390] *Roosevelt Bars*, *supra* note __.
[391] LEMKE, supra note __ at 88.
[392] LEMKE, supra note __.
[393] LEMKE, supra note __.

The Investment Company Act grew out of a two-year study. In 1935, the Congress directed the S.E.C. to examine the investment trust industry and report the results of this research. Recognizing additional investor protections were necessary for investment pools, the resulting legislation "The Investment Company Act reflects a congressional recognition that substantive protection beyond the disclosure requirements of the Securities Act of 1933 and the Securities and Exchange Act of 1934 were needed because of the unique character of investment companies and the role in channeling savings into the national economy."[394]

When President Roosevelt signed the Investment Company Act of 1940, he proclaimed that he had "great hopes" that it would "enable the investment trust industry to fulfill its basic purpose to diversify the small investors' risk and to provide a valuable source of equity capital for deserving small and new business enterprises which the investment bankers have been unable to finance."[395] Roosevelt saw the industry cooperation on this legislation as a sign that things were improving. "[W]e have come a long way from the bleak days of 1929 when the market crash swept away the veil which up to then had hidden the 'behind-the-scenes' activities of our high financiers and showed all too clearly the sham and deceit which characterized so many of their actions."[396] The Division of Investment Management at the SEC noted that the acts purpose was "to eliminate the pervasive abuses that occurred in the investment company industry prior to 1940. To correct these abuses, and police the conflicts of interest that engendered them, the Act establishes a "comprehensive regulatory framework."[397]

In 1928, Paul Cabot of State Street bank noted that:

> "… dishonesty, inattention, inability, and greed. Even if a fund is honestly and ably run, it may be inadvisable to own it simply because there is nothing in it for you. All the profits go to the promoters and managers."[398]

Fund operators had engaged in self-dealing transactions. For example, they would use fund investors' assets to buy at inflated prices securities from fund managers. They would also (over)pay affiliates out of investor's assets. Fund operators had borrowed heavily. This resulted in the creation of "senior securities" and in excessive leverage, putting the equity investors at tremendous risk. They had been careless or misused or stolen investor assets and improperly valued assets. They had created complex layering of ownership structures, creating pyramids of funds of funds. As a result, the 1940 Act "requires the safekeeping and proper valuation of fund assets, restricts greatly transactions with affiliates, limits leveraging, and imposed governance requirements as a check on fund management."[399]

E. Hedge fund regulation, present and past

Hedge funds that are established or sold in the United States do not register under the Investment Company Act of 1940 (the "1940 Act").[400] In addition, the shares (or interests) sold by hedge funds are not required to be registered under the Securities Act of 1933 (the "1933 Act")[401]. As discussed in more detail below, hedge funds are afforded these loopholes because they are supposed to be offered "privately"and/or only to "sophisticated investors." Additionally, to avoid registering its shares under the Securities Act of 1934 (the "1934 Act"), hedge funds often limit sales to no more than 499 persons.[402]

1. Exemption from the Registration, Disclosure and Liability of the 1933 Act

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[394] HALF CENTURY, supra note __ at xvii.
[395] *Roosevelt Signs Trust Measure*, N.Y. TIMES, August 24, 1940.
[396] *Roosevelt Signs*, *supra* note __.
[397] HALF CENTURY, *supra* note __ at 252.
[398] John C. Bogle, *Bringing Mutuality to Mutual Funds*, 1 ROTMAN INT'L J. OF PENSION MGMT Issue 1, 55 (2008).
[399] HALF CENTURY, supra note __ at xviii.
[400] Unfortunately, some confuse the Investment Company Act of 1940 with the Investment Advisers Act of 1940. In the industry, the former is referred to as the "1940 Act" and the latter as the "Advisers Act".
[401] See Section 4(2).
[402] LEMKE et al, *supra* note __ at 114.

The 1933 Act exception allows the hedge fund to sell shares without filing the offering documents with the SEC and without providing more comprehensive disclosure to investors. This saves time, in that the registration process which includes receiving and incorporating the agency's comments, takes many months.[403] In addition, this loophole allows hedge funds to avoid investor law suits. For example, Section 11 of the 1933 Act gives investors the right to sue for any statement made in the registration statement that is considered untrue or misleading.[404] Issuers and others involved in the registration of the securities can be liable.

Hedge funds are only entitled to this exception if they do not make a "public offering." If all offers and sales are done "privately," there is no need to register. The law itself is unclear on the meaning of a "public offering." As noted above, giving meaning to the vague language in the statue occupied the Commission and investment community since the outset. Unless Congress amended the law, it was up to the Commission and/or the Courts to provide guidance. In *Securities & Exchange Commission v. Ralston Purina,*[405] the Supreme Court tried to provide guidance to issuers on whether an offering was "public" or "private." In that case, the Court determined that an offering made to key company employees, resulting in the sale of $2 million in treasury stock (issued directly by the company) was indeed "public" because "[t]he employees here were not shown to have access to the kind of information which registration would disclose."[406] The opinion also suggested that in deciding whether the offering was public or private, one should not rely solely upon the number of potential investors who received the offer. Instead, one should consider the sophistication of the potential investors. The Court wrote:

> "It may well be that offerings to a substantial number of persons would rarely be exempt. Indeed, nothing prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims. But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation. . . . The focus of inquiry should be on the need of the offerees for the protections afforded by registration."[407]

The Court opined that an offering where the investors were "shown to be able to fend for themselves"[408] was not considered public.

Over time, courts have considered a variety of factors in determining whether the offer was public (and thus subject to registration) or private. These have included the number of offerees, the relationship between the issuer and offerees and among the offerrees, the sophistication of the offerees, the size of the offering, number of shares offered and manner of the offering, and the absence of re-sale of the securities.[409] So as not to leave the determination up to chance, in the 1980s, the SEC adopted Regulation D (rules under the 1933) that provides a "safe harbor" for issuers. This means that if the hedge fund complies with Regulation D, it will not have to worry about a court second-guessing its decision not to register.

In order to benefit from this "safe harbor," the hedge fund must file a notice no later than 15 days after the first sale of securities. The notice includes very basic information concerning the fund such as the promoter or manager, the assets involved, the minimum investment level, and the number of investors. The notice also contains the section of the 1940 Act the fund is relying upon for its "mutual fund" exemption. A duplicate may also need to be filed with the states in which the offering is made. There are additional steps under Reg. D in addition to this post-sale notice. Drawing upon the *Ralston Purina* case, the SEC requires that shares can be sold only to "accredited investors" and up to no more than 35 non-accredited investors.[410] As a practical matter, hedge funds limit sales to "accredited investors". With accredited investors, no specific disclosures to investors are required to be made. Whereas if any non-accredited investors are included, there may be reporting requirements.[411] In other words, by virtue of wealth alone, investors are thought not to need disclosure.

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[403] LEMKE et al, *supra* note __ at 77.
[404] LEMKE et al, *supra* note __ at 77
[405] SEC v. Ralston Purina, 346 U.S. 119 (1953).
[406] Ralston Purina, supra note __ at 127.
[407] Ralston Purina, supra note __ at 127.
[408] Ralston Purina, supra note __ at 125.
[409] LEMKE et al, *supra* note __ at 79.
[410] LEMKE et al, *supra* note __ at 79. Note that the non-accredited investors must be knowledgeable and experienced.
[411] LEMKE et al, *supra* note __ at 85.

An accredited investor includes entities such as large institutions, mutual funds, employer-directed pension plans, charities, trusts and the like. A natural person can be an "accredited investor" if he or she has either $1 million in net worth, $200,000 in annual income or joint income with a spouse of $300,000.[412]

In order to take advantage of the safe harbor, there can be no general solicitation or advertising. Theoretically, the offer can only be made to a prospective investor who has a pre-existing relationship with the seller.[413] However, sellers are permitted to become acquainted with investors through cold calling and questionnaire intake.

2. Freedom to Pursue Aggressive Investment Strategies: Through Original Private Company Exception: 1940 Act 3(c)(1)

The 1940 Act exclusion gives hedge fund managers tremendous freedom to pursue aggressive investment strategies. In order to avoid this comprehensive regulation of its operations, typically a hedge fund will try to fit one of two formats. One choice is to conduct itself as a "private" investment fund under Section 3(c)(1) of the 1940 Act. The other choice is to behave like "qualified purchaser" private investment fund under Section 3(c)(7) of the 1940 Act. The 3(c)(7) option was added through an amendment to the law in 1996 and a subsequent SEC rule change.

To rely on Section 3(c)(1), the outstanding securities of the hedge fund[414] can have no more than 100 beneficial owners. The "private investment company" exception applies to an issuer who sells its securities to no more than 100 persons. This exception was designed for investment clubs and other small groups of investors. "For investment companies whose shares are held by less sophisticated investors, the 100 investor limit reasonably reflects the point at which federal regulatory concerns are raised."[415] (Note that while this exception does not require any level of sophistication, to avoid liability for a non-compliant public offering, hedge funds typically do limited access to "accredited investors" so they can take advantage of the "safe harbor.")

To avoid abuse of this 100 person limit, there are rules for attributing or counting investors "behind" a institutional investor of the hedge fund. These rules get complicated as they reflect a tension between the hedge fund operator's desire to gather up assets and the government's desire to avoid bypassing the investor protections intended for public offerings. As one example, consider Fund A purchases shares of a 3(c)(1) fund (Hedge Fund B). Fund A will count as a single investor. Fund A might have 30 shareholders or even 30,000 shareholders of its own, but they will not be counted toward the 100 investor cap. However, if Fund A owns more than 10% of the 3(c)(1) fund's voting securities,.[416] The 30 shareholders, will be counted. If Fund A owned more than 10% of Hedge Fund B and Fund A had 30,000 shareholders, then clearly, the investment would be prohibited. The SEC can also "look-through" Fund A even when Fund A has less than 10% of Hedge Fund B. This depends upon the specific facts and circumstances. The SEC has found that Fund A invests more than 40% of its *own* assets in Hedge Fund B, it may be seen as having be established solely to evade the 100 owner limit.[417]

This counting game arises from business demands. Industry wants to pretend that Fund A is the only "beneficial owner" who should count toward the 100 person limit. This enables the fiction that Hedge Fund B is small and private. However, in fact, these intermediate investing entities are often just shells, collecting money from the real investors. If there are 30,000 investors in the Fund, they should be counted. As a practical matter, doing so would block the mere "accredited investor" from being exposed to hedge funds by virtue of investing into a mutual fund that then turns around and invests in hedge funds.

It is worth noting that in 1996, the ability to pretend that a shell was really just one owner was expanded. The above paragraph describes the current state of the law, however, prior to that time, the SEC looked through a wider range of entities.

Expanding the ability to ignore the real investors behind Fund A, occurred when President Clinton signed into law the National Securities Markets Improvement Act of 1996 ("NSMIA").[418] NSMIA added a new section to

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[412] Rule 501(a).
[413] LEMKE et al, *supra* note __ at 84. Once there is a relationship, even an offering to 330 potential investors was found to be "private."
[414] Other than short term borrowing – "paper".
[415] HALF CENTURY, supra note __ at xxiii.
[416] LEMKE et al, *supra* note __ at 96-7. Prior to an amendment, the test was two-part and "look-through" would only happen if the investing fund had 10% of its assets invested in the hedge fund and held 10% of the hedge fund's voting securities.
[417] LEMKE et al, *supra* note __ at 103.
[418] The National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 (1996) (NSMIA is codified in various sections of the United States Code).

the Investment Company Act, providing a new alternative for private investment pools to avoid registration.[419] This 3(c)(7) option will be discussed below. In addition, NSMIA changed the existing 3(c)(1) exception to registration, by tightening up the look-through provisions.

After NSMIA, a hedge fund relying upon 3(c)(1) would no longer have to look-through operating companies. It would only need to look-through if "Fund A" from our example above is an investment company or a private investment fund. This is a tremendous change, though it was rationalized as being acceptable. This cutting back on the look-through provision was not a problem, according to the Commission, because it did not implicate the policy concerns that the original look-through provision was intended to address. At first blush, this sounds satisfactory, until one sees how incomplete the policy concerns are that are referenced. The Commission contended that the purpose of the look-through provision was to avoid the situation where Fund A "may be a conduit that was created to enable a Section 3(c)(1) Fund to have indirectly more than 100 investors."[420] However, the policy concerns run deeper than that. The reason no more than 100 investors were initial intended under the 1940 Act was to avoid a public offering and to avoid exposing unsophisticated investors to risk for which public gatekeepers would not review or monitor.[421]

3. Unlimited Sales through the "New" Qualified Purchaser Exception: 3(c)(7)

Hedge funds presently can also avoid the 1940 Act requirements by acting as a qualified purchaser private investment fund. To take advantage of this exception, the hedge fund can sell its shares exclusively to "qualified purchasers" (and some knowledgeable employees) and cannot make a "public offering."[422] Through rulemaking, the SEC has defined the meaning of "qualified purchaser."

The 3(c)(7) exemption was an outgrowth of the Half Century study mentioned above. The recommendations from that study regarding this new hedge fund option were codified in NSMIA. In 1997, the SEC issued a final rule designed to implement those sections of NSMIA related to private investment pools.[423] In the Half Century Study, the Division pronounced that "For issuers whose securities are owned exclusively by sophisticated investors, the public offering prohibition and 100 investor limit are unnecessary constraints not supported by sufficient policy concerns."[424] Accordingly, the Division recommended that a new exception be created for "funds whose securities are held exclusively by 'qualified purchasers.'"[425]

It is important to note the foundational premise for endorsement of a new exception. The Division claimed that "The new exception would be premised on the theory that 'qualified purchasers' do not need the Act's protections because they are able to monitor such matters as management fees, transactions with affiliates, corporate governance, and leverage."[426] Also proposed was the creation of a new definition in the 1940 Act for "qualified purchaser." The suggestion was that the term would be general, allowing for the Commission to refine and adjust it through a rule. The recommended definition should include "such factors as financial sophistication, net worth, knowledge and experience in financial matters, amount of assets owned or under management, relationship with the issuer, or such other factors as the Commission determines to be within the intent of the section."[427] However, this recommendation was not put into effect. Instead, as detailed below, wealth alone qualified them.

In considering the special treatment of sophisticated investors, the Division recommended that for purposes of this new rule to expand sales of private funds, that a higher standard than accredited investor was needed. "Given the many risks to investors of committing assets to managed pools, the Division believes the ability to evaluate unregulated investment companies requires a high degree of sophistication."[428] They also noted that "natural persons" might be able to invest in the proposed new private issuers "where such persons possess a high degree of

[419] 15 USC 80a-3(c)(7).
[420] Privately Offered Investment Companies, Final Rules, Release No. IC-22597, International Series Release No. 1071, File No. S7-30-96, April 3, 1997 (hereinafter, "Final Rule on 3(c)(7)"), fn 19, referencing The Securities Investment Promotion Act of 1996: Hearing on S.1815 before the Senate Comm. on Banking, Housing and Urban Affairs, 104th Cong., 2d Sess. 40 (1995) (testimony of Arthur Levitt, Chairman,SEC).
[421] On the other hand, NSMIA did tighten-up one aspect of the look-through rule. It eliminated step-two. Thus Fund A would need to count all of Entity B's shareholders once Entity B owned more than 10% of Fund A.
[422] LEMKE, supra note __ at 104.
[423] Final Rule on 3(c)(7), supra note __ .
[424] HALF CENTURY, *supra* note __ at 104.
[425] HALF CENTURY, *supra* note __ at 104.
[426] HALF CENTURY, *supra* note __ at 104 – 105.
[427] HALF CENTURY, *supra* note __ at 111.
[428] HALF CENTURY, *supra* note __ at 113.

financial sophistication, they would be fully capable of evaluating and assuming the risks associated with the new section 3(c)(7) pools."[429]

Under the rule, an institution or a natural person could be a qualified purchaser. For a natural person to meet the definition, he or she would have to own at least $5 million in investments.[430] A family company[431] with at least $5 million in investments is also a qualified purchaser. Also trusts where the trustee and those who contributed to the trust are all qualified purchasers, so long as the trust was not created for the purpose of investing in the 3(c)(7) fund[432]. In addition, any other person such as an institution with at least $25 million in investments[433] falls within the definition. So, wealth became a proxy for financial sophistication. Legally-created entities were also considered "qualified purchasers."

In its adopting release, the SEC also addressed the question of whether participants in a retirement plan (like a 401k) could direct investments into 3(c)(7) funds where the retirement plan had more than $25 million, but where the individual participant would not on his own qualify. According to the SEC, "Congress determined generally that the person making the investment decision to invest in a Section 3(c)(7) Fund had to own a requisite amount of investments."[434] However, the Commission noted that for a retirement plan where the participant does not make the investment selections, such as a corporate, union or public pension plan, the plan would be considered a qualified purchaser of investments made by the plan trustee.

4. Freedom to Charge Performance Fees under the Private Advisers Exemption to the Advisers Act

Managers of hedge funds are exempt from registration under the Investment Advisers Act of 1940[435] (the "Advisers Act"), as they can qualify as a private adviser.[436] The SEC did adopt a rule requiring hedge fund managers to count every investor in the fund as a "client" for purposes of determining whether the fund had fewer than 15 clients. The rule went into effect in February of 2006. However, it was struck down by the U.S. Court of appeals for the D.C. Circuit in June of 2006.[437]

However, some aspects of the Advisers Act do apply to hedge fund managers, including the antifraud provisions.[438] And, many hedge fund managers register on the Advisers Act in order to meet certain standards under the Employee Retirement Income Security Act of 1974 ("ERISA") and thus attract pension fund assets. The antifraud provisions prohibit actions such as fraud, deceit, transacting with a client without first informing the "client", front-running, deliberate mis-pricing, overstating performance, taking investment opportunities that belong to the fund, failing to seek best execution of transactions, failing to disclose that brokerage commissions were used to pay brokers for referring investors, failing to disclose conflicts-of-interest, using "kickbacks" and other similar practices.[439]

Under the Advisers Act, performance fees generally are prohibited. However, the prohibition on "performance" fees does not apply to hedge funds. Thus, in addition to charging 1-2% of assets under management (similar to an actively-management mutual fund arrangement), hedge fund managers charge investors between 20-50% of returns.[440] Hedge fund managers avail themselves of this exception by advising only "sophisticated investors."[441]

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[429] HALF CENTURY, *supra* note __ at 114.
[430] Final Rule on 3(c)(7), supra note __ .
[431] A family company means those entities that are owned by at least two family members (including siblings, spouses, ex-spouses, descendants, estates and so on). See fn 7 of the Final Rule on 3(c)(7), supra note __.
[432] See fn 8 of the Final Rule on 3(c)(7), supra note __.
[433] The $25 million could be in the institutions own account or held for the accounts of other qualified purchasers. See fn 9 of the Final Rule on 3(c)(7), supra note __. The definition of "investments" is far broader than just securities. It included securities, other than those that represent controlling interests in certain types of entities as well as "real estate, futures contracts, physical commodities, and cash and cash equivalents held for investment purposes."
[434] Final Rule on 3(c)(7), supra note __ .
[435] 15 U.S.C. § 80b-1 et seq.
[436] See Section 23(b)(3).
[437] *See* Goldstein v. SEC, 451 F.3d 873 (D.D.C., June 23, 2006).
[438] LEMKE et al, *supra* note __ at 27, citing a variety of S.E.C. releases, including, In re Fanam Capital Mgmt., et al,, Investment Advisers Act Release No. 2316, Oct. 29, 2004.
[439] LEMKE et al, *supra* note __ at 36-38.
[440] LEMKE et al, *supra* note __ at 2.
[441] LEMKE et al, *supra* note __ at 41 – 42.

Whereas registered Investment Advisers became prohibited in 1970 from charging performance-based fees to mutual funds and other investment companies, this was not the case with hedge funds. Section 205(1)(a) of the Investment Advisers Act sets forth a general ban on the adviser receiving a share of one's clients profits. In particular it prohibits "compensation to the investment adviser on the basis of a share of capital gains upon the or capital appreciation of the funds or any portion of the funds of the client."[442] Congress included this provision in the Advisers Act because of the belief that these types of "performance fees created incentives for advisers to take inappropriate risks in managing a client's account in order to increase advisory fees."[443]

Initially mutual funds were carved out from this prohibition and were permitted to charge performance fees. However, in the 1970 amendments to the 1940 Act, Congress brought them under the umbrella. This was a response to the discovery that many funds that charged performance based fees awarded bonuses when the fund performed well but did not impose a penalty for poor performance.[444] In the same legislation, "fulcrum fees" were permitted. Those fees that would decrease or increase based upon a fund's performance relative to benchmark index, for example, were exempt from the prohibition.[445]

Experts diverge on their view of hedge fund compensation. Some believe the performance fee structure helps align managers with shareholders.[446] They believe the "high water mark" results in the appropriate level of caution in that the manager may not earn a percentage of profits until it is reached again. However other experts claim the opposite. Nothing that especially when the manager is below the high water mark, there is a strong incentive to take unreasonable risks.[447] In addition even when the fund is performing well:

> "the typical performance fee incentivizes a hedge fund manager to take on greater risk and leverage since the manager does not bear the full downside risk of his investment decisions but is rewarded handsomely if the fund performs well. The incentive to take on risk and leverage increases when the manager has to exceed some prior "high-water mark" to earn his performance fee."[448]

In addition, while mutual fund advisers (fund families) have a legally-mandated fiduciary duty to fund shareholders,[449] hedge fund managers do not have the same obligation. The limited partnership agreement will often limit the General Partner/manager's liability and fiduciary duties to shareholders.[450]

Many retail investors were not financially sophisticated but instead status conscious: "Hedge funds became a symbol of the richest and the best. Paradoxically, the princely fees that hedge fund managers charged enhanced their allure, for who could get away with such gaudy fees except the exceptionally talented?"[451]

F. Long-Term Capital Management: Hedge funds and Systemic Risk

Systemic risk was not the focus of the analysis when the Division of Investment Management issued its report in 1992, when Congress amended NSMIA in 1996, nor when the SEC implemented NSMIA through rulemaking in 1997. Indeed, the words "systemic risk, "systemic," "systematic," do not even appear in the document. Only the words "market integrity" show up, but in the cover letter from Richard Breeden, yet nowhere else in the document.

There had already, however been a number of hedge fund scandals. In the early 1970s there were reports of enormous losses through hedge funds. In October of 1971, Guarante-Harrington Associate informed its "blue-ribbon" list of around 35 limited partner clients that it had lost nearly all of their money, which had reached $10 million, since its 1968 inception.[452] Two of the sophisticated investors in that scheme included a Hollywood studio

[442] Investment Advisers Act of 1940, 15 U.S.C. §80b.
[443] HALF CENTURY, *supra* note __ at 237.
[444] HALF CENTURY, *supra* note __ at 242.
[445] 15 U.S.C. § 80b-5(b)(2).
[446] Carl Ackermann, Richard McEnally and David Ravenscraft, *The Performance of Hedge Funds: Risks, Return, and Incentives*, 54 J. OF FIN., No. 3 (1999), 833-74
[447] Troy Parades, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, U.ILL. L. R. (2006).
[448] Id. fn 85 at 995.
[449] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).
[450] LEMKE et al, *supra* note __ at 16.
[451] LOWENSTEIN, supra note __ at 26 (2000).
452 Robert Metz, *Market Place: Big Guys Lost in Hedge Fund*, N.Y. TIMES, Mar. 16, 1972.

head and a real estate developer. Other limited partners included a General Partner of brokerage firm Oppeheimer & Co. and a founding partner of Donaldson, Lufkin and Jenrette, Inc.[453]

However, the first backlash around hedge funds, involved more than some sophisticated investors losing their own money. In approximately one year, Long-Term Capital Management a giant hedge fund with $125 billion in assets and just a 4-year track record collapsed. When LTCM melted down, the head of every major Wall Street bank and the [New York] Fed organized a bailout.[454] LTCM was not just too big to fail, relative to the entire financial system, but also, vital to the personal fortunes of many Wall Street executives "because their own trading positions would be affected. They had loaned Long Term billions of dollars, and many prominent Wall Street executives had their own personal wealth tied up by Long Term. They were too entangled to give up without a fight." [455]

At the heart of the sudden, massive failure of LTCM was leverage. It had capital of around $4.8 billion, but assets of more than $125 billion and was said to have derivatives positions with a notional value of $1.25 trillion. In a report after the event, the President's Working Group noted:

> "The events in global financial markets in the summer and fall of 1998 demonstrated that excessive leverage can greatly magnify the negative effects of any event or series of events on the financial system as a whole. The near collapse of Long-Term Capital Management ("LTCM"), a private sector investment firm, highlighted the possibility that problems at one financial institution could be transmitted to other institutions, and potentially pose risks to the financial system.[456]

Had hedge funds been subject to any leverage restrictions, even not as draconian as mutual funds, the damage would not have been as severe. Due to the leverage restrictions under the 1940 Act, there have not been problems with the use of leverage by mutual fund or close-end funds. Moreover, the level of leverage at LTCM was far greater than the magnitude that the 1940 Act was designed to prevent. In the words of the former president of the Investment Company Institute, Matthew Fink, LTCM's leverage ratio "would have been the envy of the most speculative closed-end funds of the 1920s."[457]

The managers of LTCM, including former bond trader, Meriwether and two Nobel prize winning economists, chose a strategy somewhat similar to their forbearer. But, they were like Jones on steroids. Given that they were trying to capture small fluctuations in bond spreads, the leverage of 20 to 30 times the investment capital, was the way to magnify profits.[458]

This was not an isolated event. There were several more hedge fund scandals, including in 2006, when Amaranth Advisors lost $6.4 billion of its $9 billion in assets as a result of aggressive speculation in the natural gas markets.[459] At the time, of this various scandals, many recognized the failure of private ordering. The President's Working Group wrote that "Our market-based economy relies primarily on market discipline to constrain leverage. But market discipline can break down."[460] Nevertheless, the recommendations in the report were weak and never implemented. They were based upon disclosure alone, which did not get enacted. There was no recommendation for actual restrictions on leverage.

LTCM's failure also reflected the opacity of hedge funds. Lack of transparency led to concerns about front-running, market timing[461] and systemic risk. As Commissioner Aguilar recently remarked, "This state of affairs is what you would expect when markets are inextricably integrated and the impact of hedge funds is significant, but their actions and their risks are opaque. Simply stated, regulators, legislators and the public have little credible information as to who is out there and what they are doing."[462]

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[453] Metz, *supra* note __.
[454] LOWENSTEIN, *supra* note _ at viii.
[455] NOMI PRINS, OTHER PEOPLE'S MONEY: THE CORPORATE MUGGING OF AMERICA 163 (2004).
[456] Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management*, (Apr. 2009), available at http://www.treas.gov/press/releases/reports/hedgfund.pdf
[457] MATTHEW P. FINK, THE RISE OF MUTUAL FUNDS: AN INSIDER'S VIEW 44 (2008).
[458] LOWENSTEIN, *supra* note, at 26.
[459] Klunk, *supra* note __.
[460] President's Working Group on Hedge Funds, supra note __ at viii.
[461] For example, hedge fund were involved in the late-trading and market timing scandals in the fund industry in 2005.
[462] Speech by SEC Commissioner Luis A. Aguilar, Hedge Fund Regulation on the Horizon: Don't Shoot the Messenger, Spring 2009 Hedgeworld Fund Services Conference, New York, NY, June 18, 2009.

Aguilar also noted the potential for insider trading in the hedge fund world. "Hedge funds who participate in private placements, talk with trading desks, and maintain connections with the street are, in many cases, in a position to obtain inside information and to use it in a way that traditional surveillance may not detect. This potential for insider trading has been well publicized and public investors are concerned about the possible effects on market fairness and integrity."[463]

G. Reach and Retailization of Hedge Funds

Prior to the Global Financial Crisis, some experts recommended that ordinary retail investors be given direct access to hedge funds.[464] Professor Houman Shadab lamented that only 8.5% of U.S. households had access to hedge funds because they were not wealthy enough to qualify. He recommended lowering the existing standard of the Qualified Purchaser to a lower standard of the Accredited Investor. These legal labels have distinct meanings. As noted above, the Qualified Purchaser who is a natural person needs $5 million in investments. However, an Accredited Investor, need only have a net worth of $1 million (or annual income of $200,000 or $300,000 including a spouse's income). The SEC has confirmed that a personal residence can count toward the $1 million in net worth.[465]

There are a number of problems with this suggestion. The first is that actually, retail investors are exposed to hedge funds already. This is through institutional investors they entrust with their savings or deferred compensation. In addition, using wealth as a proxy for savvy is ineffective, as will be discussed below. If we were more intellectually honest, we'd admit that the wealth test is really about having a cushion, similar to a "suitability" standard. We are really saying that if you have a lot of money, then gambling with some of it is not an irrational act. Thus, it is unwise to allow hedge funds to gather and deploy the savings of individuals of average wealth who are already exposed to hedge funds indirectly. At least the indirect investment can be screened by institutional investors.

Moreover, there should be great concern about that 8.5%. In addition to these group, there are also those who have access through fund of hedge funds. A fund of hedge funds would be the example above where Fund A invests in Hedge Fund B. Hedge Fund B could be a 3(c)(7) fund as well.

Though originally for the sophisticated, they are now available to ordinary investors through fund-of-hedge fund structures. That is to say, in the words of FINRA[466]:

> "Historically hedge funds have been offered as unregistered securities that, because of the risks they posed, were only available to a limited number of wealthy, financially sophisticated investors. Now there are funds that are registered with the SEC and invest in unregistered private hedge funds." [467]

Yet they "use investment strategies that involve risks similar to those of traditional hedge funds." These fund-of-hedge fund structures are more costly to investors than traditional mutual funds. Direct fees and expenses (the expense ratio) is usually around 2.15% compared to an average of 1.36%. In addition, FINRA noted that managers of a fund of funds receives an addition 10% of annual gain above an 8% benchmark. Other experts observe that the performance fee is 5% or 10%.[468] In some structures the fund-of-fund manager does not charge a fee outright at all, but instead is given a share of the fees collected by the underlying hedge fund.[469]Beyond these outright fees, the fund itself has to pay fees and expenses in order to invest in the underlying hedge fund. Accordingly these are deducted from fund assets and affect investor return.[470]

FINRA noted in an investor-education website:

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[463] Aguilar speech.
[464] Houman B. Shadab, Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors, 11 N.Y. Univ. J. Legis. & Pub. Pol. 2 (2008).
[465] SEC Intepretive Release on Regulation D, 17 C.F.R. Part 231.
[466] FINRA is the private, self-regulatory organization of the financial services industry. It was the newly formed entity that combined the National Association of Securities Dealers (the "NASD") with the regulatory committee of the New York Stock Exchange. FINRA registers, regulates and educates members of the industry).
[467] FINRA Funds of Hedge Funds – Higher Costs and Risk for Higher Potential Returns, available at www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P006028
[468] LEMKE, *infra* note __ at 255.
[469] LEMKE, *infra* note __ at 255.
[470] FINRA, *supra* note __.

> "Because they are usually only open to a limited numbers of wealthy, financially sophisticated investors and do not advertise or publicly offer their securities, private hedge funds are not required to register with the SEC. As a result, unregistered private hedge funds do not provide many of the investor protections that apply to registered investment products, such as mutual funds." [471]

It seems to be incredibly ironic, that FINRA needs to explain this to potential investors in hedge funds. If someone needs to receive this explanation, how can they possible assess the complex instruments and risks their fund would take on?

Yet, the trade association for managers of alternative investments (including hedge funds), the Managed Fund Association denies that fund-of-hedge funds are offered to any different investor group than regular hedge funds. They claim that even those funds that are registered with the SEC are only open to the same level of sophisticated investors as are the underlying funds.

> Accordingly, it is inaccurate to suggest that funds of funds are contributing to a "retailization" of hedge funds by providing access to hedge funds to the general public. In reality, persons investing in funds of hedge funds, either privately or publicly offered, must meet the same eligibility criteria as persons who are permitted to invest in hedge funds directly.[472]

This statement is misleading because it overlooks the fact that the only (private) hedge funds that can be offered directly to investor, are those that are limited to just 100 investors and given the private offering rules who are "accredited." Whereas, in the fund-of-hedge fund situation, the offer and sale are made to the public, drawing in unlimited numbers of retail investors including through a 3(c)(7) structure.

There are two distinct types of fund-of-hedge funds (often called fund-of-funds). One type is the unregistered fund-of- hedge funds. The other is the registered fund-of-hedge funds. In the most typical structure the top fund (Fund A) invests in between 25 and 50 underlying hedge funds.[473] Some top funds use a leverage strategy. Other variations focus on private equity funds as an underlying investment as opposed to hedge funds. A majority of these structures are not registered under the 1940 Act. However "a growing number" decide to register. And, some fund-of-funds choose to register under the 1933 Act.The unregistered funds are common in the US as well as off shore.

Some benefits of investing in a fund-of-funds as compared to direct investment in the underlying fund follow. The minimum investment is much lower at $25,000 to $100,000 instead of $1 million. The investor is more diversified and in theory can rely upon the "selection and monitoring expertise" of the top fund management.[474] Another benefit is greater liquidity. Investors in the feeder fund are usually permitted to withdraw investments monthly.[475]

Some disadvantages include higher fees. This results from fees at both the top fund and underlying fund levels. In addition, some feeder fund managers seek out fee-sharing arrangement.[476] The undefined style is another detriment. It would be difficult to align ones investment goals with so many strategies. Also, the structure places tremendous administrative responsibility on the underlying hedge funds.[477] Finally, leverage at multiple layers of the fund-of-fund structures, known as "pyramiding leverage" can amplify problems with excessive leverage. And, in order to meet margin calls, a leveraged Fund A may need to quickly sell off its investments in underlying hedge funds.[478] It is quite interesting, that the entire premise of allowing for any type of non-registered fund is that the shareholders are sophisticated enough to select and monitor. Yet, this extra layering, first, demonstrates they are not and second, creates even more complexity for investors and evidence of abuses.

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[471] FINRA, *supra* note __.
[472] Fund-of-Funds Q & A, available at http://www.managedfunds.org/funds-of-funds-faqs.asp
[473] THOMAS P. LEMKE, GERALD T. LINS, KATHRYN L. HOENIG & PATRICIA S. RUBE, HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE 255 (2008-2009).
[474] LEMKE, *supra* note __ at 257.
[475] LEMKE, *supra* note __ at 257.
[476] LEMKE, *supra* note __ at 257 (referencing WORTHINGTON, ALTERNATIVE INVESTMENTS AND THE SEMI-AFFLUENT INVESTOR 96 (2001)
[477] LEMKE, *supra* note __ at 257-258.
[478] LEMKE, *supra* note __ at 258.

H. Obama Administration Proposal vs. Reform Recommendation

The intellectual edifice has collapsed. Relying upon "sophisticated investors,"[479] counterparties,[480] self-preservation[481] and the markets[482] generally to control leverage and speculation was never and is not today a sound approach. Accordingly, allowing any pocket of the financial system to cause systemic risk and risk to its own investors is unwise. When that pocket contains more than $1.9 trillion in assets, it's a market risk. Accordingly, this paper agrees that the current legislation introduced by the Obama Administration is a good first step, but contends that the SEC needs the authority to subject all investment pools, including hedge funds to the substantive operational controls fund under the 1940 Act. Not all of these restrictions are necessary. Nor would the same level of control be appropriate. At the very least, limits on leverage (including the use of derivatives), liquidity requirements, fair valuation practices and prohibitions on self-dealing (affiliated transactions) should be imposed.

On July 15, 2009, the Obama Administration delivered proposed legislation to Congress that would bring hedge funds and other private pools of capital under light regulation.[483] This proposal was similar to (but not identical to) previous legislative initiatives like the Hedge Fund Advisers Registration Act[484] and the Hedge Fund Transparency Act.[485] Additionally, there were many other efforts to regulate hedge funds. According to Commissioner Aguilar, "there recently have been at least a half-dozen bills introduced in Congress requiring regulation of the hedge fund industry." He included in his list a bill introduced by Senator Jack Reed that would require hedge funds and other pools to register with the SEC.

Under the Obama bill, for the first time, advisers to these pools would be required to register with the SEC. Those advisers with more than $30 million in assets would have to register. In addition, according to the Treasury department fact sheet, registered private fund advisers would be subject to detailed, confidential reporting reporting requirements. This would include reports concerning assets, leverage, off-balance-sheet exposure concerning the private funds they advise. The SEC would have the authority to share these reports with Federal Reserve and the Financial Services Oversight Council. In addition, private fund advisers would be required to make disclosures to investors, creditors and counter-parties of advised private funds. They would be subject to conflict-of-interest and anti-fraud prohibitions. The SEC would have examination and enforcement authority. Advisers would be subject to recordkeeping requirements and would be required to establish a "comprehensive compliance program."[486]

In terms of drafting, this was accomplished, in part by creating a new definition within the Investment Advisers Act. This new term, "private fund" would mean:

> " an investment fund that—
>
> "(A) would be an investment company (as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3)), but for section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7));"
> "and
> "(B) either—
> "(i) is organized or otherwise created under the laws of the United States or of a State; or
> "(ii) has 10 percent or more of its outstanding securities owned by U.S. persons."[487]

The purpose of the reporting requirements are to help monitor for systemic risk. The Treasury noted that:

[479] See Aguilar speech, supra note __ ("One of the underlying principles behind the idea that hedge funds could operate with little to no regulatory requirements was that interests in the funds were only sold in private offerings to wealthy investors. These investors were thought to be sufficiently "sophisticated" to protect their interests, and to be able to engage in effective arms-length negotiation in order to achieve fair and equitable terms.")
[480] See Greenspan, supra note __.
[481] See Greenspan, supra note __.
[482] See Bush, supra note __
[483] See U.S. Department of the Treasury Press Release, "Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: Legislation for the Regulation of Hedge Funds Delivered to Capitol Hill," July 15, 2009, available at http://www.treas.gov/press/releases/tg214.htm
[484] Introduced in January of 2009 by House of Representatives members Michael Capuano (D-MA) and Michael Castle (R-DE).
[485] Introduced in January of 2009 by Carl Levin (D-MI) and Chuck Grassley (R-IA).
[486] Treasury Release, *supra* note _.
[487] Private Fund Investment Advisers Registration Act of 2009, Title IV Registration of Advisers to Private Funds

> "This information would help determine whether systemic risk is building up among hedge funds and other private pools of capital, and could be used if any of the funds or fund families are so large, highly leveraged, and interconnected that they pose a threat to our overall financial stability and should therefore be supervised and regulated as Tier 1 Financial Holding Companies."[488]

The stated purpose of the proposed law generally was to "protect investors from fraud and abuse."[489] The fact sheet noted that

> "In recent years, the United States has seen explosive growth in a variety of privately-owned investment funds, including hedge funds, private equity funds, and venture capital funds. At various points in the financial crisis, de-leveraging by such funds contributed to the strain on financial markets. Because these funds were not required to register with regulators, the government lacked the reliable, comprehensive data necessary to monitor funds' activity and assess potential risks in the market. The Administration's legislation would help protect investors from fraud and abuse, provide increased transparency, and provide the information necessary to assess whether risks in the aggregate or risks in any particular fund pose a threat to our overall financial stability."[490]

According to SEC Chairman, Mary Schapiro, President Obama's financial regulation overhaul plan which was 85 pages was not specific enough regarding hedge fund regulation. Only 260 words were used to address the topic. She noted that additional legislation might be needed to require registration (certainly after the recent court decision this is obvious). Also the Obama plan did not make clear "how it will regulate hedge funds' short-selling, leverage, and trading and reporting of non-equity positions."[491]

As Aguilar notes in the conclusion of his hedgeworld speech, "Some have suggested that hedge funds should also register. Others have suggested that it may be appropriate to apply limited concepts from within the Investment Company Act of 1940 to hedge funds — what some have called a "40 Act-lite" regime."[492]

Aguilar suggests a tiering of funds. "As funds grow in size, different standards may be appropriate. For funds that could significantly affect the market, it may be appropriate to require more than recordkeeping. For example, it may be appropriate to think through whether some of the risk limitation concepts built into the Investment Company Act make sense to apply to these hedge funds — such as imposing limits on leverage."[493] While leverage restrictions are necessary, the tiering approach is of concern, however, because it invites more layering, gamesmanship and ultimately ignores collective risk.

I. Responses to Arguments Opposing Regulation

Those who oppose any additional regulation of hedge funds tend to make some or all of the following arguments: (1) Don't regulate hedge funds because they did not cause the GFC; (2) sophisticated investors can take care of themselves; (3) human nature (i.e. greed) cannot be successful constrained; and (4) government regulation is ineffective and undermines business growth. They shall each be addressed in turn.

a. Response to Argument not to regulate hedge funds because they did not cause the GFC

488 Treasury Release, *supra* note _.
489 Treasury Release, *supra* note _.
490 Treasury Release, *supra* note _.
491 Joseph Checkler, *Obama Plan to Regulate Hedge Funds is Far From Completed*, WALL ST. J., July 19, 2009.
492 Aguilar speech, *supra* note __.
493 Aguilar speech, *supra* note __.

The most common defense to proposed regulation is that hedge funds did not cause this crisis. It should come as no surprise that this position is often taken by those who work within the hedge fund industry[494] and those who are paid advisers to the industry, such as legal counsel.[495]

Hedge funds operators have repeatedly worked to deny the connection between their practices and systemic risk. They resist regulation of their advertising and investment practices. Even in the face of damning evidence that tighter oversight would both help prevent systemic risk and outright fraud, they arrive at sometimes comical justifications. For example, when many Bernard Madoff admitted that the hedge fund empire he operated resulted in $50 billion in investor losses, hedge fund operators distanced themselves. They publicly reasoned that since what Madoff never actually invested the money as promised, what he held out to be a hedge fund was not a hedge fund. Thus, regulating hedge funds is unnecessary. This does not pass the straight face taste. It is like saying that before the FDA was created, if someone sold snake oil and said it was a proper medicine for curing cancer, we should not therefore regulating drugs because the snake oil was not a drug at all. And, besides, the honest drug purveyors would be caught up in a mess of unnecessary regulation.

In this context, some also point to the positive actions of some hedge funds. For example, "several high profile hedge fund management firms were among the first to publicly and accurately assess the dangers inherent in the housing finance system, mortgage backed securities, and Fannie Mae and Freddie Mac."[496] One could laud the behavior of some investment trusts (the mutual fund precursor) in 1929. One scholar observed that after the crash, investment trusts bought up otherwise unmarketable securities from fund managers who needed cash.[497] However, it still made sense to regulate these investment pools then and as it does today.

SEC Chairman Aguilar raised these questions. "As we all know, there has been much speculation about the impact of hedge fund activity on the broader capital markets. For example, there are questions about whether hedge funds may have contributed to the market turmoil and how hedge funds may have contributed to the demise of Bear Stearns, Lehman Brothers and others. Additionally, it is also not clear whether the lack of oversight of the industry resulted in large amounts of risk to the market through the use of short sales and derivatives, such as credit default swaps."[498]

b. Response to Argument that Sophisticated Investors can take care of themselves

One key premise supporting the hands-off approach to private investment pools like hedge funds is that only sophisticated investors may invest and that sophisticated investors can take care of themselves.[499] Both of these assumptions are faulty. One of the greatest problems with the term "sophisticated investor" is that it evokes some sort of 1920s throwback, a champagne swilling, ascot-wearing dandy in a Newport mansion. In fact, sophisticated investors are often large institutions who manage others people's money, namely the savings and retirement pensions of millions of Americans. Sophisticated Investors are often intermediaries, sometimes fiduciaries, channeling the savings of others into unreasonably risky investments they could not reach directly. The Sophisticated Investor may be the legal owner, but is not truly an investor. An investor is someone who puts their money at risk and realizes the gains and losses of an investment. Thus, the ultimate investor at the end of a long chain of intermediaries becomes exposed to highly leveraged hedge funds and other potentially risky investment.

Another problem with the term is that it implies a high level of financial savvy, when in fact the only criteria is wealth. Thus, an individual who is considered sophisticated enough to delve into shadow market investments does not need to have any qualifications other than a large bank account, investment portfolio or even some real estate assets. Thus, the government determines that certain institutions and then other natural persons, by virtue of their wealth are somehow more capable of ferreting out fraud and protecting themselves. There is no other

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[494] *See, e.g. An Interview with a Capitalist Pig: Jonathan Hoenig on Hedge Funds, the Economic Crisis and the Future of America*, 4 THE OBJECTIVE STANDARD No. 2, (Summer 2009), available at http://www.theobjectivestandard.com/issues/2009-summer/jonathan-hoenig-interview.asp

[495] See Alexandra Poe, The Myth of the Unregulated Hedge Fund, 2 Bloomberg Law Reports No. 7 (2009), available at http://www.reedsmith.com/_db/_documents/The_Myth_of_the_Unregulated_Hedge_Fund.pdf

[496] SPECIAL REP'T ON REG. REFORM ADDITIONAL VIEWS *supra* note __ beginning at 54, 88 (submitted by Congressman Jeb Hensarling and former Senator John E. Sununu).

[497] CHERRINGTON, *supra* note _ at 7 citing the S.E.C. Investment Trusts and Investment Companies, Part III, Chapter I, page 28 (1935).

[498] Aguilar speech, supra note __ at __.

[499] See, e.g. Aguilar speech, supra note __ "truly sophisticated investors in private deals should be held accountable to the terms that they knowingly negotiate — and if an investment were to go bad, they should bear the loss." While I agree with this, I also believe that when institutional investors manage other people's money, they need to be restricted from certain actions that create undue risk.

standard, such as has the person passed all levels of the Certified Financial Analyst or Chartered Alternative Investment Analyst exam. Yet at the same time, experts in hedge fund analysis readily admit that tremendous skill and savvy is required to separate the sound strategies from the weak ones. Research in this area invites the question as to whether in order to be "sophisticated" enough to invest in hedge funds one must be a forensic accountant, possess a PhD in finance and have the ability to recognize that a traditional mean variance analysis will never distinguish between a legitimate strategy and something like a shorting out-of-the-money put options strategy. The resulting return will be mostly positive, but when the fund experiences losses, they will be extreme.[500] Moreover, how can a sophisticated investor be a match to a super computer that must run for days in order to price an instrument?[501]

One might suspect that wealth was good enough for Congress and the SEC, as the thought was that wealthier people had more of a cushion from losses, so gambling with their money would not result in as much widespread social upheaval. However, the Congress and the Commission relied upon the expectation that these sophisticated investors would have the acumen to select and monitor investments.

Missing also from any of the sophisticated investor type definitions is an tribute to systemic risk. Only recently has this been taken up as a topic with any seriousness. When the government expanded exemptions for private offerings of investment pools, they did so by showing tremendous reverence for the powers of sophisticated investors, mainly institutions, but others as well, who did not need the government's paternalism. The SEC study that exhaustively discusses private pools does not cover systemic risk in the recommendation to expand the opportunities for private investor pools.

The most important way to refute this argument that sophisticated investors can police the market and take care of themselves is the great weight of recent history. Since and including the collapse of LTCM, the news pages are filled with stories of institutions and individuals who meet the legal definitions of "sophistication" being duped or swindled. Moreover, included in this bunch are brilliant Nobel prize winners and Treasury Department Secretaries. Indeed, when on the "defense" against angry litigious investors, these same geniuses defend themselves claiming that did not or could not have understood the risks. One would hope they cannot have it both ways – to still claim that no regulation is necessary because sophisticated investors can police and protect and then also say they were unable to police and protect.

Examples include the case of the Harvard endowment. The Harvard endowment, grew from around $25.9 billion in 2005 to a peak of around $36.9 billion in 2008. It loss 30% in 2009. While the investments in question were largely "private equity," that is from a securities law prospective largely indistinguishable from hedge funds. Both are uregulated, private investment pools. [502] Though private equity is beyond the scope of this paper, the lesson here applies more broadly. Using wealth or capitalization to stand-in for "financial sophistication" is intellectually dishonest and empirically unsupportable.

At Harvard, even the most sophisticated of gatekeepers (former Treasury Secretaries Lawrence Summers and Robert Rubin) could not control their own hired hands. Apparently, Jack Meyer who was the head of Harvard Management Company left under criticism regarding remuneration and strategy. Some of his managers were paid "eight-figure salaries" and both Summers and Rubin questioned Meyers aggressive strategies. However, when Meyer left, the chief risk officer, chief operating officer and chief technology officer along with 30 portfolio managers and traders followed. Meyers was seen to have damaged the institution which was now "like a Ferrari without the engine."[503]

Perhaps employees did not sufficiently communicate with their peers or replacements and huge losses resulted. For example mistakes were made with certain derivatives contracts:

> "The swaps were put in place under former Harvard president Larry Summers in the early 2000s to protect the university against rising interest rates on all the money it had borrowed. Instead, interest rates plunged. Yet for reasons no one can seem to explain, the university simply forgot to (or chose not to) cancel its swaps. The result was a $1 billion loss."[504]

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[500] ANDREW W. LO, HEDGE FUNDS: AN ANALYTIC PERSPECTIVE (2008).
[501] Crotty & Epstein, *supra* note __.
[502] Craig Karmin & Liz Rappaport, *Harvard Cuts Risks; Loses Bond Managers*, WALL ST. J., June 23, 2009, A1.
[503] Munks, *supra* note __.
[504] Nina Munks, *Rich Harvard, Poor Harvard*, VANITY FAIR, July 2009, available at http://www.vanityfair.com/online/daily/2009/06/harvard.html

The ability of genius money managers to hold institutions captive is a pattern in this crisis. They have control over the human capital, specialized knowledge of the particular trades and investment arrangements. They use this "rent" or positional advantage disloyally. Yet, those who hire these folks, repeatedly ignore these very powerful behavioral factors. The Harvard story is similar to what the U.S. faced after bailing out A.I.G.

Another sophisticated investor was Tremont Holdings, Inc. Tremont is part of the OpenheimerFunds unit of Massachusetts Mutual Life Insurance Co. Tremont lost over $3 billion in client assets after acting as a major "feeder" to Bernard L. Madoff Investment Securities ponzi scheme. Apparently, at least half of Tremont's assets were invested (via assorted feeder funds) with Madoff. Tremont attempted to refund money to clients by liquidating other assets, however it was blocked by many "gates" and other restrictions on withdrawals from both private equity and hedge fund positions.[505] Clients have sued, claiming that Tremont should have known about the fraud. Tremont has denied the allegations. It stands to reason, then that if Tremont is liable, then it failed in its responsibilities as a sophisticated investor. If Tremont is not liable, then, it shows that sophisticated investors are incapable of monitoring.

Indeed, without such allegedly sophisticated middlemen, Madoff could not have thrived.[506] One of, if not the, largest loser in the Madoff ponzi scheme was Fairfield Greenwich Group. Led by previously well-regarded, Walter Noel, Fairfield Greenwich lost over $7.5 billion, more than half of the $14.1 billion in assets it held in February of 2008.[507] In between posing for magazine spreads and traveling between various homes in Greenwich, Palm Beach, Manhattan, Southampton and Mustique,[508] Mr. Noel, as a fiduciary was supposed to be keeping a watchful eye on his clients' money. Noel was the epitome of sophistication. He earned a masters in Economics and a law degree from Harvard. One of his partners at Fairfield Greenwich was formerly with the SEC. The problem, seemed to be that it became a capital introduction service for Madoff instead of a fiduciary to its clients. Indeed, his entire persona was straight from central casting, the elder statesman, evocative of honorable characters played by Jimmy Stewart and Gregory Peck, according to a friend and industry veteran.[509]

Fairfield Greenwich charged clients annual fees of one percent of assets under management, plus 20% of capital gains on investments. According to one estimate, on the Madoff investment alone, this would have provided Fairfield Greenwich with $70 million annually plus an additional $140 million for any year the Madoff funds reported a 10% gain (which was regularly done).[510] Significantly, a single feeder fund, the "Fairfield Sentry Fund" operated by Fairfield Greenwich, directed its assets exclusively in Madoff.[511] Had Fairfield Sentry be subject to the 1940 Act (or even any reasonably modest obligations for diversification), these losses would not have been as substantial. (Unless, of course, Fairfield Greenwich selected only ponzi schemes in which to invest).

Given how poorly these sophisticated middlemen selected and monitored investments, it is surprisingly how much their clients paid for the privilege of hiring them. Through the Ascot Partners fund, J. Ezra Merkin earned 1.5% of assets under management. This amounted to around $40 million per year for his three funds, Ascot, Ariel and Gabriel (which either invested all or a good portion with Madoff).[512] The representations made in the more than 50 page offering memorandum, were meaningless in retrospect. The limited partners (investors) learned in a short, three paragraph letter than the $1.8 billion they had entrusted him with had been entirely invested in Madoff.[513] In the letter, Merkin described himself as a "victim of fraud".[514] Yet Merkin was himself not only "sophisticated" by an SEC standards, but also a graduate of Columbia University and Harvard Law School.[515]

An attorney representing some limited partners noted that the offering document which included a variety of investment strategies did not contemplate placing all of the eggs in one basket, as it were. In addition to the high fees, there were gates restraining investor liquidity. Investors could only withdraw annually and with 45 days notice.[516]

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[505] Jenny Strasburg, *A Madoff Feeder will Auction Assets*, WALL ST. J., Aug. 15, 2009, B3.
[506] Eric Konigsberg, *In Fraud Case, Middlemen in Spotlight*, N.Y. TIMES, Dec. 16, 2008, A1; available at http://www.nytimes.com/2008/12/17/business/17hedge.html?scp=4&sq=konigsberg%20middlemen&st=Search
[507] Konigsberg, *supra* note __.
[508] Konigsberg, *supra* note __.
[509] Konigsberg, *supra* note __ (from the perspective of George L. Ball).
[510] Konigsberg, *supra* note __.
[511] Konigsberg, *supra* note __.
[512] Leslie Wayne, *Inquiry Started of Financier Who Invested With Madoff*, N.Y. TIMES, January 15, 2009.
[513] Alison Leigh Cowan, *Firm that Trusted a Disgraced Investor*, N.Y. TIMES, December 15, 2008.
[514] Cowan, *supra* note __.
[515] Wayne, *supra* note __.
[516] Cowan, *supra* note __.

Merkin's own hedge fund clients were "a large swath of sophisticated New Yorkers As a result, many charities and schools that invested with him are now holding worthless investments and trying to explain to their constituents why the money was lost."[517] His clients included 15 nonprofit institutions.[518] Among the sophisticated Merkin investors wase real estate developer and publisher Mortimer Zuckerman who claimed losses of $30 million from his charitable trust.[519] Additionally, institutions of higher learning, presumably bastions of sophistication also suffered under Merkin. Yeshiva University ($100 million) New York University ($24 million), New York Law School ($3 million), Bard College ($3 million).[520]

The offering memorandum which governed Merkin's investment mandate, reveals why so-called private ordering or private contract is no match to substantive regulations. The standard language informed the limited partners that investments were "speculative," and that "there can be no assurance that any of the hoped-for benefits of the foregoing approach will be realized."[521] Indeed, up front on page 2, it informed them that Merkin had the right to hand over assets to a third party manager. Indeed, the document also revealed that he planned "to the extent circumstances permit, to adopt a selective approach in evaluating potential investment situations generally concentrating on relatively fewer transactions that he can follow more closely."[522]

Merkin and his legal counsel may well have believed that the offering memorandum gave him enough leeway to invest all assets in Madoff. Moreover, if both Merkin and Madoff had been subject to some of (or lighter versions of) the 1940 Act requirements, this could not have occurred. Too much oversight, inspection, controls are part of the law that would be much more difficult to circumvent. Another middleman was Kingate Management which lost $3.5 billion. International banks also lost billions, including Spain's Bank Santander ($3.1 billion), Switzerland's Union Bancaire Prive ($1 billion) and Austria's Bank Medici ($2.1 billion).[523]

Another theory, that self-interest will somehow help middlemen do a better job of protecting clients is undermined by these examples. The Noel family, apparently had "a very substantial part of each family member's personal assets . . . invested with Bernard Madoff alongside those of our investors."[524] Either the annual fees were enough incentive to overlook the warning signs, or as noted above, sophisticated investors are no match to fraudsters. They need to be stopped from damaging their own "sophisticated" clients and threatening our financial system. Moreover, the federal securities laws were designed with this in mind, not simply about helping an investor on an individual transaction. However, evidence suggest that having skin in the game does not lead to better returns. In a recent study of the very temporary required hedge fund filings in 2006, the authors discovered that concentrated ownership (i.e. a greater than 75% owner) correlates with lower performance.[525]

In conclusion, sophisticated investors can neither take care of themselves nor the investors who entrust them with their money. They have proven to be no match to the complexity and fraud that arises in an opaque market. Thus, it is indefensible that the same entities who wish to have a hands-off approach to private investment pools based upon theoretical "sophisticated investors" also, when subject to litigation claim that they were incapable of monitoring investments. Clearly, the reason for wishing to uphold the "sophisticated investor" notion is to attract as many assets as possible from the largely unsophisticated and have the freedom to engage in risky, highly leveraged transactions that produce huge fees for the financiers and no liability at the other end for losses.

c. Response to Argument that Human Nature Cannot Successfully be Restrained

There is an oft-repeated cynical statement that human nature, such as it encourages greed and thus regulations are futile and ineffective. This is of course belied by the empirical evidence (shown in the COP report, as one example) that financial regulation can be effective over a long period of time. Moreover, the same types of folks who make this argument have no qualms about demanding finely honed regulations to hem in the human nature of their counterparties and customers – including such things as mandatory arbitration provisions (which fight the "self-interest" behind massive class action settlements) bankruptcy laws disfavoring consumer debtors etc. These

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[517] Cowan, *supra* note __.
[518] Wayne, *supra* note __ .
[519] Wayne, *supra* note __ .
[520] Wayne, *supra* note __ .
[521] Cowan, *supra* note __.
[522] Cowan, *supra* note __.
[523] Konigsberg, *supra* note __.
[524] Konigsberg, *supra* note __.
[525] Stephen Brown, William Goetzmann, Bing Liang and Christopher Schwarz, *Mandatory Disclosure and Operational Risk: Evidence from Hedge Fund Registration*, J. OF FIN., forthcoming, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=918461

same groups advocated for laws to restrain the human nature of the consumer advocate, plaintiff's lawyer or bankrupt consumer debtor. However, somehow human nature needs to be unfettered and free and cannot possibly be a match to regulation when it's the human nature of the financier. They understand how rules (and the absence of rules) can affect behavior, so long as it is not their own.

On a related note, Alan Blinder makes a good case that the incentive systems exasperate the natural tendencies of financiers.

> "Take a typical trader at a bank, investment bank, hedge fund or whatever. Darwinian selection ensures us that these folks are generally smart young people with more than the usual appetite for both money and risk-taking. Unfortunately, their compensation schemes exacerbate these natural tendencies by offering them the following sort of go-for-broke incentives when they place financial bets: Heads, you become richer than Croesus; tails, you get no bonus, receive instead about four times the national average salary, and may (or may not) have to look for a new job. These bright young people are no dummies. Faced with such skewed incentives, they place lots of big bets. If tails come up, OPM will absorb almost all of the losses anyway."[526]

d. Response to Argument that Regulation Undermines Business Growth and is Ineffective or Redundant

History disproves the contention that government regulation undermines business growth. In the mutual fund case the opposite was true. Only with government oversight and substantive controls was investor confidence restored in investment trusts. Then the industry flourished. The 1940 Act and accompanying regulations is complex, detailed and comprehensive. One would expect it could be the poster child of how excessive regulation killed an industry. Indeed, that is what was initially predicted. However, the opposite has occurred. One of the most regulated industries has become a success story. At the time of the Act, there were only $2 billion in assets under management at U.S. funds. By the time of the study, around $1.3 trillion.[527] And, as of June 2009, over $10 trillion.[528]

Indeed, not only did the industry grow as a result of intensive operational controls, it also grew by indirect government subsidy. With the creation and rise of the 401(k) plan, which allows employees to put away pre-tax wages into employer sponsored defined contribution plans, mutual fund assets exponentially grew. Between the late 1950's and late 1970s, assets hovered in the $40 billion dollar range. They creeped up in the early 1980s past $200 billion. Then, rapidly shot up to more than $1 trillion in less than 10 years.[529] Acknowledging the race-to-the-top effects of sound regulation, Martin Whitman wrote in a letter to shareholders that "Because of the existence of strict regulation, the outside investor knows that money managers can be trusted. Without that trust, the industry likely would not have grown the way it had grown.'"[530]

VI. Stop Enabling: End Speculation with Credit Derivatives: Shut down the Credit Casino

This paper recommends that devices, like we no longer allow credit default swaps, initially designed to minimize and distribute risk to be used for speculation or gambling. Experts contend that CDS led to bailouts of Bearn Stearns and AIG as well as the demise of Lehman. By 2005, there were $12 trillion in CDS contracts outstanding.[531] Presently, the notional value of the CDS market is $28 trillion.[532] At the peak at the end of 2007, the notional value of CDS was anywhere between $57.8 and $63 trillion.[533] In May 13, Treasury proposed to amendment the CFMA to require over-the-counter derivatives trades to be cleared through "regulated central

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[526] Blinder, supra note __.
[527] HALF CENTURY, supra note __ at xviii.
[528] Investment Company Institute website.
[529] Investment Company Institute, Wisenberger Financial Services & Lipper Analytical Services Chart, Growth of Management Investment Company Assets 1940 – 1990 in HALF CENTURY, supra note __ at ix.
[530] Aguilar speech, supra note __ citing Letter from Third Avenue Funds Chairman of the Board Martin J. Whitman to Sharheolders, at 6 (Oct. 31, 2005) available at www.thirdavenuefunds.com/ta/documents/sl/shareholderletters-05Q4.pdf).
[531] TETT, *supra* note __ at 129.
[532] *CDS Counter-party Concentration Has Increased-Fitch*, REUTERS, Aug. 20, 2009.
[533] Jonathan R. Laing, *Defusing the Credit-Default Swap Bomb*, BARRONS, Nov. 17, 2008.

counterparties."[534] While central clearing and transparency are important, ending excessive speculation is critical. The entire over-the-counter derivatives market stands at $592 trillion. Five US banks are expected to earn $35 billion in trading derivative contracts.[535] Therefore, the likelihood of winning this battle against well-funded lobbyists is slim. However, it is still a valuable discussion.

It may not have been overt fraud, given the complexity of these instruments. Even those responsible for the sale of CDS did not understand them. In around 2002, a Goldman Sachs ("Goldman") partner in charge of swaps for corporate clients called a meeting with a managing partner about credit derivatives to ask what they were.[536] Grasping the growing importance of CDS, while CEO of Goldman, Henry Paulson "took credit derivatives on board as his personal project."[537] They "were amoung the hottest and fastest-growing products in finance throughout the 1990s" and "their use grew as corporate debt issuance ballooned."[538]

The CDS market is rife with conflicts-of-interest. Apparently, some now appreciate that "It is problematic that "the dealers who make the markets should be in charge of the pricing services."[539]

Other problems arise from lack of transparency which creates a breeding ground for insider trading. A former Goldman Sachs managing director noted that banks who are planning to underwrite a new debt issuance for a corporation have been known to trade in that same firm's credit default swaps. For example, a bank involved in an emergency credit facility for Ahold, allegedly earned $15 million by trading credit derivatives prior to the public announcement of Ahold's earnings misstatement and credit facility.[540] "Other examples of heavy trading volumes preceding a news press release were at Tyson Foods and UnumProvident. Buying credit protection by trading on inside information is a way for banks to steal from investors without access to that information, and the practice is unhampered by regulations."[541]

In addition, the use of credit default swaps contracts where a corporation is the referenced credit, can interfere with reorganization under Chapter 11 of the Bankruptcy Code.[542] According to Professor Hu and Professor Bernard Black, this debt "decoupling" can undermine the welfare of individual corporations and threaten the financial system generally.[543] One example would be if a hedge fund is a direct creditor of company XYX as it owns some of its bonds. That hedge fund may also have bought credit protection (CDS) on company XYZ. The hedge fund is betting that XYZ fails. Yet, because it has rights as a direct creditor through its bond holding, it can interfere with a reorganization process designed to help XYZ survive and push the firm into bankruptcy. Both Bear Stearns and AIG were CDS dealers. A large motivation for the US government intervention was CDS exposure.[544] The uncertainty of the Chapter 11 process may have played into this decision.

Some argue that "While CDS may be used to manipulate certain markets, it is highly unlikely that manipulation with CDS did anything other than hasten the collapse of financial institutions already overinvested and overexposed to mortgage-related securities."[545] Market manipulation in and of itself is a problem. The insider trading cases involving CDS threaten investor confidence and market integrity. In addition, CDS were there at the outset and helped those financial institutions become "overinvested" and "overexposed" to begin with.

Professor Lynn A. Stout, an expert on the theory and history of derivatives regulation, concludes that these negative attributes are not balanced out by any empirical evidence of the societal benefits of CDS.[546] Instead, as reflected above, there are four attributes associated derivatives, they are linked to asset price bubbles, create risk, speculation diverts energy and effort from productive economic activities and trading in derivatives has been linked to fraud and insider trading.[547]

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[534] Timeline, *supra* note __
[535] Christine Harper, Matthew Leising and Shannon Harrington, *Wall Street Stealth Lobby Defends $35 Billion Derivatives Haul*, BLOOMBERG.COM, Aug. 30, 2009.
[536] PRINS *supra* note __, at 109
[537] PRINS *supra* note __, at 8.
[538] PRINS *supra* note __, at 9.
[539] Liz Rappaport, Carrick Mollenkamp & Serena Ng, *U.S. Tightens Its Derivatives Vise*, W.S.J., July 15, 2009 at C1.
[540] PRINS *supra* note __, at 111.
[541] PRINS *supra* note __, at 112.
[542] Hu, supra note __, citing Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 PENN. L. R. 625 (2008).
[543] *Id.*
[544] *See*, Adam Davidson, *How AIG Fell Apart*, REUTERS Sept. 18, 2008.
[545] Shadab, *Guilty by Association?* At 45.
[546] See, Lynn A. Stout, Testimony before the United States Senate Committee on Agriculture, Forestry and Nutrition, Jun. 4, 2009, available at http://216.40.253.202/~usscanf/index.php?option=com_events&task=view_detail&agid=32&year=2009&month=6&day=4&Itemid=44
[547] *Id.*

A. De-Regulation of Credit Derivatives

As described above, credit-default swaps were used to speculate on the performance of particular mortgage-backed securities as well as the mortgage market generally. Thus, the CFMA is a chief legal Enabler. The law did more than stay hands-off. It actually enabled the growth of a market.

The preamble of the CFMA identifies its purpose as "To reauthorize and amend the Commodity Exchange Act to promote legal certainty, enhance competition, and reduce systemic risk in markets for future and over-the-counter derivatives, and for other purposes."[548] The law explicitly states that "it shall supersede and preempt the application of any State or local law that prohibits or regulates gaming or the operation of bucket shops."[549] The need for this language reinforces the reality that CDS were "a form of legalized gambling that allows you to wager on financial outcomes without ever having to actually buy the stocks and bonds and mortgages. It would have been illegal during most of the 20th century under the gaming laws, but in 2000, Congress gave Wall Street an exemption and it has turned out to be a very bad idea."[550]

In addition, according to Professor Stout, the CFMA gave counterparties the ability to enforce agreements in court. In other words, this deregulated market grew with government assistance. Prior to that change, there was uncertainty about the enforceability of these swaps. "Common-law judges accordingly viewed derivatives speculation with suspicion. Under the rule against difference contracts and its sister doctrine in insurance law (the requirement of "insurable interest"), derivative contracts that couldn't be proved to hedge an economic interest in the underlying were deemed nothing more than legally unenforceable wagers."[551]

Stout contends that:

> "The CFMA not only declared financial derivatives exempt from CFTC or SEC oversight, it also declared all financial derivatives legally enforceable. The CFMA thus eliminated, in one fell swoop, a legal constraint on derivatives speculation that dated back not just decades, but centuries. It was this change in the law—not some flash of genius on Wall Street—that created today's $600 trillion financial derivatives market."[552]

Stout calculates that "By 2008, the notional value of the derivatives market—that is, the size of the outstanding bets as measured by the value of the things being bet upon—was estimated at $600 trillion, amounting to about $100,000 in derivative bets for every man, woman, and child on the planet."[553]

After the CFMA, in 2002, when the topic of regulation arose, Alan Greenspan objected.:

> "this market, presumed to involve dealings among sophisticated professionals, has been largely exempt from government regulation. In part this exemption reflects the view that professionals do not require the investor protections commonly afforded to markets in which retail investors participate. . . forced disclosure of proprietary information can undercut innovations in financial markets.[554]

Given that that premise of the sophisticated investor has crumbled, it also follows that we should examine the "sophisticated professional." In addition, the question cannot be whether these professionals can take care of themselves. They act on behalf of institutions whose value they threaten when the operate in their own personal self-interest. Moreover, they participate in the larger capital markets which should serve the general public, not operate simple to generate fees and bonuses for the gamblers therein.

[548] The Commodities Futures Modernization Act, H.R. 5660, available at http://www.cftc.gov/stellent/groups/public/@lrrulesandstatutoryauthority/documents/file/ogchr5660.pdf
[549] CFMA Sec 117 Preemption.
[550] Kroft, supra note __
[551] Stout, supra note __.
[552] Lynne A. Stout, *How Deregulating Derivatives Led to Disaster, and Why Re-Regulating Them Can Prevent Another*, 1 LOMBARD ST. 4, 7 (2009) available at http://www.finreg21.com/files/finreg21-finreg21/Lombard%207.pdf
[553] Stout, supra note __.
[554] The Federal Reserve Board, Remarks by Chairman Alan Greenspan before the Society of Business Economists, London, U.K., Sept. 25, 2002, available at www.federalreserve.gov/BoardDoc/Speeches/2002/2002209252/default.htm.

This supposition is supported by the recent Congressional testimony of Professor Henry Hu. Professor Hu informed the U.S. House Committee on Agriculture that:

> "There are structural reasons why 'sophisticated' financial institutions may misunderstand – or may act as if they misunderstand – the risks of the derivatives they offer. If such decisionmaking errors threaten the survival of the dealer itself, a request for governmental intervention will not be far behind."[555]

Hu informed the Committee that notwithstanding the intricate models created by genius quantitative analysts to price credit derivatives, certain behavioral factors interfere with accurate risk assessment. These include "cognitive biases" and an incentive system within the derivative trading units of institutions that discourages raising flags. The cognitive bias he mentions is the "tendency to ignore low probability catastrophic events."[556] Professor Nassim Taleb deemed these "black swan" events.[557]

Hu provided an excellent example of this cognitive bias. In August of 2007, well into the subprime mortgage crisis (see timeline section below), the head of the AIG financial products division (responsible for CDS sales) said the following:

> "It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing even one dollar in any of those [credit default swap] transactions."[558]

In its 2006 10K (annual filing with the SEC made in early 2007), AIG also described the "likelihood of any payment obligation" under AIG CDS as "remote."[559]

This helps illustrate the failure of sophisticated investors to either understand risk. Contracts were limited to a variety of "sophisticated" investors defined in the statute. It also illustrates the motive to ignore risk -- when one is being compensated extremely way up front and only for winning bets. The head of the AIG financial products division, Joseph Cassano, pocketed $315 million[560] growing AIG's CDS exposure to $440 billion. This exposure brought down the firm and required a $170 billion tax-payer funded bailout. The AIG example also illustrates the problem with relying solely upon a disclosure regime to protect shareholders and the public from risky activities. If the disclosure proves inaccurate or incomplete, the damage is already done. Additionally, if the problems are widespread, as noted below, the vast majority of architects escape liability.

VII. Stop Enabling: Allow Homeowners to Lien-Stripping with Chapter 13: Bailout underwater homeowners

> "[P]ick yourself up/Dust yourself off/Start all over again." [561]

The Bankruptcy Code permits bankruptcy courts to modify the terms of almost all loans. This includes secured loans, for which the lender has some right in the collateral and unsecured which are backed by nothing more than the borrower's promise to repay. One type of loan is treated differently, however. The law prevents the modification of first mortgage loans on principal residences.

This paper also suggest that Bankruptcy Code be amended to allow courts to help underwater homeowners. Courts should be able to treat a home mortgage the same way as a car loan, credit card debt or any other loan. Consumer groups,[562] academics[563] and politicians[564] have continually advocated for this change to the Bankruptcy

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[555] Henry T.C. Hu, *Credit Default Swaps and the Financial Crisis: "Interconnectedness" and "Beyond*," Hearing on The role of Credit Derivatives in the U.S. Economy, U.S. House Committee on Agriculture, Oct. 13, 2008, referencing Henry T.C. Hu, *Misunderstood Derivatives*, Yale L. J. (1993).
[556] *Id.*
[557] NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE (2007).
[558] Hu, citing Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risks*, N.Y. TIMES, Sept. 28, 2008, A1.
[559] Hu, supra note __.
[560] Michael Daly, *Pin AIG Woes on Brooklyn Boy: Joseph Cassano Walked Away with $315 Million While Company Staggered*, DAILY NEWS, Mar. 17, 2009.
[561] "Pick Yourself Up" by Dorothy Fields
[562] *See, e.g*., John Rao (National Consumer Law Center), Henry J. Sommer (National Association of Consumer Bankruptcy Attorneys), Travis Plunkett (Consumer Federation of America), Ira Rheingold (National Association of Consumer Advocates), Ellen Harnick & Eric Stein (Center for Responsible Lending), *Joint Memo for Proposed Bankruptcy Law Reform*, Apr. 27, 2007.

Code. Courts should be permitted to reduce the principal outstanding on the loan so that it is no larger than the value of the related home. This is known as lien-stripping. Permitting lien-stripping under Chapter 13 as well as Chapter 7, would create value for both lenders and borrowers. It would also help reduce poor underwriting and inflated home valuations and protecting the most vulnerable from the impact of the financial system abuses. While this might make the cost of borrowing and access to loans more difficult, the empirical evidence may suggest otherwise[565] and if it were the case, this is not a terrible result. Easy access to credit leaves middleclass consumers enslaved to the fulfillment of past desires. Restrictive bankruptcy laws make the ability to get a fresh start after unexpected health problems and job losses very difficult. Upfront barriers to unwise excessive lending can have good effects. Indeed, the state of Vermont, with extremely strict laws on mortgage lending, ranked number 48 on a listing of states with the highest repossession rates in the nation.[566]

A. Why Homes are Under Water

By the end of June 2009, more than 33% of all mortgaged homes in the U.S. were under water.[567] This is up from 10% at the beginning of 2008, at the beginning of the recession, and well into the subprime crisis. Homes are under water in large part because home values were inflated. Prices were inflated due to the refinancing craze and that the refinancing craze was propelled by the mountain of credit card debt Americans have accumulated and the demand for mortgages to pool and securitize. Whether in subprime loans or otherwise, consumers needed to treat their homes like cash-registers in order to have cash. And, even when they overspent on "unnecessary" items, this fueled the economy. An economy dependent upon consumer spending suffers, or experiences a paradox of thrift when people begin to save.

While some who believe in efficient markets would object to the suggestion that prices were wrong. Willing buyers and sellers should, in theory arrive at the right price. Buyers can observe prices more readily with internet publication of MLS listings and registry of deeds online databases. Yet, this is a mistaken assumption, something Professor Paul Krugman would call the "ketchup problem." He notes that "In the case of housing, buyers do carefully compare prices — with the prices of other houses. That is, they make sure that two-quart bottles of ketchup are the same price as one-quart bottles. As we've seen, however, they don't do a very good job of checking whether the overall level of housing prices makes sense."[568]

In addition to the ketchup problem, there is also the re-financing problem. In other words, when a homeowner is refinancing a loan, while he or she is in the role of the "buyer," there is no incentive to keep the value of the home low. In fact the incentive goes the other direction. Someone refinancing a loan who hopes to take cash-out, is looking for an inflated home value. In theory bank or mortgage originator should, in order to protect its interest, seek an honest appraisal. However, because loans were originated and sold, the incentive was to close the deal, collect a fee, sell the loan and repeat. Even those homes that are barely inhabitable received good appraisals And, when underwriters questioned a valuation, they were pressured into approving the loan. The mortgage brokers on the ground were compensated well for these practices (as well as pushing people into unwise subprime loans).

Many homeowners used refinancing to pay off huge credit card bills, medical and dental bills or car loans (past consumer spending). Others went to vacations, school tuition, expenses shopping (future spending). Not necessarily the best move, some people did not have the income available to pay the monthly minimums on huge credit card balances. Instead of finding a way to come up with a reasonable payment plan or resort to personal bankruptcy, they used the cash from their refi to pay off these debts. This had the effect of spreading debts over a longer period of time and making them look smaller from monthly basis, but has terrible long-term consequences. To add to the problem, instead of cutting up their credit cards, these same people charged away, living a lifestyle larger than they could afford based upon their wages alone. This is perfectly rational in some way, though, as everyone was doing it. Why say "no" I can't afford it, if you really can. Money just magically appeared. It did not

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[563] See, e.g. Eric A. Posner & Luigi Zingales, The Housing Crisis and Bankruptcy Reform: The Pre-packaged Chapter 13 Approach, The Initiative on Global Markets, Working Paper No. 32, Feb. 23, 2009.
[564] See the discussion below of the amendment introduced by Senator Durbin that was defeated by the Senate.
[565] See Levitan & Goodman, infra note __.
[566] Gary Fields, *Vermont Mortgage Laws Shut the Door on Bust -- and Boom*, Aug. 18, 2009.
[567] Bob Tedeschi, *The Depths of Mortgage Debt*, N.Y. TIMES, Aug. 28, 2009.
[568] Paul Krugman, *Ketchup and the Housing Bubble*, N.Y.T., July 19, 2009 available at http://krugman.blogs.nytimes.com/2009/07/19/ketchup-and-the-housing-bubble/

grow on trees, but it sure seemed like it. Also, there was that one safety valve – selling the house, paying off the debt and moving on. But this safety valve only existed when housing prices were on the rise.

There is much evidence that appraisals were biased. New York Attorney General, Andrew Cuomo reached a settlement with and Fannie Mae and Freddie Mac after allegedly discovering that " appraisers inflated values under pressure from lenders." As a result, effective May 1, 2009, a "firewall" was required to be set up to separate loan officers from appraisers. In addition, the settlement requires banks who sell mortgages to the agencies to order a second appraisal on 10% of the homes.[569]

> "Appraisals are supposed to shield home buyers from paying too much and lenders from overestimating the value of collateral. If appraisals come in too high, buyers may overpay, making defaults more likely. If they are too low, it becomes hard to sell or refinance homes."[570]

Under the Cuomo settlement, the code of conduct prohibits mortgage brokers, real estate agents or loan officers from selecting the appraiser. As a result, lenders are outsourcing appraisals to appraisal management companies which then hire appraisers.[571] Industry lobbyists have complained that appraisals are more conservative and have predicted a lending "chill". This is somewhat ironic. One should assume that some appraisals should come out lower than the sales price. And, one would think that given the previous conflicts of interest and pressures, appraisals were artificially high. Thus, it seems disingenuous for this to be taken as a legitimate complaint. And, in June of 2009 even one federal banking regulator and the Federal Reserve are resisting honest appraisals.

Meanwhile, however, a trade association representing 25,000 appraisers was in support of the settlement. This shows they were obviously relieved to be free from undue influence. "We take offense with the notion that an appraisal is only good if it happens to come in at the sales price," the group said. "That mentality helped cause the mortgage meltdown to begin with."[572] Indeed, it becomes self-perpetuating, as those honest appraisers are not hired back. One industry veteran noted that "I worked as an appraiser for a few years. I was never once offered a kickback or bribe, but I regularly lost clients who felt I was "too conservative". Not once did anyone say "hey, thanks for stopping us from funding that under-collateralized loan."[573]

B. <u>Bankruptcy Background</u>

Bankruptcy is designed to balance the interests of debtors and creditors at a time when the amount of debt a borrower has accumulated exceeds his or her current assets and ability to repay. Debtors get a temporary stay, or "breathing" room from bill collectors and ultimately a "fresh start." Creditors benefit from an orderly and fair collection and distribution of any assets in the bankrupt debtor's "estate." While this represents a practical view of the bankruptcy process, historically the process of dealing with insolvent debtors relied more on a moralistic sense of blame and punishment than a reasoned approach to resolve a situation that can occur whether with or without a debtor or lender to blame. Some residual moralizing enters the public sphere at times to justify limiting debtor access to bankruptcy or some benefit there under.

Congress was empowered under the U.S. Constitution to make uniform bankruptcy laws. However, for many years after its ratification, there were fierce battles regarding the desirability and contents of such a federal law. The debates were emotionally charged. Opponents of early bills objected to voluntary filings, claiming this supported "dishonest debtors and rogues" and thus was morally offensive.[574] Much of these battles were the byproducts of a previous legal era. Historically, the treatment of defaulting debtors was based upon notions of retribution and deterrence. This tradition dated back to at least Greece and Rome where debtors were enslaved, incarcerated, physically injured and killed for failing to pay their creditors.[575] Early America followed that tradition. Until the mid-19th Century, individuals were commonly imprisoned for defaulting on debts sometimes until death.

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[569] Dan Levy, *Home-Price Recovery May be Undermined by Appraisals*, BLOOMBERG.COM, Jun. 24, 2009, available at http://www.bloomberg.com/apps/news?pid=20601213&sid=aWyCYkxx5W1w
[570] James R. Hagerty, *Reappraising Home Appraisers*, WALL ST. J. Aug. 18, 2009.
[571] Hagerty, *supra* note __.
[572] Levy *supra* note __ .
[573] Interview with Brian Walsh. June 24, 2009.
[574] CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 52 (New York: Da Capo Press, 1972) 52 (originally published by Harvard University Press in 1935).
[575] JUKKA KILPI, THE ETHICS OF BANKRUPTCY (1998).

In contrast, the current system, a result of the Bankruptcy Code of 1978 (as amended most recently in 2005) is designed to set aside moral judgment. It attempts to balances the interests of debtors, creditors, and society at large. The US system allows for both forgiveness of debts and rehabilitation (or reorganization) of the debtor. Individual debtors, generally have two options, liquidation under Chapter 7 of the Bankruptcy Code or a reorganization under Chapter 13. Like business debtors who file for bankruptcy, individual debtors are entitled to breathing room from creditors and a fresh start, unencumbered by most pre-filing debts.

Under Chapter 7, the bankruptcy trustee collects and sells all of the debtor's assets. Assets that will not be sold include those subject to security interests, liens, mortgages etc. Some assets are protected or "exempt" from collection by the trustee, the nature and amount vary by state law ("exempted assets.")[576] The proceeds of the trustee's sale are distributed to the creditors according to priority set by law. If the debtor owns a home, the lender may have the right to foreclose upon it. Typically, after the exempted assets are set aside, there is nothing left and unsecured creditors receive nothing.

Under a Chapter 13 plan, the debtor agrees to a 3 to 5 year payment plan with creditors. One advantage of a Chapter 13 plan is that the debtor can save his or her home from the reach of creditors (other than the mortgagee). The debtor can stop a foreclosure proceeding by filing. And, he or she can keep the home. The debtor must, however keep making payments during the bankruptcy proceeding and must cure any delinquent payments.[577] Chapter 13 also allows the debtor to stretch out payments to secured creditors over the life of the plan. So, for example, a debtor might extend what she owes on a car loan for 5 additional years and the creditor with a security interest in the car will not be able to repossess it.

Secured creditors are given priority in bankruptcy. These are those creditors who received collateral for their loan or otherwise obtained a valid security interest or have a right of set-off against the debtor's property. Unsecured creditors may receive less than they were owed or even nothing at all under a Chapter 13 plan. They are only paid if the debtor has disposable income.

Through a Chapter 13 proceeding, a debtor is entitled to lien-stripping of secured claims, so he won't owe more than the assets are worth. However, there is a glaring exception. A debtor is not entitled to have a mortgage on a primary residence downsized. At the end of the payment plan, the debtor is discharged from all debts other than certain types of loans excluded by statute. This include home mortgages, certain student loans, amounts owed from drunk driving accidents, criminal fines and other claims.

C. Anti-Consumer Bankruptcy Code Changes in 20005

In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). This amended the Bankruptcy Code of 1978. Proponents of the law claimed that it was designed to separate those who truly needed relief from those who could afford to pay back creditors.[578] In other words, it was intended, in part to channel those who "can pay" into a restructuring under Chapter 13 and not a liquidation under Chapter 7. A chief supportor of the amendments, Senator Grassley promised that "The bill clearly provides that people of limited income can still file under chapter 7 and get that fresh start . . . so their debts can be wiped away, as is done right now."[579] To accomplish this sorting out of debtors, BAPCPA created a "means test," requiring the bankruptcy trustee to examine the debtor's resources and determine whether he or she is eligible for Chapter 7. Just following its effective date, there was "an abrupt drop" in consumer bankruptcy filings. This occurred while median family incomes declined, expenses rose, consumers had greater debt burdens, higher home foreclosure rates and other signs of increasing financial distress.[580]

Researchers study a sample of 2,500 bankruptcy cases from 2007 and compare the profile of the debtors filing then to debtors filing in 1981, 1991 and 2001. The found that the post-BAPCPA (2007 group) who filed had the same economic profile as the earlier filers. This indicated that the law had not effectively screened any supposed abusers. Instead, it had simply decreased the total filings. "The presumptively abusive "rich" (at least as measured

[576] U.S. COURTS, BANKRUPTCY BASICS, CHAPTER 7, available at http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter7.html
[577] U.S. COURTS, BANKRUPTCY BASICS, CHAPTER 13, available at http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter13.html
[578] Robert M. Lawless, Angela K. Littwin, Katherine M. Porter, John A.E. Pottow, Deborah K. Thorne & Elizabeth Warren, *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L. J. 349-406 (2008).
[579] Lawless et al, citing 151 CONG. REC. §1856.
[580] Lawless et al.

by income) debtors are not being squeezed out. Instead, the 2005 amendments have had the effect of squeezing *all* income groups alike—from the highest income to the lowest."[581]

BAPCPA also failed to channel the "can pay" abusers into Chapter 13. While the number of Chapter 13 cases did increase, the difference in the income profile of the filers in 2007 as compared to 2001 was not statistically significant. The average income had been $33,742 in 2001 and $35,688 in 2007.

The authors also found in comparing debtors in bankruptcy in 1981 to those in 2007, the negative net worth of a median household had increased. Debts where outpacing assets. People had more personal possessions and more valuable homes, but they also had disproportionately greater debts. In 1981, filers had a negative net worth of around $11,200. In 2007, the negative net worth was around $24,400.[582] In the concise words of the authors, they were in the hole "more than twice as deep."

It was clear that the real intention and result of BAPCPA was to protect lenders by decreasing the total number of consumer bankruptcies. Instead of bearing the full consequences of their poor lending decisions, they got the law changed after the fact. In addition, the most important pro-consumer amendment, to allow lien-stripping for underwater home owners was not made. One possible result of BAPCPA was to push overloaded borrowers into home refinancing. Instead of deleveraging through bankruptcy, many treated their homes like cash registers. With rising home values, they could borrow a bit more and use some of the proceeds of the new loan (a "cash out") to pay off credit card debt.

D. <u>Background on Lien-Stripping</u>

Prior to a landmark Supreme Court case in 1993[583], some debtors in the US were able to use the bankruptcy process to solve the problem of an underwater home mortgage. If someone owed more on their mortgage loan than the house was worth, the courts located within four federal circuits[584] would strip down the loan to the home's assessed value. In doing so, they changed not only the principal outstanding on the loan, but also the amortization schedule – the amounts due over the life of the loan. These federal courts relied upon Section 506(a) of the Code. This section is used to classify creditors' claims.[585] This section says, in part:

> "An allowed claim of a creditor secured by a lien on property . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property. . . and is an unsecured claim to the extent that the value of such creditor's interest is less than the amount of such allowed claim."

This section is applied to all claims against the debtor's estate – or the assets gathered into the bankruptcy proceeding. The purpose of this is to separate the secured claims from the unsecured claims. Secured claims are given higher priority than unsecured claims, as noted above. For example, if you loaned the debtor $10,000 and took as collateral a watch worth $10,000, that watch would be part of the "estate" and you would be fully secured. However, if the watch was no worth only $6,000, you would have a secured claim for $6,000 and an unsecured claim for $4,000. It is highly likely that you will receive only pennies on the dollar if anything for the unsecured claim. Thus, it is very important for the asset to be properly valued. From the debtor's perspective, this lien-stripping allows for a fresh start. After the 3-5 year plan (in the case of a Chapter 13), or just the end of the short process in Chapter 7, the debtor walks away free and clear.

In other federal circuits, however, judges did not permit under water home owners in a Chapter 13 proceeding to lien-strip. Instead, they relied on a different part of the law. Section 1322(b)(2) allows for a reorganization plan that among other things does:

> "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or holders of unsecured claims, or leave unaffected the rights of holders of any class of claims."[586]

[581] Lawless et al. at 359.
[582] Lawless at 369.
[583] Nobleman v. American Sav. Bank, 508 U.S. 324 (1993).
[584] Those Circuits were the 2nd, 3rd, 9th and 10th including the states of Connecticut, New York, Vermont, Delaware, New Jersey, Pennsylvania, Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Washington, Colorado, Kansas, New Mexico, Oklahoma, Utah and Wyoming.
[585] 11 U.S.C. § 506(a).
[586] 11 U.S.C. § 1322(b)(2).

These judges believed this section should apply first. In other words, if $400,000 in principal remained on a mortgage loan on a house worth $300,000, the other four jurisdictions would first determined that the "secured claim" was only $300,000. However, this other group of judges looked to this section first and determined that they could not modify the full $400,000 loan.

While Section 1322(b)(2) had been added in 1978 with the Bankruptcy Code, at that time, subprime and predatory lending was not pervasive. Mortgages were usually fixed rate and and borrowers not highly leveraged. The loan to value ratios were much lower.[587] The four circuits had tried to rectify this with the above described interpretation of the Code. However, in 1993, with *Nobleman*, all nine justices of the U.S. Supreme Court agreed to give effect to a narrow interpretation of the 1978 U.S. Bankruptcy Code.[588] This halted the practice of lien-stripping of first-lien mortgages on primary residences.

The present situation is viewed by many as abundantly unfair. The Center for Responsible Lending observes that:

> "Not only is this policy unwise; it is unjust. Because the home mortgage exception applies only to primary residences, borrowers wealthy enough to own two homes can obtain relief from the mortgage on their vacation or investment home, thereby retaining at least one shelter for their family. Nor does the exception apply to the homes of family farmers, who file under Chapter 12, or to commercial real estate owned by businesses filing under Chapter 11. The law thus deprives mostly low-wealth and middle class families of protections available to all other debtors."[589]

E. Efforts to Restore Lien-Stripping

Since the *Nobleman* decision in 1993, Congress and consumer groups have sought to remedy the anomalies in the Bankruptcy Code that allows, lien-stripping for other assets, allows owners of second homes to have the benefit of "lien stripping" and that allows businesses to have the same right. Yet, the 2005 amendments to the Bankruptcy Code, through BAPCPA went in the other direction, making it more difficult for consumers to file for bankruptcy and failing to fix these anomalies.

The Helping Families Save Their Homes Act of 2009 did not amend the Bankruptcy Code to help underwater homeowners. Senator Durbin (D-Illinois) had proposed an amendment that would have allowed bankruptcy judges to adjust both principal and interest payments for filers whose homes were worth less than what they owed. Many applauded this attempt as good for both homeowners and creditors. Homeowners would be less likely to walk away from an underwater mortgage and creditors would end up better off "mortgages worth the market value of the house rather than much lower proceeds from foreclosure.[590] Unfortunately, this amendment was defeated with a vote of 51-45, with 12 democrats joining the republican senators.[591]

While the American Bankers Association lobbied strenuously against this proposal, there are those, including a former community bankers who supported consumers on this matter.[592]

> "They claimed the amendment would lead to more bankruptcy filings and prompt more homeowners to use bankruptcy as a threat to negotiate lower monthly payments, which would force lenders to raise interest rates. . . .Those arguments fall short. Homeowners do not want to risk long-term damage to their credit rating. Housing advocates dispute the higher interest rate claim and estimate the amendment would save

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587 John Rao (National Consumer Law Center), Henry J. Sommer (National Association of Consumer Bankruptcy Attorneys), Travis Plunkett (Consumer Federation of America), Ira Rheingold (National Association of Consumer Advocates), Ellen Harnick & Eric Stein (Center for Responsible Lending), *Joint Memo for Proposed Bankruptcy Law Reform*, Apr. 27, 2007.

587 See, e.g. Eric A. Posner & Luigi Zingales, The Housing Crisis and Bankruptcy Reform: The Pre-packaged Chapter 13 Approach, The Initiative on Global Markets, Working Paper No. 32, Feb. 23, 2009.

588 Nobleman, supra note __.

589 Rao et al, supra note __ at 5.

590 Posner & Zingales, supra note __

591 Janet Hook, *Mortgage reduction bill fails in Senate*, L.A. TIMES, May 1, 2009, at ___.

592 Alexi Giannoulias, *Cram-down—from the Perspective of a Community Banker*, DAILY KOS, Jun. 26, 2009, available at http://www.dailykos.com/storyonly/2009/6/26/747122/-Cram-downfrom-the-Perspective-of-a-Community-Banker.

> hundreds of thousands of homeowners from facing foreclosure. In my experience, fewer foreclosures mean fewer bankruptcies.[593]

The double-standard was not lost. Many "Democratic leaders were furious to see bankers lobbying against consumer protection measures after Congress had approved enormous sums to shore up the financial services industry." [594]

F. The Private Ordering Option Not Working

In a post-bailout effort " eligible borrowers who are in or at risk of default to lower their monthly payments to no more than 31% of their pre-tax income through a loan modification."[595] Not surprisingly, according to the Government Accountability Office, an earlier "loan modification" program sponsored by the Treasury is not working as intended. While Treasury estimated between 3 and 4 million homeowners would receive assistance under the program, as of July 2009, only 180,000 three-month trials were underway, though 350,000 modification offers had been made.[596]

> "Borrowers and housing counselors . . . have been complaining about the program since it began. Many say their servicers are not responsive -- losing paperwork, not returning calls and never making decisions on applications. Some charge that servicers are violating the rules, such as denying modifications to those who are still current with payments. **. . .**The outcry has become so great that the administration has called servicers to a meeting in Washington . . . to determine how to improve the application process and increase the volume."[597]

It is abundantly clear that the Bankruptcy courts were better prepared to manage this process. Indeed recent news accounts show how bankruptcy judges are the ones willing to stand up to the uncommunicative lenders who are working at a snail's pace to help borrowers. It a rare move, bankruptcy court Judge Randolph J. Haines of the required a senior executive from Wells Fargo to appear before his court in a consumer bankruptcy case.[598] Far from an isolated reaction, according to Professor Robert Lawless, "The judges are seeing more and more of a pattern of indifference to record-keeping and good business practices."[599] Additionally, "in recent months, judges in Ohio and Pennsylvania have chastened mortgage servicers for failing to process payments properly and for errors in foreclosure filings, among other concerns."[600]

Given the competency of bankruptcy judges, some might think it was a mistake to create a separate government office which is not adequately staffed or to expect servicers to hustle to it when they stand to lose money. According to the GAO, the Homeownership Preservation Office is not fully staffed.[601] There is no downside for failure to comply or for dragging their feet. Moreover, services are blatantly violating the program rules by either denying qualified borrowers, initiating foreclosures while applications are pending or requiring the payment of fees up front.[602] Finally, this program will cost taxpayers more than bankruptcy would. Under bankruptcy, the investors in the mortgage pools would take the losses. Whereas, the GAO is now suggesting sweetening the deal with tax payer money.

> "Separately, the GAO questioned whether Treasury needed to pay investors additional incentives to agree to modify loans in areas experiencing steep home price declines. This payment would be on top of the

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[593] Giannoulias *supra* note __.
[594] Giannoulias *supra* note __.
[595] Tami Luhbi, *Watchdog Criticizes Obama Mortgage Plan*, CNN MONEY.COM, July 29, 2009, available at http://money.cnn.com/2009/07/23/news/economy/GAO_loan_modifications/index.htm
[596] Luhbi, supra note __.
[597] Luhbi, supra note __.
[598] John Collins Rudolph, *Judges' Frustration Grows with Mortgage Servicers*, N.Y. TIMES, Sept. 3, 2009.
[599] Rudolph *supra* note __.
[600] Rudolph *supra* note __.
[601] Luhbi, supra note __.
[602] Luhbi, supra note __.

> money investors would already receive for modifying a loan. The watchdog noted that funds should be spent to encourage adjustments that would not be made without an incentive."[603]

However, others consider the program worthwhile as not everyone will or should file for bankruptcy. Other options include a short-sale on the home. The lender typically ends up with a higher payment than in a foreclosure. However, with a short-sale, when the lender forgives the difference between the amount remaining on the mortgage and the sale price, the homeowner can be subject to taxation for "cancellation of indebtedness. [604] In order to receive an "insolvency" exemption to the CID tax, assets that would not be reachable by creditors, such as deferred retirement plan assets (IRA, 401k etc.) are included.[605] Along these lines, some have observed that since there are only around 400 bankruptcy judges, the courts do not have the capacity to handle the new volume. One possible solution put forward by Professors Eric Posner and Luigi Zingales is a pre-packaged plan.[606]

However, the prospect of bankruptcy gives homeowners bargaining power. A BATNA is the "best alternative to a negotiated agreement." The party with the better BATNA has greater bargaining power. Bankruptcy becomes the homeowners "BATNA"[607], the servicers are more likely to hustle a bit and get loans modified.

Ironically, better choices such as improving the appraisal system to eliminate conflicts of interest and pressures have met resistance. Also, efforts to require the underwriters to keep a piece of the securitized loans would make sense (as per Dr. Greenspan), though this is still in progress. In the past these efforts met a good deal of resistance.

Meanwhile, through private ordering, "lenders" and mortgage security holders may be losing out, but not to the homeowners. While Congress cannot find the strength to stand up to lenders and side with borrowers when it comes to home mortgages, it seems that lenders are possibly being challenged by some insurance firms who seem to be employing sharp practices to dig themselves out of their own financial holes. Sellers of private mortgage insurance ("PMI") policies are increasingly attempting to undo or rescind insurance they wrote residential homes. The purpose of PMI is to protect the lender in the event of the borrower's default. The borrower/homeowner pays the premiums, usually if less than 20% of the borrower's money was invested in the home. However, the policy protects the lender as it is designed to protect against the event that the property sells for less than it's originally appraised value, and it will pay out only a portion of the loss. There are exception to PMI policies; they typically exclude coverage for "strip-down, fraud and special hazards."[608] However two major PMI insurers have announced to their own shareholders that they are using recession as a loss-mitigation tool. They claim that incidents of fraud or misrepresentation during the application process have increased, justify the challenging of the policies. Claims on rescinded policies were historically 5% at one firm, but had risen to 20%.[609]

G. Arguments Against Reform and Rebuttal

Those who oppose lien-stripping "warn that cram-down will inevitably raise costs, reduce the credit supply, and give debtors a windfall." Those who support lien-stripping "argue that it prevents foreclosures, safeguards a debtor's 'freshstart,' and will have a minimal effect on interest rates." [610] It is often easy to see where a person stands on the issue by the language selected. Some use the perjorative term "cramdown" to describe reducing the amount owed on the mortgage to the market value of the home. Others who favor the practice resort to the term "lien stripping." It seems odd that "cram down" is used in this situation given that it is more commonly deployed to describe another aspect of the bankruptcy process. This has been observed by bankruptcy law experts as well as

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603 Luhbi, supra note __.
604 Conversation with Barbra Parlin, Partner Holland & Knight, August 10, 2009 (specialist in bankruptcy and creditors' rights).
605 Mortgage Forgiveness Debt Relief Act of 2007 and Conversation with Barbra Parlin, supra note __ .
606 Posner & Zingales, supra note __ at 9.
607 ROGER FISHER & WILLIAM L. URY, GETTING TO YES: Negotiating Agreement Without Giving In (1981).
608 Levitan & Goodman, supra note __.
609 Rhonda D. Orin & Pamela Hans, *Another View: Rewriting History in the Mortgage Crisis*, N. Y. TIMES, Jul. 29, 2009, available at http://dealbook.blogs.nytimes.com/2009/07/29/another-view-rewriting-history-in-the-mortgage-crisis/?scp=4&sq=losses%20since%20crisis&st=cse
610 Liao *supra* note ___ at 14.

reknown linguists. "Safire suggests that the ugly connotations of the word cramdown may be hindering legislative efforts to pass mortgage modification."[611]

Lien-stripping is not too costly. Permitting lien-stripping through bankruptcy makes economic sense. The alternatives are more value-destroying. A house in foreclosure is worth between 30-50% less than if the buyer sold it or continued to own it.[612] Foreclosed upon homes are abandoned and looted. The affects spillover into the neighborhood, lowering property values and creating more homes that are underwater.[613] In addition, with underwater homes, there is a great temptation for abandonment. Recent research data shows that when the "equity shortfall" is less than 10%, no homeowner will default. However, when the shortfall reaches 50%, 17% of homeowners will default, even if they have enough cash flow to make the payments.[614]

Given these facts, one would expect lenders to voluntarily renegotiate loans.[615] However there are at least two reasons that lenders avoid this voluntarily (and are even stalling under the current government plan where the government pays them to facilitate modifications). First, lenders are concerned about moral hazard. They may worry that borrowers in the future put less down or maintain thin equity margins in their home with the hope of a future renegotiation. However, this can be resolved by lenders requiring a greater equity cushion or raise the cost of borrowing in the future. The second concern, and the most significant one are the transactions costs associated with renegotiating the loans individually. Thus, it seems perfectly wise to use the Bankruptcy courts which are expert in the loan modification process to manage it and absorb some of these transaction costs.

A research paper proclaimed that the convention wisdom was wrong and that empirical data support the claim that underwriting standards did not decline for the subprime market.[616] Presented at a prestigious conference on the financial crisis, it boldly dismissed political, journalistic and other pronouncements that weakened lending standards in the subprime market led to the crisis. Intrigued by the endorsement given to this paper by an important scholar and conference sponsor, I read through it. Replete with complex formulas, sound methodology and seemingly convincing conclusions, it would be easy to be intimidated. Yet something was missing. The authors did not have access to debt-to-income ratios for the buyers.The underwriting standards they used were loan-to-value and FICO (credit score). They concluded that these ratios were not different from past years.[617] There were other detailed findings as well. While these are important pieces of data that underwriters collect, they are far from dispositive of the ability to pay.

Lien-stripping does not increase bankruptcy filings. Professors Adam Levitan and Joshua Goodman studied mortgage data from the 1980s and 1990s to determine whether lien-stripping had an impact upon home mortgage interest rates, the volume of mortgage loans originated, loan-to-value ratios and bankruptcy filings.[618] They found that the pre-*Nobleman* practice of allowing unlimited lien-stripping had no effect on bankruptcy filing rates. It also had not effect upon mortgage origination rates. However, lien-stripping may have very slightly increased the cost of credit – mortgage interest rates were slightly higher where Chapter 13 filings were common. The authors ultimately concluded, however that "as there is significant evidence that mortgage interest rate markets are indifferent to bankruptcy modification risk, we conclude that permitting unlimited strip-down would have no or little effect overall on mortgage interest rates."

Most notably, the ability to lien-strip very slightly lowered loan-to-value ratios.[619] In other words, with the prospect of a bankruptcy process where borrowers could downsize mortgages, lenders wanted borrowers to be less likely to default. This suggests, that lien-stripping might slightly help to prevent moral hazard – that is, the moral hazard of irresponsible lending.

Given the negative effect of bankruptcy on a borrowers future cost of credit, it is unlikely that borrowers with the ability to pay would voluntarily file. While some are concerned about this and suggest a form of "means"

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[611] Katie Porter at www.creditslips.org/creditslips/PorterAuthor.html referencing William Safire, *Cramdown*, N.Y. TIMES, January 22, 2009.
[612] Posner & Zingales, supra note __.
[613] Posner & Zingales, supra note __.
[614] Luigo Guiso, Paola Sapienza & Luigi Zingales, *Moral and Social Constraints to Strategic Default on Mortgages*, Preliminary Version, July 2009.
[615] Posner & Zingales, supra note __.
[616] Geetesh Bhardwaj & Rajdeep Sengupta, Where's the Smoking Gun: A Study of Underwriting Standards for US Subprime Mortgages," April 2009, presented at Financial Crisis Conference, sponsored by Yale SOM International Center for Finance and Review of Financial Studies, July 2009.
[617] The paper also found that FICO scores are lower on refinancing mortgages than originating ones.
[618] Adam Levitan & Joshua Goodman, *The Effect of Bankruptcy Strip-down on Mortgage Markets*, Georgetown Law & Economics Research Paper, No. 1087816, Feb. 6, 2008.
[619] Levitan & Goodman, supra note __.

testing, [620] this does not seem necessary. Moreover, it does nothing to impact the unwise lender-influenced over assessment of homes.

The question might arise as to why one class of debt addicts should be treated differently than others. In other words, some might ask doesn't consumer bankruptcy remedies suggested here make it so that the person who is over-extended fails to appreciate the consequence of his or her actions. In response to this, many of those who are underwater have come into debt troubles due to circumstances beyond their control, namely the financial crisis, health emergencies, job loss and so on. And, for those who are not in that situation, many have also be "sold" loans the brokers mislead them to believe were favorable. Finally, even for those who fall out of both of those classifications and were either speculating, foolish, greedy or otherwise, the net effect on their family members and on society outweighs the "rescue" value. Housing prices decline with boarded-up foreclosed upon homes. And, allowing for the lien-stripping properly disciplines those who are in a better position to act in response to disincentives. Namely, those who package, distribute and purchase mortgage backed securities will be better monitors of the quality of the collateral or the practices of originators (and place contractual obligations or will reprice the debt in the future) so that they can either assure they won't internalize the cost of foreclosure. This may increase the cost of credit, but rightfully so.

VIII. Stop Enabling: Accountability and Liability through the Courts

> "When the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters . . . . yet those who serve nominally as trustees but relieved by clever legal devices, from the obligation to protect those whose interests they purport to represent . . .corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even knowledge of their stockholders. . . the loss and suffering inflicted on individuals, the harm done to the social order founded upon a business base and dependent upon its integrity are incalculable."[621]" Harlan Stone 1934

This paper also suggest that we should remove the obstacles that shield corporate officers, directors and others from liability for enabling destructive behavior. It is indefensible that the same entities who wish to have a hands-off approach to private investment pools and complex credit derivatives based upon theoretical "sophisticated investors" also, when subject to litigation claim that they were incapable of monitoring investments. This section will highlight recent court decisions that have shielded intermediaries in this way. Even prior to such decisions, however, there has been an erosion in the ability for shareholders to hold financial the officers and directors of financial institutions responsible for the behavior that lined the pockets of the top executives and destroyed shareholder value.

While there is much noise that corporate directors are increasingly subject to liability for failing to prevent fraud and malfeasance by managers of the companies they watch over, the empirical data tell a different story.[622] For example, Professors John Armour, Bernard Black, Brian Cheffins & Richard Nolan studied lawsuits brought under corporate law theories against directors of publicly traded companies in the U.S. Directors owe shareholders the fiduciary duties of loyalty and care. Additionally, if the company is a target of a takeover, they also owe duties of disclosure and special care. Shareholders can bring a derivative suit (meaning they are suing on behalf of the corporation) or a direct lawsuit against directors. For example, breach of loyalty cases might include allegations of conflict-of-interest such as that the board member engaged in self-dealing or gave preferential treatment to a controlling shareholder.[623] Most publicly traded corporations adopt provisions to insulate directors from personal liability for a breach of the duty of care. This is permitted under Delaware law, the state in which most are incorporated. For many other fiduciary duty breaches, they are protected from personal liability through Directors & Officers insurance. As a result, what the directors might pay "out of pocket" is little to anything as compared to any

[620] See, Posner & Zingales, supra note __.
[621] STONE, *supra* note __ at __.
[622] John Armour, Bernard Black, Brian Cheffins & Richard Nolan, *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US*, forthcoming 6 J. EMPIRICAL STUDIES (2009).
[623] Id.

actual settlement or damages awarded.[624] They studied a large sample of lawsuits brought between 2000 and 2007 involving corporations where at least one director was named as a defendant. The authors found "that the large volume of corporate and securities lawsuits in the US does not translate into substantial financial risk for directors of publicly traded companies. Consider the position of outside directors of a US public company. Unless their company is bankrupt or they put money in their own pockets, they face very little personal liability risk from shareholder litigation."

In 1994, with the Central Bank of Denver[625] decision, the Supreme Court cut back on "the ability of investors to police transparency failures involving financial institutions working with public companies."[626] Aiding and abetting liability had been abolished by the Supreme Court in the early to mid 1990s. Then, with the Private Securities Litigation Reform Act of 1995, there was less litigation risk. The PSLRA created a major obstacle to securities law suits was the new, special pleading rule that the complaint to contain particularized facts giving rise to a 'strong inference of fraud.'[627] This means that upon filing a lawsuit and before obtaining the "discovery" from the other side, the plaintiffs must have more factual information in a securities fraud suit than other civil cases. This presents a Catch-22. Plaintiffs need discovery -- i.e. the relevant documents, witness depositions, answers to interrogatories in order to gather enough facts to plead the case, but need the particular facts before obtaining discovery. Thereafter, in 2008, the Supreme Court[628] eliminated liability to investors of financial institutions who were "participants in a fraudulent scheme."[629] These decisions not only help contribute to the risky behavior, but also diminish trust in the market. Additionally, they help to perpetuate a system of unjust enrichment of a strata of society at all of our expense.

In cases after the Global Financial Crisis, directors have been protected by the "business judgment rule". In *In re Bear Stearns Litigation*, No. 600780/08 plaintiffs had challenged the adequacy of the payment made by JPMorgan Chase for Bear Stearns. In December 2008, the New York trial court judge granted the defendant's motion for summary judgment – threw out the case before discovery or a trial and dismissed the consolidated class action.[630]

The courts as Legal Enablers have also created a perverse incentive to herd and participate in bubbles as liability is less likely to follow when everyone was making the same stupid decisions. Already it is difficult for an analyst, for example, to go against the tide of opinion. Failing to capture the gains during a bubble could result in great losses and investor dissatisfaction. The courts add to this problem, making it all the more "dangerous to be sane in an insane world."[631] By way of example, in August of 2009, a Federal court judge in Pennsylvania dismissed a securities fraud case filed by Luminent Mortgage Capital and other real estate investment trusts against Merrill Lynch. The plaintiff's had purchased mortgage-backed securities from Merrill in 2005.

Those who think the private enforcement system and government enforcement has been successful might point to the Madoff example. However, while the person who turned himself in to the authorities and admitted a $50 billion ponzi scheme was easy to convict, those who facilitated his fraud by feeding him billions of dollars in other people's money will be harder to successfully hold responsible. Indeed, the finance executives who operated the larger "ponzi scheme" [632] will largely escape legal responsibility."

IX. Conclusion: From the Bath to the Tsunami

[624] Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability* 58 STAN. L. REV. 1055, 1090-91 (2006)
[625] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).
[626] SPECIAL REP'T ON REG. REFORM *supra* note __ at 15.
[627] COFFEE *supra* note __ at 154, citing Section 21D(b)(2) the Securities Exchange Act of 1934, 15 U.S.C., Section 78u-4(b)(2).
[628] Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).
[629] SPECIAL REP'T ON REG. REFORM *supra* note __ at 15.
[630] The Financial Crisis and the Business Judgment Rule, Sullivan & Cromwell, Dec. 8, 2008, available at http://blogs.law.harvard.edu/corpgov/files/2008/12/sc_publication_the_financial_crisis_and_the_business_judgment_rule.pdf
[631] COFFEE *supra* note __ at 69.
[632] Munger Inteview, *supra* note __ at . ("The conglomerate rage of buying companies at 10 times earnings and issuing stock time after time at 30 times earnings to pay for them was a legitimate business operation mixed with a Ponzi scheme. That made it respectable.Nobody called it illegal.")

> "We cannot rely on perfect foresight - whether of regulators or firms. . . This crisis has also clearly demonstrated that risks to the system can emerge from all corners of the financial markets and from any of our financial institutions."[633]

Before he realized the errors in his thinking, even during his phase of trusting the "invisible hand," Alan Greenspan did have moments of doubt. Perhaps that is why, in a state of relaxed contemplation, "The concept of irrational exuberance came to [him] in the bathtub one morning as [he] was writing a speech."[634] It is with some irony that the head of our nation's central bank was taking a bath when he decided to raise the question as to how we might know whether the stock market valuations suggested we were caught up in a moment of "irrational exuberance." After all, the idiom "took a bath" or "got soaked" means that one has been overcharged. One has to wonder about the power of the unconscious to influence the rational mind. Is it possible that beneath the surface, he was thinking, I'm taking a bath and then considered, are we all taking a bath? Did his subconscious mind use a pun to prompt him to action? Whatever the origin of the phrase, though, the answer to the question of whether the stock market was overvalued in late 1996[635] and whether we would soon all take a bath, can easily be answered in retrospect. Yes it was. Yes, we did.

At the other end of the crisis, Alan Greenspan's description of the GFC as a "credit tsunami," suggest that market corrections of this magnitude are neither man-made nor common. Just like climate change deniers, though, many rely upon these water-weather metaphors to de-link the predictable human causes. Importantly, the content of his speech belies the metaphor; Greenspan absolutely attributes the crisis to human behavior.

So, how do we rebuild and how do we avoid this in the future? Plenty of action has been taken to help prevent this recession from becoming a full-fledged Depression. Commitments nearing $13 trillion have been made and, regulators are seeking out more authority from Congress to manage these crises in the future. For example, the Treasury introduced legislation to allow for receivership or conservatorship for a restructuring or wind-down for those failing financial firms to help "avert" systemic risk. This is of course important. It's vital to rescue the economy and to institute a mechanism for avoiding the untenable choices of either allowing a Lehman Brothers type bankruptcy or a massive government bailout. However, not enough has been done to root out excessive leverage and speculation. And, there has not been satisfactory efforts to protect those who are the most vulnerable, those at risk of losing their homes to foreclosure.

As this paper demonstrates, legal Enablers have permitted gambling and the use of excessive leverage with the retirement savings of ordinary people. These practices cannot be retrained with mere disclosure. We must eliminated the loopholes that allow unregistered investment pools broad discretion to operate in the shadows, without transparency or supervision, to engage in self-dealing or related-party transactions, to inaccurately value and inadequately protect assets and to take on excessive leverage. In addition, regarding derivatives, it would end speculation or gambling by both limited the use of derivatives by hedge funds through the leverage and liquidity restrictions, but also prohibiting "naked" credit default swaps. To redress the harm of this excess and speculation, homeowners who are underwater need the bankruptcy option to strip their liens down to the size of the value of the home. We should thus amend the Bankruptcy Code to allow lien-stripping under Chapter 7 and Chapter 13 of first-lien home mortgages on principal residences. While bankruptcy would not be the first choice for many, the option would create stronger bargaining power to encourage lending institutions who have profited heavily through aggressive practices and inflated home assessments to modify mortgages, take losses and essentially owned up to the risk they took on. Moreover, they may retain greater value this way than through foreclosure, and the benefits wills spillover to the neighboring committees. Finally, courts need to be empowered to end the dismissal or summary judgment of cases brought under corporate or securities law theories, simply because the defendants were within in a herd of short-sighted, intentionally aggressive practices. It only encourages giant bubbles and discourages the thoughtful from refusing to forego profits from systemically dangerous practices. As it is, the reward for contrarian honesty is too low and the punishment for corrupt, short-sighted behavior too small. The Global Financial Crisis gives us a second chance. We can reinstate, fully apply and update the laws from the early 20th Century that

[633] Treasury Assistant Secretary for Financial Institutions Michael Barr quoted in Meena Thiruvengadam, *UPDATE: Tsy Hedge Fund Proposal Heading To Hill Weds –Official*, WALL ST. J., July 15, 2009.
[634] ALAN GREENSPAN, THE AGE OF TURBULENCE: ADVENTURES IN A NEW WORLD 176 (2007). Note that according to Robert Shiller, the term was rarely used before, though he noted it appeared in AMANDA CROSS, A TRAP FOR FOOLS 99 (1989). *See* http://www.irrationalexuberance.com/definition.htm
[635] Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, The Challenge of Central Banking in a Democratic Society, Remarks At the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research. (December 5, 1996).

prevented a major panic for more than 50 years. Though, **"**Only second chance we get is to make the same mistake twice."[636]

[636] David Mamet, STATE AND MAIN (1999), available at http://www.dailyscript.com/scripts/state-and-main_shooting.html