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Introduction: The Market Meltdown of 2008 and the Future of Financial Reregulation

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In hindsight, most of us involved in the area of financial regulation look like we were "Lotus Eaters."[1] For almost twenty years, the reigning financial ideology supported the belief that market participants and counterparties would effectively police themselves; that the business cycle was over because new technologies and global exchange had moved the economy to a new place; that professional reputation was a superior proxy for legal enforcement; and that American-style, financial capitalism was unqualifiedly the optimal form of economic organization. Both from within and beyond the academy, and from the highest positions in government and finance, the belief spread that developed capital markets and their participants were mostly rational; that financial risk could be precisely quantified and "managed" to the point of near irrelevance. We presumed that investment bankers and their hugely leveraged firms, by manufacturing ever more complex, unregulated derivatives, were creating real, new wealth, rather than compounding systemic risk. Conflicts of interest that affected stock analysts, securities underwriters, auditors, credit rating agencies, corporate law firms, mortgage lenders, compensation consultants, and many "independent directors" at financial firms as well as operating companies were ignored or downplayed by the law. The notion that the rich getting richer would benefit everyone was accepted as common wisdom. The increased social acceptability of massive personal and public debt seemed to promise benevolent, comprehensive access to a utopian "ownership society."

Now to the present. We can barely calculate the scope of the losses that have pummeled Wall Street and Main Street since 2007. Remarkably, a large swathe of the high-finance community—after massive government aid—has regrouped, restructured, and renewed its profitability. To appease a public stunned by "the bank bailout," President Obama has floated a proposal to "tax the banks"[2]—a proposal that is probably unworkable in the age of globally mobile capital. As for Main Street, we've taken to speaking of "the Great Recession."[3] It seems that every day I meet someone whose financial circumstances have been severely altered. Almost everyone has substantially less savings, or worse, is scrambling just to get by; has lost a job, or is supporting a previously working spouse. Social scientists have even reported an increase in domestic abuse linked to the radically heightened financial stresses caused by the recession.[4]

1. In Greek mythology, the Lotus Eaters were a race of people who ate the lotus plant, which was narcotic and addictive, and caused a feeling of peaceful apathy. HOMER, THE ODYSSEY 9.85–100 (Rodney Merrell, trans. Univ. of Mich. Press, 2002).

2. Damian Paletta, Deborah Solomon & David Enrich, *White House's Tax Proposal Targets Big Banks' Risks*, WALL. ST. J., Jan. 14, 2010, at A4; Jonathan Weisman and David Enrich, *Obama Unveils $90 Billion Bank Tax With Sharp Words*, WALL ST. J., Jan. 15, 2010, at A4.

3. *E.g.*, Gary S. Becker, Steven J. Davis & Kevin M. Murphy, Editorial, *Uncertainty and the Slow Recovery*, WALL ST. J., Jan. 4, 2010, at A17; Arthur B. Laffer, Letter to the Editor, *We Can, and Should, Do Better Than Ben Bernanke*, WALL ST. J., Jan. 26, 2010, at A16; Mortimer Zuckerman, Editorial, *The Great Recession Continues*, WALL ST. J., Jan. 22, 2010, at A19; Elizabeth Warren, Editorial, *Wall Street's Race to the Bottom*, WALL ST. J., Feb. 9, 2010, at A19.

4. *Domestic Abuse on Rise as Economy Sinks*, MSNBC.COM, Apr. 10, 2009, http://www.msnbc.msn.com/id/30156918/; Sheryl Ubelacker, *Domestic Abuse on Rise as Families Try to Cope with Recession*, TORONTO

This Lotus-Eating period was not an especially enjoyable time to be a corporate and securities law professor (like myself) who believes in an essential role for law and regulation in maintaining robust capital markets and a healthy economy. Of course, there were more than a few business law academicians who believed that the absence of vigorous enforcement of corporate, securities, and banking laws was creating overconfidence.[5] Many of my colleagues and other commentators shared my instinct that the twenty-year process of financial deregulation reflected an ideological shift more than anything like dependably welfare-enhancing economic transformation.[6] Yet the financial markets continued their exuberant, unyielding climb right through the fall of 2007—reigniting one of the longest bull markets in history.[7] Hence, this frightened and unpleasant instinct was rarely articulated—not in the academy, the government or media, and especially not in print.[8] The relative academic silence partially reflected that this instinct was not readily susceptible to quantitative proof. Thus, the true extent and peril of the compounding, financial risks were under-analyzed in the academic literature.

STAR, Apr. 14, 2009, *available at* http://www.thestar.com/News/Canada/article/618334; Thomas L. Hafemeister, *Castles Made of Sand? Rediscovering Child Abuse and Society's Response*, 36 OHIO N.U. L. REV. (forthcoming 2010) (manuscript at 6–15, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1565582).

5. *See, e.g.*, Raymond H. Brescia, *Trust in the Shadows: Law, Behavior, and Financial Re-Regulation*, 57 BUFF. L. REV. 1361, 1362–63 (2009) (arguing that "a complex web of financial institutions and transactions . . . developed and thrived in a deregulatory atmosphere . . . . [causing] overconfidence").

6. Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 734 (2009); John W. Cioffi, *State of the Art*, 48 AM. J. COMP. L. 501 (2000) (reviewing COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH (Klaus J. Hopt et al. eds. 1998)); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*, 46 WM. AND MARY L. REV. 1597 (2005); Faith Stevelman Kahn, Bombing Markets, *Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579, 1636–37 (2002); Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429 (2000); Clyde D. Stoltenberg, *Law, Regulation, and International Business*, 40 AM. BUS. L.J. 445 (2003); Posting of Lynn A. Stout to Dealbook, *Why We Need Derivatives Regulation*, http://dealbook.blogs.nytimes.com/2009/10/07/dealbook-dialogue-lynn-stout/?emc=eta1 (Oct. 7, 2009, 16:30 EST); *see also* ROBERT KUTTNER, EVERYTHING FOR SALE: THE VIRTUES AND LIMITS OF MARKETS (1999).

7. Atul Prakash, *Chartists See a Late 2009 Recovery*, N.Y. TIMES, Nov. 15, 2008; Paul J. Lim, *An Aging Bull Can Still be a Raging Bull*, N.Y. TIMES, Oct. 14, 2007, at BU3; Alexandra Twin & Steve Hargreaves, *Dow: Longest Bull Run in 80 Years*, CNNMONEY.COM, May 4, 2007, http://money.cnn.com/2007/05/04/markets/markets_0530/index.htm.

8. Steven L. Schwarcz, one of the contributors to this issue, warned Congress in early October 2007 of the pending crisis, based on research he was doing at the time and subsequently published as *Systemic Risk*, 97 GEO. L.J. 193 (2008). *Systemic Risk: Examining Regulators' Ability to Respond to Threats to the Financial System: Hearing Before the H. Comm. on Fin. Srvs.*, 110th Cong. 14 (2007) (statement of Steven L. Schwarcz, Stanley A. Star Professor of Law and Business, Duke University Law School), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/ht1002072.shtml); *see also* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007); *Assessing the Current Oversight and Operations of Credit Rating Agencies: Hearing Before the S. Comm. of Banking, Housing, and Urban Affairs*, 109th Cong. (2006) (statement of Frank Partnoy, Professor of Law, University of San Diego School of Law), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=52adc6a1-5fc5-4f1a-88a5-036416c7acbe.

A further contributing factor was that the most perilous forms of financial transacting were occurring often in areas of the economy beyond the scope of contemporary financial regulation. Hence, many of these transactions skipped between the interstices of corporate, securities, banking, and insurance law. Naturally, it is easier to critique the regulations that exist than the effects of absent regulation, and easy to miss seeing the impact of gaps between multiple financial regulatory structures. At a pedagogical level, the gaps and holes in this amalgamated regulatory framework meant, also, that even a sincere, rigorous, politically "nonpartisan" professor of business law could teach a full course load without addressing his or her students (or peers) about the increasingly dangerous alchemy of compounding financial risk, increased leverage, and deregulation.

For the last three years, the Treasury and Federal Reserve, Wall Street's brightest, the academy, and the media have all been playing catch up. We are attempting to bring into focus what happened and what must happen, in terms of institutional and law reforms, to avoid further disaster. In this effort, of course, a central question has been the appropriate role of law in governing the capital markets and financial transacting. The House of Representatives passed a comprehensive set of financial reforms in the fall of 2009.[9] But the outcome of Senate efforts remains indefinite. Most recently, in mid-March 2010, Senator Chris Dodd promised that a tougher version of financial regulatory controls would emerge from the Senate Banking Committee.[10] Nevertheless, as of the time this issue is published, Republican Senators stand opposed and promise a fight.[11] Certainly the breadth of the proposed reforms—reforms that address mortgage lending, consumer credit practices, derivatives oversight, executive pay, shareholders' voting, banks' capital requirements, and the "too big to fail" phenomenon[12]—present a challenge to the passage of legislation.

This question—the appropriate role of law and regulation in governing the financial and capital markets—was the fundamental question around which we organized a symposium at New York Law School on April 24, 2009. Entitled "Fear, Fraud, and the Future of Financial Regulation," the symposium was the second sponsored by the law school's Center on Business Law and Policy. The papers published in this symposium issue of the *Law Review* reflect the breadth of that day's program. I will comment briefly on each of the papers published herein.

9. Wall Street Reform and Consumer Protection Act of 2009. H.R. 4173, 111th Cong. (2009).

10. Senator Chris Dodd, Statement on Restoring American Financial Stability (Mar. 15, 2010), http://banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=68006e3f-cfb7-343d-99c1-11047b96c944&Region_id=&Issue_id=; Restoring American Financial Stability Act of 2010, S. 111th Cong. (as re-introduced by Senator Chris Dodd on March 15, 2010, and reported out of the Senate Committee on Banking, Housing, and Urban Affairs on March 22, 2010).

11. Brady Dennis, *New Regulation Bill, Same Outlook; No GOP Support for New Plan—Dodd's Concessions Yield Few Gains in Senate*, WASH. POST, Mar. 16, 2010, at A12.

12. Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial* Crisis, 61 ADMIN. L. REV. 463, 474 (2009); Nelson D. Schwartz, *A Risky High-Wire Act*, N.Y. TIMES, Sept. 8, 2008, at C1; Mark Trumbull, *Who's Really Too Big to Fail?*, THE CHRISTIAN SCIENCE MONITOR, July 12, 2008, *available at* http://www.csmonitor.com/Money/2008/0712/p25s18-usec.html.

As Professors Merritt Fox, Lawrence Glosten, and Paul Tetlock note in the introduction to their article, there have been few subjects as perplexing for regulators as short selling.[13] In the most intense moments of the financial crisis in the fall of 2008, shorting became a great concern in relation to the destruction of confidence, and hence value, in financial firms.[14] Selling short has the potential to improve liquidity and price accuracy and to limit bubbles, and these are all socially beneficial effects. But shorting also may encourage the spreading of harmful, value-destroying rumors, facilitate coordinated efforts at market manipulation (through bear raids, for example), and hence decrease investors' confidence in the fairness of the market. As the authors note, there are legitimate concerns about illegal insider trading in regard to a substantial percentage of short selling. For this reason, and because the volume of short selling is a substantial proportion of all equity trading, much is at stake in Congress's or the SEC's decision to impose, or not to impose, limits on short selling—for example, whether the "uptick rule" should be restored.

Along with his co-authors, Fox surveys various theories regarding shorting's effects, the history of Congress's and the SEC's treatment of shorting, and newly emergent empirical studies seeking to illuminate the circumstances motivating the most common patterns of short selling. In their article, Fox and his co-authors make a new contribution to the empirical literature by studying the association between above-normal levels of shorting and the next-day release of negative news about listed issuers (that is, news reported in the media). The technical apparatus for effectuating this study is itself quite a feat. The study concludes that a substantial portion of all short selling is driven by (i) the seller's having obtained material, nonpublic, negative news about the issuer; or (ii) the seller's having shorted and then spread false negative news about the issuer; or (iii) the seller's having shorted and then spread true negative news about the issuer (i.e., information that represented his or her independently arrived-at conclusions based on already public data). As the authors note, these conclusions need reinforcement by further empirical study. The existing empirical studies present neither a conclusively positive nor conclusively negative picture of shorting. Hence they do not lend themselves to easy policy prescriptions.

As if the Commission had taken to heart Fox and his co-authors' mixed conclusions, in February 2010 the SEC determined to enforce certain narrow price-based constraints on selling short. In a 3–2 vote along partisan lines (with Democrats in the majority), the SEC resolved to reestablish both a price test and a circuit breaker on short selling (the former being an alternative version of an uptick rule).[15] At the same time, the Commission deliberately chose to avoid imposing any bright-line proscriptions on short selling, noting that many commentators on the proposed rule

13. Merritt B. Fox, Lawrence R. Glosten & Paul C. Tetlock, *Short Selling and the News: A Preliminary Report on an Empirical Study*, 54 N.Y.L. Sch. L. Rev. 645 (2009/10).

14. Dealbook, *S.E.C. Halts Short Sales of Financial Stocks*, http://dealbook.blogs.nytimes.com/2008/09/19/us-and-britain-move-to-ban-short-sales-of-financial-firms/?emc=eta1 (Sept. 19, 2008, 07:11 EST).

15. Fawn Johnson, *In 3–2 Vote, SEC Limits Short Sales*, Wall St. J., Feb. 25, 2010, at C1.

had highlighted the potentially salutary effects of shorting (consistent with Fox, Glosten, and Tetlock's conclusions). In the end, the SEC's adopting release emphasized the importance of maintaining investor confidence via clear, enforceable financial regulations—in particular, enhancing investors' faith that the SEC would act to minimize extreme volatility and coordinated efforts at market manipulation.[16] In conclusion, the challenge of determining the appropriate approach to regulating short selling illustrates the enormous regulatory and political challenge before Congress and other financial regulators.

Professor Houman Shadab's article tackles a different area of finance and financial regulation. The crisis, as we all know now, was linked to the mispricing of the risk attached to mortgage-backed and other asset-backed securities (which were tied to mistaken assumptions about real estate values, inter alia). Professor Shadab's article analyzes the related but distinct phenomenon of credit default swaps ("CDSs").[17] These CDSs were used both in hedging strategies on bond portfolios and in speculating. Where used as bond insurance, the CDSs were only as good as the creditworthiness of their issuers. In this vein, Shadab explains certain of the vulnerabilities in CDSs that would have bankrupted AIG and shaken bank asset portfolios to the core. As he describes it, a combination of agency costs (for example, gaps between individual CDS sellers' compensation and the risk carried by the seller institution), inaccurate assumptions (for example, overreliance on credit ratings in valuing asset-backed securities), institutional infirmities (including looser, more inchoate bank capital requirements), lassitude in counterparties' risk monitoring, and even banks' "gaming" of moral hazard all fueled the coming disaster. These hazards were compounded by the absence of governmental oversight in the market for CDSs and, even, the absence of a central clearinghouse or other self-regulatory, oversight body.

Beyond providing a breathtakingly clear roadmap through an area of finance so complex that many bankers appeared to have been caught unawares, Shadab's article raises a fundamental question about the nature of what counts as "regulation." Most fundamentally, can bilateral, readily enforceable, and market-adjusting counterparty commitments operate as effective and lesser-cost surrogates for government-imposed standards and oversight? Can these private, contractual understandings be considered an alternative, meaningful form of "regulation?" Or, is the very use of the term "self-regulation" as it relates to counterparty monitoring in credit derivatives (and otherwise) a loaded, normative judgment about the limits of law?

Following on the themes identified by Professors Fox and Shadab, Professor Steven Schwarcz's article opens with the insight that "[f]inancial market failures can

16. Press Release, U.S. Sec. & Exch. Comm'n, SEC Approves Short Selling Restrictions (Feb. 24, 2010), http://www.sec.gov/news/press/2010/2010-26.htm; Amendments to Regulation SHO, Exchange Act Release No. 34, 61595, 75, Fed. Reg. 11,231 (Mar. 10, 2010) (to be codified at 17 C.F.R. pt. 242).

17. Houman B. Shadab, *Counterparty Regulation and Its Limits: The Evolution of the Credit Default Swaps Market*, 54 N.Y.L. Sch. L. Rev. 689 (2009/10).

be attributed in large part to three causes: conflicts, complacency, and complexity."[18] Schwarcz focuses on the problem of ambiguity facing trustees in securitizations, bond issues, and other issuances of debt securities. In cases of financial distress, where a default has occurred or is imminent, these financial structures generate conflicts among the multiple classes of investors therein—investors who are likely to have incompatible financial rights and expectations. Schwarcz offers the examples of senior and subordinated bond investors, and investors who hold claims on the "interest only" or "principal only" tranches of securitized debt.

The importance of developing better legal guidance for addressing the "conflicted trustee dilemma" is one of the lessons emerging from the financial crisis. As Schwarcz notes, it is remarkable that precise legal direction for trustees faced with resolving these conflicts generally appears nowhere in the relevant contracts, case law, or even model acts or restatements.

One fascinating thing here is the analogy Schwarcz draws between the problems facing "conflicted" trustees on debt securities and the potentially conflicting duties facing directors of corporate boards. These contexts include corporate transactions proposed by controlling shareholders and transactions undertaken during the company's insolvency (or near insolvency). In the former setting, corporate law's "entire fairness" standard has not offered sufficiently clear advice to the conflicted corporate board or special committee.[19] The corporate fiduciary case law addressing the obligations, if not the potential liability, of the boards of insolvent or near-insolvent firms has been similarly murky.[20] Schwarcz's article offers several potential routes to limiting the confusion, or at least the potential liability, facing trustees on debt securities. Such guidance might also be relevant to corporate boards in the scenarios identified above.[21]

Picking up on the theme of complexity, Professor Eric Pan's article surveys the confusing doctrinal evolution of the "duty to monitor."[22] As he notes, corporate boards' duty to monitor their corporations' affairs has been variously interpreted as a stand-alone duty, a facet of the duty of care, a dimension of the duty of good faith, and a subset of the duty of loyalty. Of course, each of these iterations of directors' fiduciary duties implies different burdens of proof and different potential liability

18. Steven L. Schwarcz, *Keynote Address: The Conflicted Trustee Dilemma*, 54 N.Y.L. Sch. L. Rev. 707 (2009/10).

19. For a discussion of the case law applying the entire fairness standard to transactions proposed by controlling shareholders, see Faith Stevelman, *Going Private at the Intersection of the Market and the Law*, 62 Bus. Law. 775 (2007).

20. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., CV No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991); D.J. Baker, John Wm. Butler, Jr. & Mark A. McDermott, *Corporate Governance of Troubled Companies and the Role of Restructuring Counsel*, 63 Bus. Law. 855 (2008); Stephen Fraidin & Faith Stevelman, *Duties to Bondholders in Recapitalizations and Restructurings*, 754 PLI/Corp. 277, 297–318 (1991).

21. *See generally* Stevelman, *supra* note 19.

22. Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y.L. Sch. L. Rev. 717 (2009/10).

exposure. For example, the company's charter exculpation clause, insurance, and indemnification provisions would apply differently depending on which duty was implicated. After careful explication of the most recent cases addressing the duty to monitor and the duty of good faith, Pan concludes that Delaware has expunged the duty to monitor as a distinct legal obligation of corporate boards. He notes how this judicial result creates a conflict with section 141 of the Delaware General Corporation Law, which provides that "corporate affairs must be managed by or under the direction of the corporate board."[23]

Pan also observes the tension between Delaware's laxity vis-à-vis boards' monitoring duties and certain federal court cases interpreting directors' liability for faulty corporate reporting. Finally, Pan notes, Delaware's narrow reading of boards' duty to monitor flies in the face of increasing and widespread calls (for example, from the influential Treadway Commission) for enhancing boards' responsibilities for risk management—calls that have only become more urgent in the wake of the financial crisis.[24] In sum, the first state of corporate law appears to have effectuated its own, unique form of "equitable" deregulation.

Pan concludes, rightly, that in electing virtually to eliminate directors' liability for failures of risk management, Delaware has created greater risk of loss for shareholders and other constituencies, especially in the case of financial firms. One wonders how far Delaware can play the hand of avoiding the toughest issues in corporate governance (and placating corporate managers, who select the state of incorporation) while maintaining the widespread respect of investors and corporate legal academicians. Certainly, the financial crisis has raised the stakes of Delaware's deregulatory gamble.

Against the background of the financial crisis, fraudulent market practices, and populist expressions of outrage, Professor Celia Taylor interrogates a commonly shared anxiety—asking whether the very nature of the corporate form of organization encourages "greed and inequity."[25] Accordingly, Taylor surveys the opposing intellectual constructs of shareholder valuism and corporate social responsibility. Then, in precise detail, she analyzes several recent innovations in business structures targeted at promoting not just capital formation, but also broader social welfare goals. Of these, the "B corporation" is the most widely known. But what is remarkable, as Taylor illuminates, is the variety, number, and varied origins of these many structural innovations targeted at the public interest. Taken together, Taylor observes, these structural innovations are challenging the conventional dividing line between for-profit and non-profit business structures. Hence, as Professor Taylor argues, we must "carpe crisis" to think creatively about the relationship between commerce, business structure, and the common good.

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23. Del. Code Ann. tit. 8, § 141 (2001).

24. Committee of Sponsoring Organizations of the Treadway Commission, Enterprise Risk Management—Integrated Framework (2004), *available at* http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf.

25. Celia R. Taylor, *Carpe Crisis: Capitalizing on the Breakdown in Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. Sch. L. Rev. 743 (2009/10).

Much has been learned in the nearly two-and-a-half years since the beginning of the financial crisis. Academic conferences like the one held at New York Law School in April 2009 have contributed to this process, providing fresh data and fresh insights. The challenge before us is whether we can find a better equilibrium between enabling financial transacting and empowering government to circumscribe abuse—a question that will no doubt catalyze significant political partisanship, as well as academic debate.

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