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REGULATORY REFORM

Casablanca and the Crisis in Capitalism: Which 'Reforms' Will Save Us?

BY C. EVAN STEWART

We lawyers tend to have a high opinion of ourselves. We are the ''best and the brightest,'' we are the ''gatekeepers'' of the capital markets, etc. Just a perusal of CLE programs currently being run on the sub-prime meltdown and the liquidity freeze-up in the capital markets underscores our collective judgments that we are not only at the centerpiece of this latest crisis in capitalism,[1] but that we will also be the latter-day embodiments of General George S. Patton Jr. leading the rescue effort at the Battle of the Bulge.[2]

These suppositions are not supported by any evidence, however. The country's financial system got into this mess without much lawyerly assistance and will likely get out of it by the same token. That being said, it is important to try to understand how we slipped on the banana peel, what the ''reforms'' being bandied about to right the ship of state will likely lead to (as with most ''reforms,'' there are or will be unintended consequences), and what all this may mean to the legal profession.

How Did We Get Here?!

In any crisis, there are usually some number of Claude Rains characters (Captain Renault in ''Casablanca'') who—in hindsight—profess to be ''shocked, shocked that gambling is going on in a casino!''[3] Thus, for example, the editors of *The New York Times* opined on September 20th:

> [M]ake no mistake, this crisis could have been avoided if regulators had enforced rules and officials had dared to question risky lending and other dubious practices.[4]

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[1] For some prior ''crises in capitalism'' and lawyerly responses thereto, see C. E. Stewart, ''The False Promise of 'Reform,' '' *New York Law Journal* (February 21, 2008); C. E. Stewart, ''Caveat 'Reformers': Lessons **Not** to be Learned from Enron's Collapse,'' *BNA Securities Regulation & Law Report* (February 25, 2002).

[2] *See* C. D'Este, *Patton: A Genius for War*, 672-702 (Harper Collins 1995); M. Blumenson, *The Patton Papers (Vol. II)* 595-617 (Houghton Mifflin 1974).

[3] Similar gasps were heard several years ago when people ''discovered'' that research analysts were compensated by investment banking revenues—something that had been known for years and for which judicial notice could have been taken. *See In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003), *aff'd in relevant part sub nom. Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005).

[4] *The New York Times* A18 (September 20, 2008). The editors, not wishing to miss a political opportunity, also blamed

And a few days later, the SEC's Inspector General issued a report excoriating the SEC's role in the collapse of Bear Stearns, faulting the agency for missing ''numerous potential red flags'' that led to the investment bank's collapse and take-over by J. P. Morgan (e.g., poor oversight of the firm's risk management controls, poor oversight of the firm's annual report, poor oversight of the firm's communications with investors, etc.).[5]

And while hindsight is, by definition, 20-20, the current financial brouhaha is not really the fault of the SEC, nor is it all that complicated; in fact, we could see it coming, somewhat like watching an accident in slow motion. First came the confluence of interest rates being held at low rates for an extended period of time by the Federal Reserve Board, together with Congressional encouragement of Fannie Mae and Freddie Mac to extend the American Dream of home ownership to a broad range of people, many of whom did not meet traditional credit standards. These ''sub-prime'' mortgages were then pooled and securitized into derivative financial products (e.g., collateralized debt obligations), given high ratings by the oligopolistic rating agencies, and heavily marketed throughout the world—as everyone (e.g., foreign countries, sovereign wealth funds, U.S. investment banks, etc.) wanted to cash in on the ever rising U.S. housing market. To ''hedge'' against the highly leveraged investment risks that investment banks took on with CDOs (sometimes at 30 to 1 leverage), credit default swaps were entered into with such financial powerhouses as AIG.[6]

Even before the housing market started to turn south, the investment banks knew (at least) two things: (1) unlike stocks on the New York Stock Exchange or NASDAQ, there was no ready market for these derivative securities—you could not, for example, go to a Bloomberg screen to see current ''bid'' and ''ask'' quotes; and (2) under the accounting protocols of the U.S. accounting system—FASB #157—these illiquid securities had to be ''marked to market.'' This accounting ''reform'' had been put in place after earlier financial crises and was designed to promote transparency in times of ''orderly markets.''[7]

Unfortunately, as media phenom, Angelo Mozilo of Countrywide, started to come clean, revealing that his mortgage company (among others) had a growing number of sub-prime defaults, the financial institutions holding the mortgage derivatives had to start marking down those assets; and this mark-to-market valuation was not a mathematical or scientific process—why? because even though the assets had (and have) significant value, there were no buyers. Then the whirlpool began in earnest: the Bear Stearns hedge funds started to fail; financial firms' quarterly profits started to slide (or worse); their stock prices then began to tank; their credit ratings were lowered; they then needed to raise capital to bolster stock prices and to prevent even lower credit ratings; U.S. financial institutions became increasingly unwilling to put themselves at credit risk to each other; this led to liquidity crunches and further mortgage defaults and mark downs on the value of the derivatives, which led to the same frothy cycle (etc., etc.).[8]

This whirlpool ultimately brought on the deaths of Bear Stearns and Lehman Brothers, Merrill Lynch becoming a division of Bank of America, AIG becoming (at least) 80% owned by the federal government, Morgan Stanley and Goldman Sachs converting into bank holding companies, a threatened run on the commercial paper market (with potentially disastrous consequences to the country's money market system), and who knows what else that lurks in the near future.[9]

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this regulatory failure on ''the Bush administration's magical belief that the market, with its invisible hand, works best when it is left to self-regulate and self-correct. The country is now paying the price for that delusion.'' Of all the things that contributed to the current financial meltdown, however, ideological adherence to Adam Smith's ''invisible hand'' was *not* in the mix.

[5] *See* K. Scannell, ''SEC Faulted for Missing Red Flags at Bear Stearns,'' *Wall Street Journal* A3 (September 27, 2008); S. Labaton, ''S.E.C. Concedes Oversight Flaws Fueled Collapse,'' *New York Times* A1 (September 27, 2008). *See also* S. Labaton, ''Agency's '04 Rule Let Banks Pile Up New Debt, and Risk,'' *New York Times* A1 (October 3, 2008). As set forth above, in my view it is just too simplistic and too easy to hold the SEC solely accountable for a mess that had many chefs; and this is from someone who has not historically been a huge fan of many of the Commission's actions. *See, e.g.*, ''The SEC 'Wells' Process: Due Process or Just Process?'' *New York Sun* (June 2, 2008); ''Defeat is an Orphan: When the SEC is Forced to Litigate. . .,'' *New York Law Journal* (May 17, 2007); ''The Wrong Track to Reforming Corporate Governance,'' *New York Law Journal* (October 10, 2006).

[6] There is roughly $62 trillion booked to this previously little-known financial product, as compared with approximately $1 trillion of sub-prime mortgages. The derivatives market itself is currently $531 trillion, up from $106 trillion in 2002. Some armchair generals are now blaming ''all this'' on Alan Greenspan's tenure as Fed Chief and his support for, *inter alia*, derivatives as a mechanism for diversifying financial risks among sophisticated investors. *See* P. Goodman, ''Taking Hard Look at a Greenspan Legacy,'' *New York Times* A1 (October 9, 2008).

[7] *See* C. Johnson, ''Wall Street Blames Credit Crisis on Accounting Rule,'' *New York Sun* 7 (September 24, 2008) (quoting Professor Beresford of the University of Georgia).

[8] Some commentators have wondered why this housing crisis has had so much more of a severe fallout than other housing downturns in our country's history. *See* B. Stein, ''In Financial Food Chains, Little Guys Can't Win,'' *New York Times* B2 (September 28, 2008). The financial firms' extreme leveraging of mortgage based derivatives—which is akin to a basic margin account—does much to explain this. When you leverage your investment upside by borrowing, you can hit a home run, so long as there is a rising tide; when the market goes into a free-fall in reverse, however, your downside is not that you can lose your investment and what you borrowed, your downside is (theoretically) limitless. One of the key contributors to the ongoing battering received by the equity markets has been the large margin plays by individuals and hedge fund managers. *See* A. Barenson and G. Fabrikant, ''Margin Calls Prompt Sales, And Drive Shares Even Lower,'' *New York Times* B1 (October 13, 2008).

[9] Other consequences have included the FDIC's seizure of Washington Mutual, Inc. and the subsequent auctioning of it off to J. P. Morgan Chase for $2 billion. The FDIC also engineered Citigroup Inc.'s planned acquisition of Wachovia Corp. for $2.16 billion (in agreeing to cap Citigroup's exposure to Wachovia's bad mortgages at $42 billion, the federal government was to have received $12 billion worth of warrants for Citigroup stock and preferred shares); at the proverbial eleventh hour, Wachovia left Citigroup at the altar and agreed to marry Wells Fargo instead in a $15.4 billion all-stock deal, with no FDIC involvement. After a bit of a taffy-pull between Citigroup and Wells Fargo, Wachovia was ultimately ''won'' by Wells Fargo, with Citigroup left to pursue a civil law suit for

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Here Come the 'Reforms'!

Much of this ''near-death'' experience[10] is still being addressed (or not addressed). But there are a few items upon which there can and should be comment. Let's start out with the attack on ''short sales''.

What is a ''short sale''? It is when a person (or entity) sells a security she (or it) does not own. It is a technique used (i) to profit from a future decline in a security, or (ii) to protect a profit in a long position in that security. As the stock prices of major financial firms started going south, many (including those firms' executives) blamed the drop on short sellers who (it was said) were engaged in rumor mongering/trash talking of those firms in order to ensure a self-fulfilling prophecy and thus reap a financial harvest. Those same executives then brought on enormous political pressure to bear, which led to the SEC issuing a temporary (July 21, 2008 through August 12, 2008) ban on ''naked'' short sales,[11] covering 19 financial firms. After that ''emergency'' measure lapsed, in the midst of the market melt-down the following month, the SEC issued new emergency measures, including: (i) an outright ban on short sales in 799 companies; (ii) requiring institutional money managers to report any short sales of certain publicly traded securities; (iii) requiring short sellers (and their broker dealers) to deliver securities by settlement dates (T + 3); and (iv) making it illegal for short sellers to lie about their intentions or ability to deliver securities. The latter three measures continue on in effect; the short-sale ban came off on October 8th.

Did the ban work? No. And it could never have worked, especially in the way it was implemented. First of all, temporary band-aids are only that—if an investor believes a company is weak, the day after a short sale ban ends, she will be back shorting the stock; put another way, bans may have bought Lehman Brothers a few weeks of relative peace, but after they were lifted folks were back shorting its stock.[12] Second, by selecting some companies for protection but not others, the SEC was arbitrarily distorting the investing market in ways it could never anticipate.[13] And one such unintended consequence of the SEC's action was to choke off liquidity by hampering hedge funds from employing short-selling strategies.[14] The fact of the matter (as they say in Washington) is that short-selling—in general—is not an inherently bad thing, and can often be good, insofar as it increases market liquidity. Incredibly, the most important thing to reform about short-selling to deal with trading abuses would be to reinstate the ''Uptick Rule''—something the current SEC chairman has said he will *not* do![15]

The major reform effort has been directed to detoxifying the toxic securities being held by U.S. financial firms and to unfreeze the credit markets. But as Houdini was often asked: just how do you do that trick? Some cried: set up a large federal bureaucracy, like the Resolution Trust Corp., which (purportedly) had been uniformly successful in addressing the Savings and Loan debacle of the late 1980s – early 1990s. Others demanded that we deep-six mark-to-market accounting (FASB #157). Still others wanted the federal government to either (i) ''bail-out'' Wall Street firms by buying the toxic securities off of their balance sheets and then (at some point in the future) selling the securities at their ''true'' market value, or (ii) take minority interests in selected financial firms (investment banks and ''traditional'' banks) to jump-start their capital bases and thus ensure greater market liquidity (or at least the perception thereof). So what did we get? It looks like some conglomeration of all of them.

Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke have led a frantic, frenetic, and often ad hoc effort by the federal government to deal with failing firms, toxic securities, and the frozen credit markets; and this has been done in the final year of an exhausted and unpopular administration, which has the far end of Pennsylvania Avenue firmly controlled by the opposing political party. Notwithstanding, and not without some stumbles and delays,[16] a $700 million ''bail-out'' package was ultimately passed by Congress. The legislation (Troubled Asset Relief Program, or ''TARP'')

$60 billion in damages, based upon Wells Fargo's interfering with Citigroup's ''exclusive'' deal with Wachovia.

[10] On Thursday, September 18, Fed Chairman Ben Bernanke told Congressional leaders that: ''If we didn't do [the bail-out plan], we may not have an economy on Monday.'' A. Ross, ''36 Hours of Alarm and Action as Crisis Spiraled,'' *New York Times* A1 (October 2, 2008).

[11] ''Naked shorts'' (or ''see-through underpants''—*see* W. Safire, ''Toxic Bailout,'' *New York Times Magazine* 14 (October 5, 2008)) are when the seller sells the security without having physical custody of the security or ensuring that she (or it) can in fact get physical custody (via borrowing).

[12] As one asset manager put it: ''If [a stock is] going to go down, it's going to go down.'' *See* L. Story, ''a Debate on a Ban on Short-Selling Ends: Did It Make Any Difference?'' *New York Times* B8 (October 8, 2008) (comments of A. Fishman). To a certain extent, the anti-short sellers are embracing a form of censorship of public expression, which is inconsistent with the First Amendment.

[13] As shown above, first it was 19 companies getting protection, then 799—and actually that number was expanded to include another 190 companies. *See* L. Story, ''A Debate on a Ban on Short-Selling Ends: Did It Make Any Difference?'' *New York Times* B8 (October 8, 2008). *Seealso* K. Scannell and C. Karmin, ''Short-Sale Ban Ends to Poor Reviews,'' *Wall Street Journal* C3 (October 9, 2008); P. Diamond, ''SEC Extends Naked Short-Sake Ban Through 8/12; Rulemaking to Follow,'' *BNA Securities Regulation & Law Report* 1207-08 (August 4, 2008) (objections by, among others, the Coalition of Private Investment Companies, Managed Funds Association, American Banking Association).

[14] Another unintended consequence is to enhance the competitive advantage of foreign capital markets which allow short-selling. *See* A. Cox, ''A Global Financial Shift,'' *The Washington Post (National Weekly)* 6 (October 6-12, 2008) (China, for example, has recently approved short-sales in Chinese stock markets). It should be remembered that the New York Stock Exchange was originally created by short sellers in 1792, in reaction to a law passed by the New York State Legislature to bar short selling (''An Act to Prevent the Pernicious Practice of Stock-Jobbing, and for Regulating Sales at Public Auction'').

[15] The ''Uptick Rule,'' which had been in place since 1938, was eliminated by the SEC on July 6, 2007. The rule had basically required that a short sale be done at a price above the price of the immediately preceding sale or at the last sale price if it were higher than the last different price.

[16] There appears to be a growing ''conventional wisdom'' that not saving Lehman Brothers from bankruptcy was a mistake, given the counterparty impacts Lehman's bankruptcy has had on credit swaps and the commercial paper markets. *See* S. Ng, ''Swaps Market Is Pressed To Ease Market Strains,'' *Wall Street Journal* C2 (October 10, 2008).

is hardly self-evident or perfect,[17] but once TARP passed, the steps by which we (and our major trading partners) might get out of this mess started to fall into place.[18]

And what are those steps? Well, they are pretty well known by now: (i) the federal government will partially nationalize the country's largest financial institutions, for at least several years, by taking down preferred equity stakes (this $250 million investment will draw down from some of the TARP money authorized by Congress); (ii) the federal government will guarantee senior debt issued by banks for several years; (iii) the FDIC will uncap insurance for non-interest bearing accounts through 2009 (this will impact mostly small businesses); (iv) the Treasury Department began to implement an auction process to acquire the toxic securities and allow the banks' balance sheets some breathing room from marking them to market (using other TARP moneys)—a process it abruptly shut down on November 12th;[19] and (v) the accounting profession and the SEC are in the process of changing, ''clarifying,'' or ''reinterpreting'' the mark-to-market rule (FASB #157), so that we do not blow out our own brains again.

The markets' initial reaction(s) to the foregoing appears to have been positive—at least a financial tsunami seems to have been dodged.[20] Besides the time-honored caveat that ''the Devil is in the details,'' what unintended consequences may be lurking as a result of the amazing and unprecedented actions that have been taken to save our economic system (and our way of life)? Among others, these consequences are:

- Capitalism may have been saved, but it has been accomplished by adopting a fair amount of socialism. No one can really predict how this will play out vis-à-vis the federal government making business decisions, inhibiting risk taking, influencing capital formation, etc. To the argument that this may be only ''temporary'' socialism, that is an ahistorical argument—governments and bureaucrats seldom cede (willingly) power that has been given to them. And as for the benefits of socialism, Mussolini may have made the trains run on time, but the experience of the U.S. government running the railroads has certainly not been edifying.

- A new federal bureaucratic agency may not have been created, but it is certainly indisputable that vast new powers have been placed in the hands of the Treasury Department, the Federal Reserve, and the FDIC Many of these powers will only become clear (or more clear) as non-elected government officials start flexing their new found muscles. Who will hold these posts after January 21, 2009, and how they will interpret and use these powers, are pretty important questions.

- Not to be a kill-joy, but somebody has to pay for all this. Years ago, when Carl Sagan used to talk about ''billions and billions,'' people used to think that was a lot. Now, many people (especially our representatives in Washington) do not seem to believe that.[21] Make no mistake, however, we are mortgaging our standard of living to the Chinese, sovereign wealth funds, and anyone else willing to fund an immense (and growing) budget deficit. The primacy of America's capital markets is already under attack; this profligacy will only speed the process along.[22]

- Any ''clarifications'' of FASB #157, to lessen the severity of mark-to-market valuation of assets, have thus far not brought a lot of clarity. Moreover, there continues to be a heated debate whether the rule should be kept as it was (in the name of accuracy and transparency) or whether the ''clarifications'' do not go anywhere far enough (in the name of placing a realistic value on an asset, as opposed to a fire-sale price). [23] Regardless of where this debate ends up, until there is a clear winner there will be no meaningful relief.

- The politigencia have made it exceedingly clear that, together with all the taxpayer money being pumped into the financial system, that system is going to be a whole lot more regulated.[24] If the politigencia believes such ''heightened'' regulation means that you can bullet-proof the financial markets from future material failures, however, history shows us that such a belief is illusory. To the extent folks want regulation to be directed toward hedge funds or credit default swap in-

[17] It included numerous boondoggles to entice the support of specific members of Congress. *See* W. Yardley, ''Bicycle Commuter Tax Credit Is a Bittersweet Victory for Measure's Backers,'' *New York Times* A17 (October 10, 2008) (Congressman Blumenauer (D. Ore.) predicated his support of the legislation on a $20 per month tax credit for those who commute to work on a bike.).

[18] As Lehman Brothers, Merrill Lynch, AIG, and others were having their troubles, some Europeans gleefully opined that the financial meltdown was purely an American problem; within a matter of days, such national chauvinism was confronted by the reality of the global economy. *See* J. Slater, ''A Crash Heard Around the World,'' *Wall Street Journal* A8 (October 13, 2008). Far more important was the fact that the U.S. and its major trading partners coalesced around a coordinated strategy to unfreeze the world's financial markets. *See* B. Bernanke, ''We're Laying the Groundwork for Recovery,'' *Wall Street Journal* A21 (October 14, 2008).

[19] Out of the blue, Secretary Paulson announced that having the government buy the toxic securities was ''not the most effective way'' to utilize the $700 billion. Perhaps the Treasury Department recognized that the auction process being put in place had all sort of easy to spot flaws. Among the easiest were conflicts of interest in the folks running and/or advising the process, as well as how to ensure that the securities purchased by the Treasury Department were at the ''right'' levels. We would not have known until years later whether this process worked well (i.e., taxpayers benefited) or not (i.e., taxpayers took a bath).

[20] This does not mean, however, that these steps can forestall basic macro-economic forces pushing the U.S. and the world into a recession. In the New York City economy alone it is difficult to see a short-term, happy scenario with so many high end jobs in the financial sector having gone up in smoke.

[21] *See* G. Hitt, ''Democrats Mull $300 Billion Stimulus,'' *Wall Street Journal* A3 (October 15, 2008) (lame duck Congress is drawing up an economic stimulus plan equivalent to 2% GDP, notwithstanding a projected $455 billion budget deficit).

[22] *See* A. Cox, ''A Global Financial Shift,'' *The Washington Post (National Weekly)* 6 (October 6-12, 2008); D. Leonhardt, ''A Power That May Not Stay So Super,'' *New York Times Week in Review* 1 (October 12, 2008). *Seealso* C. E. Stewart, ''The False Promise of Reform,'' *New York Law Journal* (February 21, 2008).

[23] *See* F. Norris, ''S.E.C. Moves To Relax Asset Rule,'' *New York Times* B1 (October 1, 2008). *Compare* A. Levitt and L. Turner, ''How to Restore Trust in Wall Street,'' *Wall Street Journal* A17 (September 26, 2008) (''Mark-to-market accounting is the solution, not the problem.'') *with* M. Anderson and D. Reilly, ''FASB Rules Come Under Fire by Banks,'' *Wall Street Journal* C2 (October 14, 2008).

[24] *See* M. Rosenwald and D. Cho, ''Push Is on for Regulatory Overhaul,'' *Washington Post* D3 (October 16, 2008).

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struments, query whether those folks have thought through the knowledge, experience, manpower, resources, etc. issues in order to make a meaningful contribution of any kind.[25]

- And, of course, there will be a host of additional, unforeseeable unintended consequences that we will have to live through.[26]

And the Legal Profession?

So where do the lawyers fit in all this hullabaloo? Many people think that bad markets mean good times for lawyers (especially litigators); as a litigator, I guess I should hope they are right. But that conventional wisdom might be wrong this time. Why? First of all, with the instant ''consolidation'' of the financial services industry, scores and scores of lawyers have been left without a whole bunch of clients.[27] The corresponding impact on law firms has been swift, with well-known firms failing, merging, or firing wide swatches of lawyers.[28] Another important reason is that much of the financial damage has been directed either at institutions or at indisputably sophisticated investors who specifically opted for risk-based strategies; such entities and individuals are different from Mom and Pop Main Street plaintiffs.[29] And while I would never sell the very creative and determined plaintiffs' bar short, it is hard to see how the legal profession will be profiting greatly at a time when everyone else is taking a hit.

Conclusion.

Like the mission statement of the U.S.S. Enterprise in ''Star Trek,'' we have gone (maybe not boldly) to an economic place no person has gone before. Is there a light at the end of the tunnel? Hopefully, yes. But keep your seatbelts tightly fastened until then.

[25] Prior, tentative efforts by the SEC to regulate hedge funds have failed, in fact and legally. *See* C. E. Stewart, ''The Wrong Track to Reforming Corporate Governance,'' *New York Law Journal* (October 10, 2006). That segment of the financial world is in its own shakedown and reorganization at present; and that on-going process is probably the best ''regulation'' for sophisticated, wealthy investors who will continue to seek outpaced returns. As for competing cries by the SEC and the New York Attorney General that either or both will regulatorily bring order to the credit default swaps market, stay tuned for that train wreck. *See* S. Ng. and L. Rappaport, ''New York Tries Taming Credit-Default Swaps,'' *Wall Street Journal* C3 (September 23, 2008); J. Westbrook & D. Scheer, ''Cox Says Congress Should Regulate Credit-Default Swaps,'' *New York Sun* 7 (September 24, 2008).

[26] *See* L. Rappaport and S. Ng, ''Crisis Reverberates in Credit, Stock Markets,'' *Wall Street Journal* C1 (October 16, 2008) (investors selling off Freddie Mac and Fannie Mae for more attractive bonds issued by banks).

[27] One colleague of mine, for example, recently told me that one of his law partner's three principal clients were Bear Stearns, Lehman Brothers, and Merrill Lynch.

[28] E.g., Heller Ehrman, Thelen, Cadwalader, Wickersham & Taft, Clifford Chance, etc.

[29] And even many Mom and Pop Main Streets may not have actionable claims. As one example, consider the auction rate securities problems caused when that market started to freeze up in late 2007 and early 2008. Most plaintiffs (or potential plaintiffs) do not have any monetary injury in light of settlements financial firms entered into with regulators.