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FOUR KEY ELEMENTS TO SUCCESSFUL FINANCIAL REGULATORY REFORM

Reza Dibadj

1. INTRODUCTION

The most recent crisis on Wall Street presents our nation with an extraordinary opportunity to begin a conversation about the economic and social policies that have led to the financial meltdown we have witnessed over the past few months. In keeping with the timely and crucial theme of the Hastings Business Law Journal’s Symposium, this Article does not chronicle the crisis, but rather focuses on the lessons it might hold in getting “beyond the bailout.” To mitigate, or perhaps even avoid, future disasters I argue that policymakers should focus on remedying four pernicious facilitators to scandal: dissemination of untruthful or misleading financial information, abuse of regulatory gaps, exploitation of credulous consumers, and the ability to use corporate size to privatize profits and socialize costs.

Identifying and blocking these facilitators requires a return to first principles. Conventional discourse—too often polarized and bitter—offers precious little help. Consider first those who argue that the government should simply get out of the way and let private markets work their magic. Such a laissez-faire argument, with its seemingly respectable intellectual roots in the Chicago and Virginia schools of law and economics, has been both enticing and spectacularly successful. Over the past forty years, we have espoused public policies driven by the notion that we can organize our collective economic life simply by having government get out of the way and allowing private actors to bargain among themselves to achieve an efficient outcome. As I have argued in detail well before our current crisis, this “deregulatory”

* Professor of Law, University of San Francisco. I thank the editors of the Hastings Business Law Journal for giving me the opportunity to present the ideas contained in this Article at the Journal’s Symposium, “Beyond the Bailout,” in San Francisco, on April 16, 2009.


3. Even this term is misleading. As Cass Sunstein points out:

What “deregulation” really means is a shift from the status quo to a system of different but emphatically legal regulation, more specifically one of property, tort, and contract rights, in
approach simply misunderstands economic reality; notably, it does not pay attention to transaction and enforcement costs, behavioral biases such as greed and overconfidence, or even equitable distribution of resources. Periodic scandal and collapse ensues.

In reaction to the disappointment with the facile assumptions of neoclassic laissez-faire economics, its polar opposite has emerged—asking government to become an active player in the financial markets. Unfortunately though, this perspective is left wanting as well. Economic history has shown government has little expertise in trying to allocate resources from the top down. The omniscient “command-and-control” über-regulator who seeks to override markets simply does not work.

Neither of these conventional positions will allow us to get “beyond the bailout.” Instead, policymakers must begin by recognizing a threshold issue that we have regrettably lost sight of: markets need rules. Government’s role is to create the backdrop and regulations to assure free, open markets that operate in the public interest. Consistent with new research in regulatory design, the objective of reform is not to override markets, but rather to ensure fair and open participation in markets. As Alfred Kahn observes, “free markets may demand governmental interventions just as pervasive and quite possibly more imaginative than direct regulation; but its lesson is that those interventions should to the greatest extent possible preserve, supplement, and enhance competition, rather than suppress it.” In the words of Ronald Coase, the Nobel Prize winning economist: “for anything approaching perfect competition to exist, an intricate system of rules and regulations would normally be needed.”

which government does not impose specific public interest obligations but instead sets up initial entitlements and then permits trades among owners and producers. This is a regulatory system as much as any other. . . . The issue is thus not whether to “deregulate,” but whether one or another regulatory system is better than imaginable alternatives.


6. As Joseph Kearney and Thomas Merrill summarize in their study of the transformation of regulated industries, “[u]nder the new paradigm, the regulator plays a far more limited role. Instead of comprehensively overseeing an industry in order to protect the end-user, its principal function is to maximize competition among rival providers, in the expectation that competition will provide all the protection necessary for end-users.” Joseph D. Kearney and Thomas W. Merrill, The Great Transformation of Regulated Industries Law, 98 COLUM. L. REV., 1323, 1361 (1998) (emphasis added).


8. R.H. Coase, The Firm the Market and the Law 9 (1988). In an often ignored portion of his landmark article, The Problem of Social Cost, Coase suggests that there is no reason why, on occasion, such governmental administrative regulation should not lead to an improvement in economic efficiency. This would seem particularly likely when . . . a
In the wake of deregulation, consider a wonderfully simple example that yet another Nobel Laureate, George Akerlof, provides:

If you let your toddler out of her playpen, you need to watch her more carefully. This wisdom is known by every American parent but has been systematically ignored in economic deregulation. For example, in the 1980's, savings and loans were given greatly expanded freedoms. But in misguided zeal for deregulation, regulatory budgets were cut, not raised. Enterprising individuals found ways to loot to the savings and loan for their own gain. Taxpayers, as the ultimate guarantors of deposit insurance, were left holding the bag. . . . Now is the time to remember the lessons of the playpen: increased scope for action must be accompanied by increased regulatory oversight.9

Put succinctly in the words of a business journalist: "[m]arkets are a great way to organize economic activity, but they need adult supervision."10 This Article is devoted to exploring four areas where the toddler has wandered, and how we can introduce some measure of adult supervision.

II. FOUR FACILITATORS

Four phenomena have facilitated our current crisis: (A) the dissemination of information that is false or misleading; (B) the ability to abuse regulatory gaps; (C) the willingness to exploit credulous consumers; and (D) the use of corporate size to privatize profits and socialize losses. Below, I identify each facilitator and discuss how and why government should block it.

A. MISLEADING INFORMATION

A very simple, though too often glossed-over, principle animating securities regulation is that markets must process information into prices for companies and assets. If information is inaccurate or misleading, then the entire system breaks down—in the parlance of the computer programmer, "garbage in, garbage out." In today's environment, we are unfortunately
witnessing a confluence of several factors which should give pause to any careful investor: often nebulous accounting standards, the delegation of credit-rating functions to private actors unaccountable to the public, and a sharp curtailing in the ability to bring private antifraud lawsuits.

First, government could play an active role in setting more muscular accounting standards. Consider first that the Securities and Exchange Commission ("SEC") has delegated accounting standards to a private organization, the Financial Accounting Standards Board ("FASB"). Not only does the FASB present the inherent conflict of using private funding to set standards to protect the public, but even when it has seemingly acted in the public interest it has faced political pressure to back down.11

Three examples should illustrate the point. Approximately a decade ago, in the controversy surrounding the expensing of stock options, "members of Congress opposed by an overwhelming margin a proposal by the Financial Accounting Standards Board to require companies to account for stock options as an expense—until, that is, a series of major financial scandals changes the political calculus somewhat."12 More recently, when faced with a rule requiring financial firms to value their assets at fair market value:

Marshalling a multimillion-dollar lobbying campaign, these firms persuaded key members of Congress to pressure the accounting industry to change the rule in April [2009] . . .

The rules had required banks, securities firms and insurers to use market prices to help assign values to mortgage securities and other assets that don't trade on exchanges—to "mark to market." But when markets went haywire last fall, financial firms complained that the rules forced them to slash the value of many assets based on fire-sale prices. That contributed to big losses that depleted their capital and left several of the nation's largest firms on the brink of failure[.]

The American Bankers Association, a trade group, acknowledges that it exerted pressure to change the rules.13

Finally, and perhaps most importantly, consider that balance sheet shenanigans are often a root cause of scandal, as current and past crises have shown. After all, the Enron fiasco was to a large extent about its off-balance sheet investment vehicles, and our recent financial bubble was facilitated by the ability of financial institutions to remove subprime assets from their

11. As one former SEC Chairman notes:
   The Financial Accounting Standards Board—a private organization, supported by corporate contributions, that sets auditing standards—needs greater ability and freedom to set new and tougher rules when necessary. Its decisions on new standards can be agonizingly slow. This important agency must also be free from Congressional pressure, which is often applied when powerful corporations seek to undermine new accounting rules that might hurt their earnings.


balance sheets. As one observer notes:

Some of the biggest and worst surprises of the financial crisis came when banks suffered large losses from assets that they had not even reported they owned. . . . Those rules hinged largely on something called “qualified special-purpose entities,” or Q’s for short. If a bank set up a Q so that it would operate automatically, with others owning the securities it issued, the bank could get the assets off its own balance sheet.14

Reform should be simple: force financial institutions to report their assets on their balance sheets, so that investors can make their decisions with full information. Indeed, the FASB seems headed in this direction with new rules scheduled for implementation in 2010.15 Quite predictably, banks have tried to delay implementation of the rules.16 More importantly, analysts are already pointing to loopholes in the FASB’s rules which harken back to previous failed attempts to restrict off-balance sheet games.17

In all three examples, the pattern is regrettably clear:
The accountants let us down.

That is one of the clear lessons of the financial crisis that drove the world into a deep recession. We now know the major banks were hiding dubious assets off their balance sheets and stretching rules if not breaking them. We know that their capital was woefully inadequate for the risks they were taking. Efforts are now being made to improve the rules, with some success.

But banks have persuaded politicians on both sides of the Atlantic that the real problem came not when their financial inadequacies were obscured by bad accounting, but when they were revealed as the losses mounted. . . .

Accounting rule makers at FASB and its international equivalent, the

16. See, e.g., Susan Pulliam, Banks Try to Stiff-Arm New Rule—Delay Sought in Accounting Change, as Investor Groups Plot Own Response, WALL ST. J., Jun. 4, 2009, at Cl (“The financial-services industry is taking steps to delay an accounting rule that would force banks and others to bring some of their off-balance-sheet vehicles back onto their books next year, which could force some to raise additional capital.”).
17. As one accountant suggests:

FAS 166 and 167 are intended to limit “sale accounting” to situations where a company has truly surrendered control of the assets in question, and to ensure that companies consolidate the entities they do control. While these goals are proper, they are also familiar. The last derecognition and special purpose entity standards, FAS 140 and Financial Interpretation No. 46(R), had the same goals, and the goals weren’t met.

Scott Taub, FASB’s New Start on an Old Menace to Balance Sheets, 6 COMPLIANCE WK. 1 (Aug. 2009), at 1. See also Jennifer Hughes, Beware the Off-Balance Sheet Return, FIN. TIMES, June 24, 2009, available at http://www.ft.com/cms/s/0/b03656e4-60d9-11de-aa12-00144feadbdc0.html?nclick_check=1 (“But there are still potential loopholes. . . . We could yet see some interesting new shadowy structures.”).
International Accounting Standards Board, have been lambasted for efforts to improve transparency by forcing banks to disclose what their dodgy assets are actually worth, as opposed to what the banks think they should be worth.\(^{18}\)

More needs to be done to repair accounting, with the SEC the most appropriate agency to take the lead.\(^{19}\) The proposed international convergence in accounting standards will likely only make things more complicated.\(^{20}\)

Second, government needs to reform credit rating agencies. To a large extent, these agencies facilitated our current economic crisis:

The utter failings of our nation’s credit rating agencies—you know the drill: repeatedly slapping triple-A ratings on piles of dubious mortgage securities—were central to the financial crisis. And anything-goes ratings from Fitch, Moody’s Investors Service and Standard & Poor’s have left investors around the world with trillions in losses.\(^{21}\)

There are two principal reasons for the dysfunction. First and most simply, there is a conflict of interest at the heart of the ratings business model; “banks and other issuers have paid rating agencies to appraise securities—a bit like a restaurant paying a critic to review its food, and only if the verdict is highly favorable.”\(^{22}\) Second, “the credit rating system is one of capitalism’s strangest hybrids: profit-making companies that perform what is essentially a regulatory role”—rather than perform the function itself, the “[SEC] opted to created a new category of officially designated rating agencies, and grandfathered the big three—S&P, Moody’s, and Fitch. In effect the government outsourced its regulatory function to three for-profit companies.”\(^{23}\)

Many reforms are possible. Government could provide public ratings, refuse to provide a quasi-official imprimatur to private rating agencies, or require investors, rather than issuers, pay for ratings.\(^{25}\) At the very least it

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19. Cf. Taub, supra note 17 (“Everybody knows how important ‘tone at the top’ is to internal controls, ethics, and achieving just about any other goal. For U.S. financial reporting, only the Securities and Exchange Commission can set that tone.”).
20. See, e.g., Norris, supra note 14 (“The fights over bank accounting are taking place against the backdrop of the S.E.C. trying to decide whether and when to move the United States to international accounting standards, and as the two boards seek to converge on one set of accounting rules.”).
22. David Segal, Debt-Rating Agencies Avoid Broad Overhaul After Crisis, N.Y. TIMES, Dec. 8, 2009, at A1. See also Roger Lowenstein, Triple-A Failure, N.Y. TIMES, Apr. 27, 2008, at MM36 (in structured finance deals, “the banks pay only if Moody’s delivers the desired rating. . . . If Moody’s and a client bank don’t see eye to eye, the bank can either tweak the numbers or try its luck with a competitor like S.&P., a process known as ‘ratings shopping.’”).
23. Segal, supra note 22.
24. Lowenstein, supra note 22.
25. See, e.g., Michael Lewis & David Einhorn, Op-Ed, How to Repair a Broken Financial World, N.Y. TIMES, Jan. 4, 2009, at W10 (“There should be a rule against issuers paying for ratings. Either investors should pay for them privately or, if public ratings are deemed essential, they should be publicly provided.”); Lowenstein, supra note 22 (“Though some have proposed requiring that agencies with official recognition charge investors, rather than issuers, a more practical reform may be for the government to stop certifying agencies altogether.”).
could insist on greater oversight and transparency. Unfortunately, though, even modest reforms are unlikely to happen on the theory that

The Big Three [Moody’s Investors Service, Standard & Poor’s and Fitch Ratings], by allowing companies and public entities to raise money by issuing debt, are an essential engine in the country’s vast credit factory, and given the still-fragile condition of the equipment, lawmakers are reluctant to try anything but basic repairs, patches and a new alarm system. . . . There is no talk, for instance, about creating a fee-financed, independent credit rating agency.27

As a consequence, “the market for ratings is sure to look uncannily similar to the one that helped usher in the crisis: three rivals, all of them paid by issuers, bestriding the market.”28 To make matters worse, the credit rating agencies seem to be making money from rating new securities wrought from the mess they themselves created.29

Third, and perhaps most importantly, we need to reinvigorate private antifraud suits as a deterrent to the dissemination of false and misleading information. A cursory glance at securities filings indicates that there is more than enough disclosure of information. However, there are at least two problems with placing an overwhelming emphasis on disclosure. As Adam Pritchard has observed, “Congress and the SEC focus almost exclusively on disclosure because it reinforces the myths of investor autonomy and sovereignty, a very lucrative myth as far as the financial services sector is concerned.”30 Further, and perhaps less cynically, disclosures are effectively useless unless there are stronger mechanisms to ensure the truthfulness of the disclosures. These mechanisms have been watered down over the past several years. Both federal statutes and federal common law have made it increasingly difficult to bring private securities antifraud lawsuits against disclosures that either finesse or obfuscate the truth.

Perhaps it is no coincidence that scandals have mushroomed since the mid-1990s, when a triad of securities reform statutes began making it increasingly difficult to bring private antifraud claims. First, in 1995 the Private Securities Reform Litigation Act (“PSLRA”) introduced, “inter alia, heightened pleading requirements for class actions alleging fraud in the sale of national securities.”31 One year later, in 1996, the National Securities Market

26. See Levitt, supra note 11 (“Credit ratings agencies should show greater accountability. Because they have quasi-public responsibilities, they should reveal more about how they operate. The S.E.C. should also assess their impact on the markets and consider requesting new authority to oversee their operations.”).
27. Segal, supra note 22.
28. Id.
29. See id. (“Meantime, to the consternation of detractors, the companies are now earning fees from a new source: re-Remics, an acronym for resecuritization of real estate mortgage investment conduits. . . . To some, it seems to be a way for rating agencies to profit from a mess they helped make.”).
Improvements Acts ("NSMIA") whose "primary purpose . . . was to preempt state 'Blue Sky' laws which required issuers to register many securities with state authorities prior to marketing in the state."32 Third, the Securities Litigation Uniform Standards Act ("SLUSA") in 1998 made "federal court the exclusive venue for class actions alleging fraud in the sale of certain covered securities and by mandating that such class actions be governed exclusively by federal law."33 Through heightened pleading standards and the preemption of more generous state securities laws, Congress has made it increasingly difficult for private plaintiffs to bring securities actions.34

Federal common law has evolved into a more defendant-friendly posture as well. Beginning with two landmark cases in 1975—Blue Chip Stamps v. Manor Drug Stores35 and Cort v. Ash36—the United States Supreme Court has by and large cabined the federal common law of securities fraud. Over the past five years and in rapid succession, the Court has placed restrictions on plaintiffs along two principal dimensions. Decisions such as Dura,37 Tellabs,38 and Stoneridge39 move in the direction of imposing heightened pleading requirements on plaintiffs. Moreover, opinions such as Merrill, Lynch40 and Credit Suisse41 have effectively given broad preemptive effect to the federal securities regime, to the detriment of state securities and antitrust law, respectively.

Notwithstanding the strictures placed on private antifraud cases, one might argue that there are other mechanisms to police fraud. First, there are private securities regulations, notably promulgated by the Financial Industry Regulatory Authority ("FINRA").42 Unfortunately, however, "Wall Street's self-regulators have missed virtually all of the major securities scandals of the

33. Lander, 251 F.3d 101, at 108.
42. FINRA was "[c]reated in July 2007 through the consolidation of [National Association of Securities Dealers] and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange." About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA (last visited April 3, 2010).
past two decades—from troubles that brought down Kidder Peabody, to analysts’ conflicts, to favoritism in awarding initial-public-offering shares, to trading abuses at the NASDAQ Stock Market. 43 Recent scandals and crises are regrettably no exception. Second, and more importantly, one might argue that public enforcement, not private litigation, must play a central role. Yet even the latter point is incomplete: not only does enforcement wax and wane depending on the era, 44 but even in an ideal world public enforcement cannot be everywhere at once. Private antifraud suits should thus play a complementary role in deterring companies from disseminating information that obfuscates or finesses the truth—and punishing them when they do. More broadly, there needs to be a rethinking of disclosure as a cure-all. A renewed emphasis on deterring and punishing fraud may do a lot more to deter abuse than adding even more disclosure to an array of information that even the most sophisticated investors apparently have trouble absorbing. 45

B. REGULATORY GAPS

A second facilitator that needs to be thwarted is the abuse of regulatory gaps. There are many examples of actors and products that have “fallen through the cracks” of regulatory oversight: mortgage brokers, hedge funds, and derivative instruments such as credit default swaps. The problem cannot be overestimated. As the Chairwoman of the Federal Deposit Insurance Corporation (“FDIC”) observes, “[t]he principal enablers of our current difficulties were institutions that took on enormous risk by exploiting regulatory gaps between banks and the nonbank shadow financial system, and by using unregulated over-the-counter derivative contracts to develop volatile and potentially dangerous products.” 46 The problem is not new, and recent

44. For example, for many years the federal Securities and Exchange Commission (SEC) was seduced by free market arguments and the notion that abuses would somehow magically correct themselves. As a consequence, the SEC did not aggressively pursue transgressions perpetrated by corporations and their advisors. See, e.g., Mark Maremont & Deborah Solomon, Behind SEC’s Failings: Caution, Tight Budget, ’90s Exuberance, WALL ST. J., Dec. 24, 2003, at A1.
45. Interestingly, even commentators who suggest moving toward a voluntary disclosure regime for offerings nonetheless advocate maintaining mandatory antifraud liability. See, e.g., Alan R. Palmeter, Toward Disclosure Choice in Securities Offerings, 1999 COLUM. BUS. L. REV. 1, 130 (1999) (“A critical adjunct to my proposal of disclosure choice is that issuers in public offerings would be subject to a mandatory antifraud standard—namely, Rule 10b-5 liability. Disclosure choice would shift compliance from ex ante line-item disclosure to ex post liability standards.”).
46. Sheila C. Bair, Op-Ed, The Case Against a Super-Regulator, N.Y. TIMES, Sept. 1, 2009, at A29. As just one example, consider the plea to regulate credit-default swaps. There are now tens of trillions of dollars in these contracts between big financial firms. An awful lot of the bad stuff that has happened to our financial system has happened because it was never explained in plain, simple language. Financial innovators were able to create new products and markets without anyone thinking too much about their broader financial consequences—and without regulators knowing very much about them at all. It doesn’t matter how transparent financial markets are if no one can understand what’s inside them. Until very recently, companies haven’t had
scandals offer important lessons, if we are willing to heed them. Consider, for example, that regulatory voids enabled the Enron fraud, not to mention the one perpetrated by the giant commodities broker Refco. The motivation for miscreants to exploit regulatory gaps is obvious. It becomes government’s responsibility to elevate function over form and close them.

Efforts at reform face the usual headwinds from the business lobby— notably, a recent effort funded by major banks “to counter an expected attempt to rein in credit-default swaps and other derivatives—the sophisticated and profitable financial instruments that were intended to limit risk but instead had helped take the economy to the brink of disaster.” The complicating factor here, however, is institutional, along two dimensions. First, there are disagreements over whether Congress has delegated authority to an agency to regulate. Second, even with authority to regulate, debates ensue around how to allocate jurisdiction among agencies, leading to well-publicized “turf wars”— for example, between the SEC and the Commodities Futures Trading Commission (“CFTC”), and between the FDIC and the Comptroller of the Currency. Perhaps even before embarking on substantive long-term reforms,

to provide even cursory disclosure of credit-default swaps in their financial statements. See, e.g., Lewis & Einhorn, supra note 25.

47. The so-called Enron loophole, a notorious eleventh-hour addition to the Commodity Futures Modernization Act of 2000, gave an exemption to private energy-trading markets, like the one operated by Enron before its scandalous collapse in 2001. Regulators later accused Enron traders of using this exempt market to victimize a vast number of utility customers by manipulating electricity prices in California. See Diana B. Henriques, Commodities: Latest Boom, Plentiful Risk, N.Y. TIMES, Mar. 20, 2008, at A1.

48. As two financial journalists sum it up: Unlike Refco’s other subsidiaries, the Bermuda-based unit is largely free of government scrutiny—because the government decided five years ago to forgo regulating derivatives transactions that occur away from regulated futures exchanges. . . . After fierce lobbying by financial institutions and their trade groups, Congress in late 2000 passed a bill that made clear that, in most cases, over-the-counter derivatives weren’t subject to regulation. Deborah Solomon & Michael Schroeder, How Refco Fell Through Regulatory Cracks: Scandal Highlights a System that Didn’t Require Much Oversight of the Firm’s Units, WALL ST. J., Oct. 18, 2005, at A4.

49. In the candid words of one article in the business press, “[b]usinessmen, by and large, don’t like free and open markets. From John D. Rockefeller on, they have found markets to be messy, chaotic, and insufficiently profitable.” Alan Murray, Exile on G Street: Bush’s Economists Play a Peripheral Role, WALL ST. J., May 13, 2003, at A4.

50. See, e.g., Jackie Calmes, Both Sides of the Aisle See More Regulation, and Not Just of Banks, N.Y. TIMES, Oct. 14, 2008, at A15 (“Companies and instruments that currently are not regulated could be brought under the government’s thumb: unregulated derivatives, hedge funds, mortgage brokers and credit-rating agencies all have been implicated in the current crisis.”).


52. See, e.g., Henriques, supra note 47 (“The courts have also curbed the commission’s [CFTC’s] reach. In three cases since 2000, judges have interpreted federal law to severely limit the commission’s [CFTC’s] ability to fight fraud involving both over-the-counter markets and specious foreign currency contracts used to victimize individual investors.”).

53. See, e.g., Kara Scannell, Exchanges Offer Varying Views as Regulators Discuss Turf, WALL ST. J., Sept. 3, 2009, at C3 (“The two agencies [SEC and CFTC] have different philosophies in regulating markets.”).

Congress should confirm the authority of our administrative agencies, and at the same time resolve once and for all the jurisdictional boundaries. A serious look also needs to be given at the advantages of having a single financial regulator versus the disadvantage such a reform would present in not having regulatory power dispersed among different agencies. At the very least, there needs to be better coordination among public officials, such that miscreants are not able to exploit regulatory gaps.

C. CREDULOUS CONSUMERS

Another facilitator has been the exploitation of credulous consumers, upon which an ever-increasing array of financial products and decisions has been foisted. Along with the drive to deregulate has come a massive and dramatic shift in economic risk to the shoulders of middle class and working Americans. While the culprits have largely been a shift from defined-benefit to defined-contribution retirement plans and shrinking healthcare insurance, the phenomenon is broader:

[Deregulating industries, shrinking social programs and promoting a free-market ideal in which everyone must forge his or her own path, free to rise or fall on merit or luck . . . has come at a large and largely unnoticed price: a measurable increase in the risks that Americans must bear as they provide for their families, pay for their houses, save for their retirements and grab for the good life. A broad array of protections that families once depended on to shield them from economic turmoil—stable jobs, widely available health coverage, guaranteed pensions, short unemployment spells, long-lasting unemployment benefits and well-funded job training programs—have been scaled back or have vanished altogether . . . The bottom line: more risk for less reward.

55. See, e.g., Gary DeWaal, America Must Create a Single Financial Regulator, FIN. TIMES, May 19, 2005, at 13 (“[O]nly by amending its [financial] regulatory system and adopting unitary regulation of financial services can the US ensure it will maintain its supremacy as the home of global financial services participants.”).


57. In the former, the employee is guaranteed a fixed sum per month during her retirement years; however, in the latter, the employee is simply given a sum of money to invest with no guarantee of how much will actually remain by the time retirement rolls around.

58. Even those with insurance must deal with co-payments, out-of-pocket deductibles, coverage limits and the like.

Like it or not, almost every working adult is now an investor. Yet too many consumers are making risky life-changing decisions without having sufficient knowledge of financial basics such as the time value of money or the implications of credit. We thus need to place new emphasis on financial education, perhaps beginning as early as elementary or middle school. Suffice it to say that enticing advertisements from self-interested financial intermediaries—urging you to entrust them with your money, so that you too could be the happy couple strolling down the beach in the advertisement—do not count.

To be sure, thoughtful commentators have expressed justifiable concern that citizens have become disengaged from public discourse. But the relative weight the polity has spent discussing economic issues is particularly troubling. Note, for instance, how much time we have spent considering social issues—abortion, guns, gay marriage, to name just a few. By contrast, observe how stunningly little time we have spent discussing economic issues that affect our everyday livelihood. Granted, economic topics are often not as glamorous as social ones; after all, one might argue, we all have better things to do with our time than worry about esoteric things like collateralized debt obligations and credit default swaps. Perhaps, but a lack of education on economic and financial issues is at least partially to blame. Most immediately, with more knowledge consumers would be less credulous and less willing to purchase the often shoddy financial products peddled at them. Longer term, an informed citizenry could enter a conversation about the assumptions that have transformed economic life in America over the past half century.

D. USING SIZE TO PRIVATIZE PROFITS AND SOCIALIZE LOSSES

In addition to the dissemination of misleading information, abuse of regulatory gaps, and exploitation of credulous consumers, there is one additional crucial facilitator: the ability to use corporate size to privatize profits and socialize costs. With the creation of corporate behemoths via mergers and acquisitions, industries have become increasingly concentrated and oligopolistic. Despite the usual eloquent assurances from companies that mergers will unlock "synergies" or reduce costs and thus provide greater value to consumers, these deals are too often consummated to benefit corporate insiders—even shareholder interests are frequently secondary. Sadly enough,
one is hard-pressed to find cases where industry concentration has actually helped consumers: it is no coincidence that consumer advocates tend to oppose mergers.  

Yet, antitrust policy over the past forty years has stood idly by and condoned the creation of large corporate behemoths in industries as diverse as financial services, airlines, telecommunications, and computer hardware and software.  

A recent and leading antitrust monograph even declares that the “very ubiquity of merger-created efficiencies is why we evaluate mergers under a fairly benign set of rules.” There is no discussion, however, of what these “efficiencies” are and whether they will be passed onto consumers. What permits such a logical leap? Regrettably, antitrust has been seduced by the Chicago School, which in a rhetorical masterstroke, managed to redefine “consumer welfare” as “allocative efficiency.” Careful to sidestep over ever having to measure “efficiency,” these theorists posit that if a company’s activities are good for the company, then they should be good for the economy and consumers as well. Predictably enough, the result has been shriveled antitrust policy that too often condones mergers on the theory that large concentrated industries are somehow a positive social good. Far from the putative consumer-friendly cost savings and shareholder-friendly synergies promised, large mergers have too often punished citizens as both consumers and shareholders.

In times of crisis, however, citizens also suffer a third way: as taxpayers. Large companies become so gargantuan that they become “too-big-to-fail” (“TBTF”)—a brilliant way to internalize profits when things go well, and externalize costs when they do not. When the putative synergies of expensive acquisitions do not pan out, macroeconomic conditions deteriorate, or scandals

64. See, e.g., Deregulated: Airlines, Banking, Electricity, Telephones, Cable TV, CONSUMER REP., July 2002, at 30.


67. See, e.g., Frank H. Easterbrook, Does Antitrust Have a Comparative Advantage?, 23 HARV. J.L. & PUB. POL’Y 5, 6 (1999) [hereinafter Easterbrook, Comparative Advantage] (“Modern antitrust law is thus a search for economic explanations of problematic conduct. If the explanations show the conduct efficient—and therefore ultimately to consumers’ benefit—then the court stays its hand; if not, the court condemns the conduct.”) (emphasis added).

68. Robert Bork, for instance, believes that the “closer the members of the industry come to maximizing their profits, the closer they come to maximizing the welfare of consumers.” ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 97 (1978).

69. See, e.g., RICHARD A. POSNER, ANTITRUST LAW 2 (2d ed. 2001) (the “small businessman usually is helped rather than hurt by monopoly.”).
grow out of control, taxpayers come to the rescue. With respect to our current crisis, consider that financial actors were chasing higher returns in areas such as subprime lending and the trading of esoteric financial instruments—to belabor the obvious, any profits made from these activities would belong to them. All this might be fine as far as it goes, provided of course that the financial actors also suffer any losses they may incur from their risky escapades. Yet instead, when things have gone wrong, these seemingly sophisticated actors instead turn to the federal government for a handout to bail out their escapades, on the theory that they are simply TBTF.

The culminating affront here, of course, is that it is the individual—the ordinary taxpayer who might have already suffered mightily as shareholder and consumer—who is asked to be the insurer of last resort. As such, there is cause for bitterness:

If a failing firm is deemed “too big” for that honor, then it should be explicitly nationalized, both to limit its effect on other firms and to protect the guts of the system. Its shareholders should be wiped out, and its management replaced. Its valuable parts should be sold off as functioning businesses to the highest bidders—perhaps to some bank that was not swept up in the credit bubble. The rest should be liquidated, in calm markets. Do this and, for everyone except the firms that invented the mess, the pain will likely subside.70

Yet rather than contemplate such a course of action, we seem unwilling to heed warnings and learn from history. In 2004, two Federal Reserve officials argued that the TBTF scenario would apply to several banks: their collapse would so harm the overall economy that government would have no choice but to bail them out.71 Even though they seem small by the size of today’s interventions, in the 1980s taxpayers were asked to avenge the savings and loan industry’s death through a $150 billion bailout,72 and in the 1990s the Federal Reserve marshaled financial institutions to provide nearly $4 billion to bailout the investment fund Long-Term Capital Management.73 Frequent requests from automobile manufacturers and airlines are also par for the course.

Above all, TBTF facilitates hypocrisy: extol the virtues of free markets and private profits, then conveniently come begging to Washington to socialize the losses.74 Lax antitrust has thus indirectly brought with it a peculiar...
absurdity: the public as benefactor of last resort, as already-suffering taxpayers reallocating resources precisely to those corporations who were imprudent in the first place. To add insult to injury, taxpayers are unwittingly funding the next round of consolidation—to the extent bailout money is used for mergers and acquisitions, the actors in the next crisis will be even bigger and more destabilizing. If the educational program advocated above gains traction, hopefully more people will ask how this has come about and whether it is inevitable.

Perhaps citizens should begin by asking why antitrust law—once heralded by the United States Supreme Court as “the Magna Carta of free enterprise . . . as important to the preservation of economic freedom and our free-enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms,”—has descended into impotence? After all, the current ethos has lost sight of the fact that the antitrust “was premised upon a political judgment that decentralized power was essential to a free society.”

As Eleanor Fox and Lawrence Sullivan sum up:

[Antitrust traditionally had two central concerns. The first was political—distrust of bigness and of fewness of competitors as well as a policy preference for diversity and opportunity for the unestablished. The second was socioeconomic, especially as seen from the vantage point of the small businessperson and the consumer. Antitrust set fair rules for the competitive game. What mattered was getting a fair shot as an entrepreneur, and having choice and receiving a fair deal as a consumer. Antitrust was not a tool for increasing aggregate national wealth (sometimes called or equated with allocative efficiency).]

The current fashion in antitrust has been simply to ignore these concerns, but it is time to reconsider whether antitrust should be so demure.

Citizens should also ask whether the confluence of lax antitrust and deregulation has provided cover for the TBTF syndrome. Years ago, in a short op-ed piece, I argued that lax antitrust and deregulation have combined to create a tragedy in three “acts.” In the first act, new regulatory laws are introduced with much fanfare. In the second, mergers and acquisitions facilitate the development of oligopolies. Finally, in the third act, the oligopolists descend into financial trouble, with taxpayers providing a bailout. Writing in 2003, I could mention airlines, savings and loan associations, and the like.

to invest or remain in localities. Cities compete for the opportunity to provide sports teams with ever more luxurious stadiums. Huge companies get government help when they face financial ruin. Private companies rarely turn down the opportunity to feed greedily at the public trough.


76. Mindy, supra note 67, at 1755.


78. See Dibadj, Deregulation, supra note 62.
Today, we can add banks to the list. First, advocates of deregulation obtained by 1999 the formal repeal of the Glass-Steagall act, which had separated commercial from investment banking—successfully arguing that antitrust laws would forbid mergers unfriendly to consumers. The following decade witnessed an explosion of bank mergers and acquisitions, followed by our current bailout woes. Who is to blame? After all, faced with deregulation’s shortcomings, the deregulators can conveniently shift the blame to lax antitrust enforcement—like the child’s game of “hot potato.” As such, the unfortunate bifurcation between antitrust and regulation has allowed policymakers enamored of simplistic deregulation to assuage critics by sloughing off responsibility to antitrust enforcement. If antitrust is considered to be part of regulation, it becomes more difficult for regulatory pundits to pass the buck when things go awry. Responsibility just might breed reform.

III. CONCLUSION

After consideration of the four facilitators, it might be worth considering the political economy of financial reform. Some might consider my proposals hopelessly naive. After all, special interests benefit from imperfect information, regulatory gaps, consumer ignorance, and lax antitrust—and it is in their interest to maintain the status quo. Such an argument has powerful roots in public choice theory, whose ideas can be traced backed to Madison’s account of how “factions” can organize to push their own agenda to the detriment of society at large. As Mancur Olson noted in his classic book, The Logic of Collective Action,

The smaller groups—the privileged and intermediate groups—can often defeat the large groups—the latent groups—which are normally supposed to

79. As the father of airline deregulation, Alfred Kahn, notes with humility:

This kind of defense of the deregulation record—"It wasn’t my fault, the trouble is you other people didn’t do your job"—is a trifle glib. It contains more than a trace of justifying the abandonment of direct regulation, because of its severe imperfections, in terms that implicitly demand perfection of performance by such agencies as the Department of Transportation, the Savings and Loan Bank Board and Congress—higher levels of prescience, conscientiousness, information, incorruptibility or simple effectiveness than can reasonably be expected.

To some extent, similarly, thrusting upon the antitrust authorities both blame for some of the monopolistic consequences of airline deregulation and responsibility for their future remedy implicitly more of competition-preserving policies than they can deliver.

Kahn, supra note 7, at 350-31.


81. See, e.g., DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION 44 (1991) (in “public choice, government is merely a mechanism for combining private preferences into a social decision.”).

82. Madison defines factions as a “number of citizens, whether amounting to a majority or minority of the whole, who are united and actuated by some common impulse of passion . . . adverse to the rights of other citizens, or to the permanent and aggregate interests of the community.” THE FEDERALIST No. 10, at 54 (James Madison) (Jacob E. Cooke ed., 1961).
prevail in democracy. The privileged and intermediate groups often triumph over the numerically superior forces in the latent or large groups because the former are generally organized and active while the latter are normally unorganized and inactive.83

As a consequence, the “multitude of workers, consumers, white-collar workers, farmers, and so on are organized only in special circumstances, but business interests are organized as a general rule.”84 As commentators have observed in subsequent years, “[p]rivate entities have successfully lobbied Congress for public resources to subsidize their own financial activities... Such governmental subsidization reflects the organizational advantages of the few who can benefit at the expense of the less well-organized public.”

Recognizing this point, however, is perhaps the most crucial step in blocking the facilitators to scandal. After all, if the broader polity can agree on goals—policing fraud, closing regulatory gaps, educating consumers, enforcing our antitrust laws—then we can at last shift debate toward how to sidestep the special interests and make reforms a reality.

There are at least two categories of approaches worth considering. First, there is campaign finance reform. As Steven Croley correctly points out in his critique of public choice, if “the relationship between legislators and regulation-seeking interest groups constitutes the real lynchpin of the public choice theory—then reforms in the area of campaign finance, for one example, might go far to alleviate the problems that lead public choice theorists to call for deregulation.”86 Or, as Amitai Etzioni asks, “[c]an campaign financing be thoroughly reformed, not by our current method of merely closing one floodgate as money gushes over and around the dam and everywhere else, but in a way that will stop the drift toward a plutocracy of one dollar, one vote?”

A second and complementary approach would be to place greater emphasis on regulatory agencies as policymakers. In their discussion of “why sophisticated voters might prefer the delegation of policymaking discretion to unelected experts,”88 David Spence and Frank Cross point to “the lobbying behavior of the special interest groups. These interest groups do not generally

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84. Id. at 143. As Olson further observes:
   The number and power of the lobbying organizations representing American business is indeed surprising in a democracy operating according to the majority rule. ... The high degree of organization of business interests, and the power of these business interests, must be due in large part to the fact that the business community is divided into a series of (generally oligopolistic) “industries,” each of which contains only a fairly small number of firms.
rush to Congress and say please, ‘Regulate us!’

As Spence argues in a later article, “[t]he ability to influence legislators’ reelection prospects through campaign contributions, issue advertising, and the like, offer well-heeled interest groups much greater leverage over legislators than over agency bureaucrats.”

Similarly, Joseph Kearney and Thomas Merrill remark that

"The public choice perspective is also vulnerable insofar as its central premise—that positive regulation is always inferior to market ordering—is usually advanced as an article of faith rather than by empirical demonstration. The history of the great transformation that we have recounted—in which regulatory agencies often led the charge for regulatory reform—should by itself be enough to give pause before one asserts any invariant hypothesis about the behavior of regulators. Contrary to the theory popular in the late 1960s and early 1970s, agencies do not always behave as the hopeless captives of their client industries.”

In sum, as Croley puts it, public choice theory “rests on a seriously incomplete and under-theorized understanding of regulatory government, and furthermore that its empirical predictions are not supported by careful consideration of the evidence about how regulatory agencies operate or what they do.”

Perhaps most importantly, repeatedly our society has turned to administrative agencies to help get it out of serious trouble. Note how history repeats itself:

Americans have repeatedly turned to federal regulatory government in times of crisis to address the country’s most stubborn problems—from the banking crises and business corruption of the early twentieth century, through the Great Depression, stock market crisis, and labor unrest of the 1930s and 1940s, through the environmental crisis and civil rights revolutions of the 1960s and 1970s, to the threat of terrorism and the creation of the huge Department of Homeland Security at the beginning of the twenty-first century, to name a few.

It is of course no coincidence that federal agencies are front-and-center in the discussion of how to rescue the economy from our recent financial crisis.

Given this reality, as John Kenneth Galbraith observes, the “massive ideological attack [that] has been mounted on public regulation in and of the economy” is “an escape from thought.” And in his detailed study of the

89. Id. at 122.
91. Kearney & Merrill, supra note 6, at 1406.
92. STEVEN P. CROLEY, REGULATION AND PUBLIC INTERESTS: THE POSSIBILITY OF GOOD REGULATORY GOVERNMENT 3 (2008). See also Richard W. Parker, Grading the Government, 70 U. CHI. L. REV. 1345, 1355 (2003) (demonstrating the shoddiness of the “empirical foundation for the anti-regulatory fervor that has gripped Congress, academia, and millions of Americans for over a decade.”). Cf. Suleiman, supra note 60, at 7 (“the maintenance of a democratic order... requires a trained, nonvenal bureaucratic machine.”).
demise of public administration, Ezra Suleiman concludes that “the attacks on the federal government, whether with a hammer or with a velvet glove, achieved none of the grandiose goals of reducing alienation, creating a sense of community, increasing participation, or increasing trust in government.”

Society should instead redirect its efforts toward improving the administrative state, to “create a regulatory superstructure that encourages the betterment of regulatory technology itself ... for it is nothing less than the aspiration that government, like all things human, can improve.”

In the end, we should aspire to free and open markets, but not fall prey to the idealization that they happen by accident. At its core, blocking the facilitators is about government takes steps to ensure the rules of the game are fair. As the banker and diplomat Felix Rohatyn puts it:

I had always believed that this country’s basic goals consisted of the primacy of freedom, the objective of fairness and the creation of wealth. This concept seemed to hold until the ’80s, when greed overcame fairness and the creation of wealth became an individual fever that knew no limits. Our present situation calls for a rethinking of many of our economic and social assumptions, especially the notion that there is but a minor role appropriate for the government in our economy. ... I am also a capitalist and believe that market capitalism is the best economic system ever invented: but it must be fair, it must be regulated, and it must be ethical. The last few years have shown that excesses can come about when finance capitalism and modern technology are abused in the service of naked greed. Only capitalists can kill capitalism but our system cannot stand much more abuse of the type we have witnessed recently, nor can it stand much more of the financial and social polarization we are seeing today.

The facilitators I have discussed have helped create the mess Rohatyn describes. Government should block them. Nothing less than capitalism’s integrity is at stake.

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96. Suleiman, supra note 60, at 309-10.
97. Duffy, supra note 5 at 1080.
98. As Frederic Jameson observes, “to get it right, you have to talk about real markets just as much as about metaphysics, psychology, advertising, culture, representations, and libidinal apparatuses.” FREDERIC L. JAMESON, POSTMODERNISM, OR, THE CULTURAL LOGIC OF LATE CAPITALISM 264 (1991).
100. Cf. Kurt Eichenwald, Could Capitalists Actually Bring Down Capitalism?, N.Y. TIMES, June 30, 2002, § 4 (“[T]he corporate calamities of the new millennium are of a different ilk, one that challenges the credibility of the financial reporting system, and in turn the faith of investors in the capital markets—the very engine that has driven capitalism to success.”).