University of Richmond Law Review

Volume 44 | Issue 2 Article 2

1-1-2010

The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review

Daniel J. Morrissey
Gonzaga University School of Law

Follow this and additional works at: https://scholarship.richmond.edu/lawreview

Part of the Law and Economics Commons, Legislation Commons, and the Securities Law Commons

Recommended Citation
Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. Rich. L. Rev. 647 (2010).
Available at: https://scholarship.richmond.edu/lawreview/vol44/iss2/2

This Article is brought to you for free and open access by the Law School Journals at UR Scholarship Repository. It has been accepted for inclusion in University of Richmond Law Review by an authorized editor of UR Scholarship Repository. For more information, please contact scholarshiprepository@richmond.edu.

ARTICLES

THE ROAD NOT TAKEN: RETHINKING SECURITIES REGULATION AND THE CASE FOR FEDERAL MERIT REVIEW

Daniel J. Morrissey *

Financial services regulation has failed at its most basic task, protecting the soundness of the system.[1]

I. INTRODUCTION: INADEQUATE FINANCIAL REGULATION, PAST AND PRESENT

The severe recession that began in 2008 appears to have been caused, at least in part, by the same failure of financial regulation that contributed substantially to the Great Depression more than seventy-five years earlier. As a congressional committee found in 1933, "Whatever may be the full catalogue of the forces that brought to pass the present depression, not least among these has been this wanton misdirection of the capital resources of the Nation."[2] Back then, the state securities laws that had come into existence in the preceding two decades proved powerless to prevent fraudulent investment practices conducted on an

---

* Professor of Law, Gonzaga University School of Law. J.D., 1974, Georgetown University School of Law; B.A./B.S., 1971, Georgetown University. The author wishes to thank Gonzaga Law student Jefferson Boswell for his assistance in the preparation of this manuscript. He also would like to acknowledge the fine work of Vicky Daniels in helping to produce the article.

1. Gerald P. O'Driscoll, Jr., *To Prevent Bubbles, Restrain the Fed*, WALL ST. J., Nov. 17, 2008, at A19.

2. H.R. REP. NO. 73–85, at 2–3 (1933).

interstate basis,[3] and there were no national laws whatsoever regulating the capital markets.

President Franklin D. Roosevelt and Congress reacted with the passage of two landmark pieces of financial legislation: the Securities Act of 1933[4] and the Securities Exchange Act of 1934.[5] While the former required pre-sale registration of securities,[6] the latter more broadly regulated the securities industry and set up a regime compelling ongoing disclosure by large, publicly traded firms.[7] Although some critics on the left said those measures did not go far enough to assure the financial well-being of the nation,[8] they seemed to work well enough in the decades of prosperity that followed the Second World War.[9] During the last three decades, however, conservative critics have claimed that much of this legislation not only was unnecessary to protect investors, but also hampered capital formation by businesses.[10] In response to those pressures, Congress and the Securities and Exchange Commission ("SEC" or "the Commission"), the federal agency set up to enforce and administer those laws, progressively deregulated the financial markets.[11]

As a result, far too much debt was packaged in exotic securities.[12] Additionally, ill-informed investors began to blindly speculate in those complex, privately traded instruments, many of which were connected to an inflated housing market. When the housing bubble burst, it took surprisingly little to destabilize the world market for debt securities. The resulting collapse of commercial credit wreaked havoc on the economy.[13] It not only en-

---

3. *See* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 22–23 (1983).

4. 15 U.S.C. §§ 77a–77bbbb (2006).

5. *Id.* §§ 78a–78nn.

6. *See id.* § 77e(c).

7. *See id.* §§ 78b, 78*l*, 78m(a), 78q.

8. *See, e.g.*, William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 522–23 (1934).

9. As Joel Seligman, the current president of the University of Rochester, noted, "The revival of a strong new issues market in the post-World War II period, however, undercut arguments that the mandatory corporate disclosure system or its enforcement by the SEC in any significant sense obstructed new securities flotations, at least by large corporations." Seligman, *supra* note 3, at 2.

10. *See infra* note 16 and accompanying text.

11. *See infra* notes 38–56 and accompanying text.

12. *See infra* notes 153–55 and accompanying text.

13. *See infra* notes 175–86 and accompanying text.

dangered the livelihoods of wealthy investors, but also those of almost everyone else. At great potential cost to future prosperity, the federal government then had to borrow huge sums to bail out shaky financial institutions and re-stimulate a shell-shocked monetary system.[14]

Perhaps economic historians will eventually explain in complete fashion how an apparently thriving economy could come so quickly to a near meltdown.[15] In the meantime, policymakers must reach some provisional understanding of what caused this fiscal debacle and what legal measures should be taken to make sure such events never recur. Chief among those considerations must be a new analysis of the laws governing our capital markets. This analysis must include a reassessment of the laws first put in place in the 1930s and a rethinking of how they have been applied over the succeeding seventy-five years, particularly during the deregulatory zeal of the last three decades.[16]

This is a large project, even more so now that the capital markets are huge and globally interconnected. At its inception, however, our nation's system of financial regulation had a significant shortcoming. By adopting disclosure as the underlying philosophy of the federal securities laws, the framers of that legislation put too much faith in the prudence of investors and the self-policing mechanisms of the capital markets. As such, they passed up the opportunity to exercise more meaningful control over the quality of issued securities by a regime of merit regulation.[17]

The weaknesses in such a half-measured approach were compounded when even that flawed system of financial regulation was undermined by an expansion of the exemptions to its central requirement, i.e., that securities first be registered before they are sold.[18] In addition, those defects became more acute in recent

---

14. *See infra* notes 198–200 and accompanying text.

15. For instance, Nobel Prize winning economist Paul Krugman has already pointed out that the credit collapse was compounded by America's huge borrowings from nations like China, which created an illusion of wealth. Paul Krugman, Op-Ed., *Revenge of the Glut*, N.Y. TIMES, Mar. 2, 2009, at A23.

16. As one commentator aptly put it, "For three decades now, the American economy has been in . . . the Age of Reagan. The government has deregulated industries, opened the economy more to market forces, and above all, cut income taxes." David Leonhardt, *A Free-Market-Loving, Big-Spending Fiscally Conservative Wealth Redistributionist*, N.Y. TIMES, Aug. 24, 2008 (Magazine), at 28.

17. *See infra* notes 225–41 and accompanying text.

18. *See infra* notes 38–71 and accompanying text.

years as highly complex and speculative investments gained prominence in the capital markets.[19]

As a prelude to proposing that a merit-based system of securities regulation replace the current disclosure-based laws, this article will present two premises for that proposition. First, it will describe how deregulation undercut even the modest protection that the existing system afforded investors and, in doing so, jeopardized the soundness of our entire capital markets.[20]

Second, the article will examine the most prominent of those new financial arrangements: credit derivatives, collateralized debt obligations, and credit default swaps.[21] The values of these securities are obtained from other investments and contingent on factors unknowable to their holders. When questions finally arose indicating their diminished worth, a financial panic ensued.[22] Not only did their owners then see much of their portfolios wiped out, but the whole country was pushed into a brutal recession leaving ordinary citizens vulnerable to an economy badly strapped for capital.

II. DEREGULATION HAS UNDERMINED THE MODEST PROTECTIONS OF THE CURRENT SYSTEM

A. *The Current Registration Requirement*

As the Supreme Court aptly put it, the Securities Act of 1933 (the "Securities Act") was designed "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[23] Building on that premise, the SEC has made this statement about the Securities Act's central provision requiring registration of securities before they can be offered and sold: "A primary means of accomplishing these [investor protection] goals is the disclosure of important financial information through the registration of securities."[24]

19. *See infra* notes 72–130 and accompanying text.

20. *See infra* notes 38–71 and accompanying text.

21. *See infra* notes 72–130 and accompanying text.

22. *See infra* notes 175–86 and accompanying text.

23. SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (citing A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 40 (1941)).

24. U.S. Securities and Exchange Commission, The Investor's Advocate: How the SEC

The contents of a registration statement are prescribed by the Securities Act. It must contain a prospectus providing specific items of factual information to investors.[25] The SEC has promulgated specific regulations that govern the disclosures and forms that the issuer must employ in this process.[26]

The completion of a successful registration is a complicated matter requiring the skills of attorneys, accountants, investment bankers, and the active cooperation of the issuer's officials.[27] The prospectus must contain all the information called for by the SEC regulations and forms.[28] Such disclosure, however, is necessary but not sufficient. The anti-fraud provisions of the Securities Act compel the revelation of all facts that an investor would consider important in making a decision to purchase the securities, because a failure to do so may result in criminal[29] and civil penal-

---

Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (alteration in original) (last visited Dec. 18, 2009). Supporting this is the Supreme Court's own acknowledgement that "[t]he registration requirements are the heart of the Act . . . ." Pinter v. Dahl, 486 U.S. 622, 638 (1988) (alteration in original).

25. Securities Act § 10, 15 U.S.C. § 77j (2006). "Prospectus" is defined broadly as, among other things, any writing "which offers any security for sale or confirms the sale of any security." Securities Act § 2(a)(10), 15 U.S.C. §77b(a)(10).

26. The Securities Act empowers the SEC to prescribe further information for a registration statement. Securities Act § 7, 15 U.S.C. § 77g(a). Section 10(c) of the Securities Act also gives the SEC such power in regard to the prospectus. 15 U.S.C.§ 77j(c). For such regulations, see Regulation S-X, 17 C.F.R. §§ 210.1-01 to 210.12-29 (2009); Regulation S-K, *id.* §§ 229.10 to 229.1208; Regulation C, *id.* §§ 230.400 to 230.498. See also *id.* §§ 239.0-1 to 239.800, for registration forms that are prescribed under the Securities Act.

27. For a thorough discussion of the registration process, see generally Carl W. Schneider, Joseph M. Manko & Robert S. Kant, *Going Public: Practice, Procedure, and Consequences*, 27 VILL. L. REV. 1 (1981).

According to Professor C. Steven Bradford, the direct costs of registration consist of: "(1) the direct expenses of preparing, filing and distributing the required disclosure documents, (2) the commissions and fees paid to underwriters and others selling the securities, (3) the delay associated with registration, (4) the costs of maintaining the government registration system, and (5) other miscellaneous costs associated with registration." C. Stephen Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591, 602 (1996). Professor Bradford also discusses other costs of registration that he says are less direct and more difficult to quantify, such as having to make public disclosure about one's business, and subjecting the company to filing periodic and other reports with the SEC as required by the Securities Exchange Act of 1934. *Id.* at 608–09.

28. *See supra* note 26. The SEC has summarized the essential facts that a prospectus must contain as "[1] [a] description of the company's properties and business; [2] [a] description of the security to be offered for sale; [3] information about the management of the company; and [4] [f]inancial statements certified by independent accounts." U.S. Securities and Exchange Commission, Registration Under the Securities Act of 1933, http://www.sec.gov/answers/regis33.htm (alteration in original) (last visited Dec. 18 , 2009).

29. *See* Securities Act § 24, 15 U.S.C. § 77x (imposing criminal penalties on "any per-

ties.[30] All this activity is directed toward the preparation of a document that will satisfy the SEC's staff who may review it and must typically accelerate its effective date before the issuer may sell the securities.[31]

For the last several decades, the SEC has been sensitive to charges that the process of registration is unduly costly and burdensome on issuers, inhibiting the formation of capital and even discouraging entrepreneurship.[32] In response, the SEC has

---

son who willfully, in a registration statement . . . omits to state any material fact . . . necessary to make the statements therein not misleading . . . ."); Exchange Act § 32, 15 U.S.C. § 78ff(a) (imposing criminal penalties on "any person who willfully and knowingly makes, or causes to be made, any statement in . . . any undertaking contained in a registration statement which . . . was false or misleading with respect to any material fact . . . .").

30. See Securities Act § 11(a), 15 U.S.C. § 77k(a) for a detailed list of those who may be held civilly liable to purchasers for any material misstatements or omissions in an effective registration statement. See also Securities Act § 11(b), § 77k(b), for available affirmative defenses. These defenses, such as the "due diligence" defense of Section 11(b)(3) (15 U.S.C. § 77k), allow individuals to avoid liability if they can show that they met a specific standard of knowledge or conduct with respect to the material misstatements or omissions. *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 682–703 (S.D.N.Y. 1968) (analyzing the availability of the "due diligence" defense to various defendants in a securities class action).

Similar to Section 11 liability, Section 12 of the Securities Act imposes civil liability on any person who offers or sells securities by means of written or oral communication containing material misstatements or omissions. 15 U.S.C. § 77*l*(a)(2). Section 12, however, only applies to a purchaser in a public offering. *See* Gustafson v. Alloyd Co., 513 U.S. 561, 569–70 (1995). Section 15 extends liability to those in control of a person liable under sections 77k and 77*l*. 15 U.S.C. § 77o (noting that a controlling person "shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable"). Notwithstanding these express remedies of Sections 11 and 12, courts have also long recognized an implied right of action for securities fraud under Section 10(b) (15 U.S.C. § 78j(b)) and Rule 10b-5 of the Securities Exchange Act of 1934 (17 C.F.R. § 240.10b-5 (2009)). Herman & McLean v. Huddleston, 459 U.S. 375, 380 & n.10 (1983) (citing prior cases).

31. *See* Securities Act § 8, 15 U.S.C. § 77h. Section 8 provides for the acceleration of the effective date by taking into account

> the adequacy of the information respecting the issuer theretofore available to the public, . . . the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of holders thereof can be understood, and . . . the public interest and the protection of investors.

Securities Act § 8(a), 15 U.S.C. § 77h(a). *See also* Securities Act Rule 461, 17 C.F.R. § 230.461(b) (2009) ("[I]t is the general policy of the [SEC], upon request, . . . to permit acceleration of the effective date of the registration statement as soon as possible after the filing of appropriate amendments."). For more on this process of SEC review, see generally, THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION §§ 3.6–.7 (5th ed. 2005).

32. For a discussion of the burdens surrounding the registration requirements of the Securities Act, see Stephen F. Gertzman, Note, *A Primer on Private Offerings*, 24 FLA. L. REV. 458, 458–61 (1972).

streamlined the process for small issuers[33] and companies already public,[34] and initiated "shelf registration" so that companies may register securities for later sales.[35] Most recently, in 2005, the SEC also substantially liberalized the activities that companies may undertake while in registration.[36]

As Professor and former SEC Commissioner Roberta Karmel has noted, however, the SEC's principal response to the criticism that registration is too burdensome has not been to make it "more user-friendly," but to expand exemptions to it so that issuers will be able to avoid the process entirely.[37] It is here that during the past several decades the limited safeguards of the current system have been substantially eroded.

B. *The Private Placement Exemption and Regulation D*

Not every offering of securities must be registered with the SEC. Certain classes are deemed "exempt securities" in Section 3 of the Securities Act,[38] and certain specific transactions are freed from the registration mandate by Section 4.[39] The SEC gives this summary of the most common of these, placing them in four cate-

---

33. *See* Small Business Initiatives, Securities Act Release No. 6949, Exchange Act Release No. 30,968 [1992–1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,439, at 62,165–66 (July 30, 1992) (repealing Form S-18 and replacing it with Form SB-2 in an effort to "facilitate capital raising by small businesses and reduce the costs of compliance with the federal securities laws"); Additional Small Business Initiatives, Securities Act Release No. 6996, Exchange Act Release No. 32,231 [1992–1993 Transfer Binder] ¶ 85,134, at 84,118–20 (Apr. 28, 1993) (adopting new registration statement Form SB-1 in order to "facilitate financings by small business issuers . . . and their compliance with the reporting requirements"). *See generally* Bryan Vaaler, *Financing a Small Business in Mississippi: A Practitioner's Guide to Federal and State Securities Exemptions, Part I*, 63 MISS. L.J. 129, 184–86 (1993) (explaining the standards for the use of Forms SB-1 and SB-2).

34. *See* Adoption of Integrated Disclosure System, Securities Act Release No. 6383, Exchange Act Release No. 18,524, 1 Sec. Reg. & L. Rep. (BNA) at S-3 (Mar. 10, 1982) ("This action integrates the disclosure systems under the various federal securities laws and simplifies and improves the disclosure requirements imposed under these systems.").

35. Securities Act Rule 415, 17 C.F.R. § 230.415 (2009).

36. Securities Offering Reform 70 Fed. Reg. 44,722, 44,725–27 (Aug. 3, 2005). *But see* Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U. L. REV. 561, 605–07 (2007) (arguing trenchantly that the SEC has gone too far with those reforms and is neglecting its mission of protecting investors).

37. Roberta S. Karmel, *Regulation by Exemption: The Changing Definition of An Accredited Investor*, 39 RUTGERS L.J. 681, 681, 690 (2008).

38. 15 U.S.C. § 77c (2006).

39. *Id.* § 77d.

gories: "[1] [p]rivate offerings to a limited number of persons or institutions; [2] [o]fferings of limited size; [3] [i]ntrastate offerings; and [4] [s]ecurities of municipal, state, and federal governments."[40]

The Commission then goes on to state, "By exempting many small offerings from the registration process, the SEC seeks to foster capital formation by lowering the cost of offering securities to the public."[41] Contrary to the SEC's implication, however, exempt offerings are not required to be small—neither in the dollar amounts they raise nor in the number of investors they involve. The exemption for transactions "not involving any public offering," for instance—the so-called private placements of securities—literally contains no such limits on its applicability.[42] The legislative history of the provision is rather terse, stating that it is intended for situations "where there is no practical need for [the Securities Act's] application or where the public benefits are too remote."[43]

The orthodox interpretation of the exemption comes from a seminal Supreme Court case, *SEC v. Ralston Purina Co.*[44] There the Court refused to impose a numerical limit on the number of offerees or purchasers who could participate in a valid private placement.[45] Rather, the Court said the exemption exists for those who can "fend for themselves," i.e., those who do not need the disclosure compelled by a registration statement to make "informed investment decisions."[46]

The Court in *Ralston Purina* went on to give its opinion that top-level officials of an issuer would be the type of individuals that would be covered by the exemption because they would have access to the type of information contained in a registration statement.[47] Early case law after *Ralston Purina* interpreted the exemption narrowly, making it virtually inapplicable to offerings made to non-institutional investors who were not top officials of

40. Registration Under the Securities Act of 1933, http://www.sec.gov/answers/regis33.htm (alteration in original) (last visited Dec. 18, 2009).

41. *Id.*

42. *See* Securities Act § 4(2), 15 U.S.C. § 77d(2).

43. H.R. REP. NO. 73–85, at 5 (1933).

44. 346 U.S. 119 (1953).

45. *Id.* at 125.

46. *Id.* at 124–25.

47. *Id.* at 125–26.

the issuer.[48] It would have been better if that is where the law had remained.

Instead, responding to promoters who wanted the exemption broadened, the Commission began using its rulemaking authority to create an administrative "safe harbor"—Rule 146—which would allow these exempt offerings to be made to a broader class of investors.[49] These potential purchasers were said, in the language of *Ralston Purina*, to "be able to fend for themselves" because of their wealth or financial sophistication.[50]

Even after the exemption for non-public offerings was broadened by Rule 146, criticism continued that its criteria were still overly technical and unduly burdensome to entrepreneurs.[51] Congress, responding to the small business lobby, then added Section 4(6) to the Securities Act in 1980[52] to prod the SEC into further liberalizing the private placement exemption.[53] The change freed offerings under $5 million from registration so long as they were made only to "accredited investors."[54]

Congress defined that term to include certain financial institutions and other persons that the SEC might so designate "base[d] [on] such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets

---

48. *See, e.g.*, SEC v. Cont'l Tobacco Co., 463 F.2d 137, 158 (5th Cir. 1972) ("The record does not establish that each offeree had a relationship with [the issuer] giving access to the kind of information that registration would have disclosed."); Hill York Corp. v. Am. Int'l Franchises, 448 F.2d 680, 689 (5th Cir. 1971) ("[The Securities Act's] exemptions must be narrowly viewed.").

49. *See* Securities Act § 19(a), 15 U.S.C. § 77s(a) (2006) (empowering the SEC to proscribe rules and regulations to carry out provisions of the Act, and making good faith compliance with those administrative pronouncements a defense to any civil liability imposed by the Act); 17 C.F.R. § 230.146 (2009).

50. *Ralston Purina*, 346 U.S. at 125.

51. *See* Rutheford B. Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139, 1143 (1977) (concluding that "the [SEC] has failed horribly" in its attempt to alleviate the uncertainty surrounding Rule 146); H. David Heumann, *Is SEC Rule 146 Too Subjective to Provide the Needed Predictability in Private Offerings?*, 55 NEB. L. REV. 1, 9 (1975) ("[W]hat is needed is a major overhaul of Rule 146 with the purpose of providing greater *certainty* as to the Rule's application."); Ellsworth A. Weinberg & Michael W. McManus, *The Private Placement Exemption Under the Securities and Exchange Act of 1933 Revisited, and Rule 146*, 27 BAYLOR L. REV. 201, 231–32 (1975) (outlining the pitfalls of Rule 146).

52. Securities Act § 4(6), 15 U.S.C. § 77d(6).

53. Karmel, *supra* note 37, at 686–87.

54. Securities Act §§ 3(b), 4(b), 15 U.S.C. §§ 77c(b), 77d(6).

under management . . . ."[55] Taking its cue from that legislation, as well as the deregulatory fervor of the Reagan administration, the SEC replaced Rule 146 in 1982 with Rule 506 of Regulation D—a new and expanded safe-harbor provision designed to cover not only private placements, but also other exemptions for small and limited offerings.[56]

C. *Enter the Accredited Investor*

Regulation D's major innovation was the "accredited investor": a category of securities purchasers who would automatically meet the *Ralston Purina* criteria of being able to fend for themselves, i.e., they would not need the disclosure compelled in a registration statement.[57] According to former SEC Commissioner Roberta Karmel, this new concept has created a "huge exemption[ ] from [the SEC's] regulatory scheme" and helped create "an enormous private placement market."[58] Included in the definition of that term are not only certain institutional investors and insiders of the issuer, but also individuals with net worths of at least $1 million or annual incomes of at least $200,000 in each of the two most recent years, with expectations of reaching that level in the current year.[59]

Under Rule 506 then, the SEC allows an unlimited amount of money to be raised from any number of accredited investors who do not need to be supplied with any documentary disclosure.[60] Registration is therefore unnecessary, according to the SEC's Regulation D reasoning, if an investor meets certain minimum net worth requirements.[61] Such individuals, regardless of their

55. Securities Act § 2(a)(15), *id.* § 77b(a)(15)(ii).

56. SEC Regulation D Limited Offering Exemption, Securities Act Release No. 33-6389, 14 Sec. Reg. & L. Rep. (BNA) 495 (Mar. 17, 1982).

57. *See* Karmel, *supra* note 37, at 686–87 (discussing regulatory reforms in response to *Ralston Purina*).

58. *Id.* at 681–82.

59. Securities Act Rule 501(a), 17 C.F.R. § 230.501(a) (2008). Net worth valuations can include assets of both spouses. *Id.* Annual income may include any spousal income; however, the threshold income level increases to $300,000 where joint income is relied upon to reach accredited investor status. *Id.*

60. *See id.* §§ 230.502(b)–(c), 230.506(b). Subject to certain restrictions, nonaccredited investors are also allowed to participate in Rule 506 offerings: there can be no more than thirty-five of them; they have to be supplied with registration-like written information; and they or their advisors have to be financially sophisticated. *Id.* § 230.506(b).

61. *Id.* § 230.501(a)(5).

business acumen, are automatically considered able to "fend for themselves" when it comes to purchasing securities. Some questioned, however, whether that is actually the case and correspondingly, whether the SEC had gone beyond its statutory authority in promulgating Regulation D.[62]

Ralston Purina interpreted the Section 4(2) exemption as requiring that offerees be among "the particular class of persons [who do not] need[ ] the protection of the Act."[63] Rule 506, however, focuses solely on purchasers of securities, dispensing with the need for any inquiry into the suitability of those to whom the investment is offered.[64] *Ralston Purina* also held that the exemption was designed for those who "have access to the same kind of information that the Act would make available in the form of a registration statement."[65] Yet Rule 506 has no requirement that accredited investors have such data available to them.[66]

Along those lines, case law following *Ralston Purina* held that for the private placement exemption to be satisfied, all investors must have access to the type of information that registration would provide.[67] Yet it does not follow that wealthy individuals necessarily have such investment data. Even if they do, there is no assurance that on their own they would have the sophistication to analyze it appropriately.[68] Put starkly, it seems that with

62. Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 382 (1984) ("[T]he reforms adopted by the SEC . . . may overestimate the abilities of the presumably wealthy. . . . Experience indicates that the wealthy often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment. Consequently, they frequently fail to seek professional advice . . . ."). The Madoff affair has proven the contemporary relevance of those remarks. *See infra* notes 204–15 and accompanying text.

63. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125, 126 n.12 (1953) ("[O]ne of the factors stressed in an advisory opinion . . . 'as significant [is] the relationship between the issuer and the *offerees*.'" (quoting Letter of General Counsel Discussing the Factors to be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 285, 11 Fed. Reg. 10,952, 10,952 (Jan. 24, 1935) (emphasis added)).

64. *See* 17 C.F.R. § 230.506(b)(2) (exempting offerings on the basis of the expected number of purchasers, the accredited investor status of purchasers, or the sophistication of purchasers).

65. *Ralston Purina*, 346 U.S. at 125–26.

66. *See* 17 C.F.R. § 230.506(b)(2)(ii) (requiring only nonaccredited investors to have access to sufficient knowledge and experience to evaluate the potential investment).

67. Lawler v. Gilliam, 569 F.2d 1283, 1289 (4th Cir. 1978); Doran v. Petroleum Mgmt. Corp., 545 F. 2d 893, 903 (5th Cir. 1977).

68. *See* Warren, *supra* note 62, at 382.

Regulation D the SEC was abandoning attempts to safeguard investors with a certain amount of personal assets from fraud.[69]

In the quarter century since its adoption, the SEC continued to broaden that exemption. As late as the summer of 2007, for instance, the Commission proposed, among other things, to expand the definition of accredited investors to include individuals with as little as $750,000 in "investment owned funds."[70] As Commissioner Karmel has suggested, the Commission was perhaps giving ground again on the scope of the registration requirement to preserve its "jurisdictional grip and ideological purity with respect to the regulation of initial public offerings."[71] In other words, to forestall the outright repeal of the registration requirement by deregulatory zealots, the Commission seemed to be trying to appease them by permitting its death by a thousand cuts.

III. THE WORLD OF CREDIT DERIVATIVES

A. *New, Complex Securities*

In the last decade investment bankers and their lawyers began producing new financial instruments.[72] When combined with various deregulatory developments they produced a lethal mix for the economy.[73] These novel securities were called credit deriva-

69. *Cf. id.* at 382 ("It is important to note that the categories of 'wealthy' investors frequently include widows and orphans whose protection traditionally has been the sacred trust of the SEC."). This is alarming given evidence of widespread investment fraud on the elderly. *See, e.g.*, Press Release, N. Am. Sec. Admr's Ass'n, NASAA Survey Shows Senior Investment Fraud Accounts for Nearly Half of All Complaints Received by State Securities Regulators (July 17, 2006), *available at* http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/4998.cfm; Press Release, U.S. Senate Special Comm. on Aging, Kohl Highlights Senior Investment Scams at Aging Committee Hearing (Mar. 29, 2006), *available at* http://aging.senate.gov/record.cfm?id=268430 ("[W]hile seniors 60 and older make up 15 percent of the U.S. population, they account for about 30 percent of fraud victims.").

70. *See* Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. 45,116, 45,123–24 (Aug. 10, 2007) ("[T]he proposed alternative standards would not result in a reduction in the number of investors eligible for accredited investor status; rather, the standard is intended to ease issuers' threshold determinations and provide a possibly more logical basis for them."). The SEC reasoned that the recommended reduction in the threshold net worth requirements are motivated, in part, by proposed exclusion of the investor's primary residence from future net worth calculations. *Id.* at 45,124 n.88.

71. Karmel, *supra* note 37, at 681.

72. *See* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1020 (2007).

73. *Cf. id.* at 1033 ("[C]ompanies that take on much of the risk . . . have no relation-

tives because their values were based on debts owed to others.[74] Unlike plain vanilla lending agreements where a borrower issues credit instruments such as bonds or debentures as evidence of its debt, these investment contracts were made by parties who were not involved in the original lending transactions.[75]

Those arrangements ostensibly arose to provide more sophisticated risk management for firms and investors.[76] Originators of loans could sell them to others or make contracts protecting themselves in case of default by their borrowers—thus laying off their exposure to loss.[77] In addition, those sellers could enhance their liquidity by getting fresh cash for their loans, enabling them to originate new loans more rapidly.[78] Purchasers of those securities were also said to gain by having new, fruitful investment opportunities.[79]

As recently as 2005, no less a sage than Alan Greenspan was extolling those developments, saying that "the growing array of derivatives and the related application of more-sophisticated methods for measuring and managing risk [has] been [a] key factor[ ] underlying the remarkable resilience of the banking system, which [has] recently shrugged off severe shocks to the economy and the financial system."[80] Greenspan then went on to urge Congress not to regulate this derivative market so that it could continue to grow and innovate.[81] By the same token, he added that

---

ship with the borrower and are less skilled and experienced in evaluating risk. Overall this situation suggests that [use of credit derivatives] . . . can lead to moral hazard on the part of borrowers who are subject to less financial discipline from their lenders.").

74. *See* Jongho Kim, *Can Risks Be Reduced in the Derivatives Market? Lessons from the Deal Structure Analysis of Modern Financial Engineering Debacles*, 6 DEPAUL BUS. & COM. L.J. 29, 29 n.5 (2007).

75. As one astute commentator said about the complex nature of these arrangements,

> It is difficult for civilians to understand a derivatives contract, or any of a range of closely related instruments, such as credit-default swaps. These are all products that were designed initially to transfer or hedge risks—to purchase some insurance against the prospect of a price going down, when your main bet was that the price would go up.

John Lanchester, *Melting into Air*, THE NEW YORKER, Nov. 10, 2008, at 80, 83.

76. *See* Kim, *supra* note 74, at 31.

77. Partnoy & Skeel, *supra* note 72, at 1023–24.

78. *See id.* at 1024–25.

79. *See id.* at 1025.

80. Alan Greenspan, Chairman, Fed. Reserve, Risk Transfer and Financial Stability (May 5, 2005) (transcript available at http://www.federalreserve.gov/boarddocs/speeches/2005/20050505/default.htm) (alteration in original).

81. *See id.*

"the history of the development of these [credit derivatives] encourages confidence that many of the newer products will be successfully embraced by the markets."[82]

These credit derivatives were of two general kinds: collateralized debt obligations ("CDOs") and credit default swaps ("CDSs").[83] The former were a type of securitized asset, generally structured as complex mortgage-backed securities.[84] The latter were contracts, which functioned like an insurance policy against default on a loan.[85] They typically provided that if such a situation occurred, the party who sold this protection would have to pay the principal of the loan to the other party who had bought it as a safeguard against that possibility.[86] The two forms became connected when a CDO was not constructed so as to provide cash flow from actual assets, but rather as a "synthetic CDO" whose income was derived from selling protection on a loan which underlies the CDS.[87]

B. *Collateralized Debt Obligations*

CDOs are a type of asset-backed security and as such are in essence financial commodities.[88] They are contracts that are marketed to investors as offering payouts from an entity holding certain income-producing property.[89] Such arrangements had their genesis in the 1970s when the federal government chartered the

82. *Id.*

83. Partnoy & Skeel, *supra* note 72, at 1019.

84. *See infra* notes 99–103 and accompanying text.

85. *See infra* notes 113–30 and accompanying text.

86. *Id.*

87. *See* Partnoy & Skeel, *supra* note 72, at 1031.

88. *Mortgage-Backed Securities*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/subjects/m/mortgage-backed-securities/index.html?offset=0&s=newest (last visited Dec. 18, 2009); Nathan Vardi, *The Next Big Dump*, FORBES, Dec. 8, 2008, at 36.

89. Partnoy & Skeel, *supra* note 72, at 1019. The SEC has defined an asset backed security, in part, as follows:

> *Asset-backed security* means a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases.

17 C.F.R. § 229.1101(c)(1) (2009).

Federal National Mortgage Association ("Fannie Mae") to purchase residential loans from their originators and issue bonds to investors, promising pay-outs that ultimately came from the home-owner/borrowers.[90] These early mortgage-backed securities had the beneficial result that was intended by their creator, the United States government.[91] They increased the money available for borrowers to buy homes and spread the risk of their default.[92] They were considered safe investments, not only because they were secured by valuable residences, but also because they had the implicit guarantee of the federal government.[93]

This process of backing securities with income-producing properties crossed over to the general world of finance during the 1990s[94] when creative investment bankers began taking income-generating assets, such as credit card receivables and auto loans, and bundling them into packages.[95] They then sold them to a specially created entity that would issue securities based on their payouts.[96] Like mortgage-backed securities, those new arrangements were touted as providing an immediate, fresh source of capital for the original lenders,[97] while providing investors with new products that would furnish them bountiful income streams.[98]

In the real estate boom of this decade, however, the market for mortgage-backed securities boomed and those arrangements morphed into more complicated CDOs.[99] Bankers would set up special purpose entities ("SPEs") to acquire various loan portfolios secured either by parcels of real estate or by corporate debt.[100] They would then sell securities issued by the SPEs in various segments called tranches, which would be rated according to the

---

90. Nomi Prins, *The Risk Fallacy*, FORTUNE, Nov. 10, 2008, at 112.

91. *Mortgage-Backed Securities*, *supra* note 88.

92. *Id.*

93. U.S. Securities and Exchange Commission, Mortgage-Backed Securities, http://www.sec.gov/answers/mortgagesecurities.htm (last visited Dec. 18, 2009).

94. Prins, *supra* note 90.

95. *See, e.g.*, DWIGHT ASSET MANAGEMENT CO., FIXED INCOME PRIMER: ASSET-BACKED SECURITIES 1 (2005).

96. Partnoy & Skeel, *supra* note 72, at 1027.

97. *Id.* at 1025; *Mortgage-Backed Securities*, *supra* note 88.

98. *Mortgage-Backed Securities*, *supra* note 88.

99. *See id.*

100. *See* Partnoy & Skeel, *supra* note 72, at 1027.

quality of the assets supporting them.[101] Different tranches would thus, in theory, bear different risks. Typically, however, the bankers would arrange to have purportedly independent rating agencies certify all but the most junior tranches as investment quality.[102] "Billions of dollars in these instruments were [thus] sold and resold," usually to institutional investors.[103]

This financial engineering was said to have benefits that "'complete[d]' the markets" by giving investors a wide array of choices of purportedly high-yield securities.[104] The bankers used mathematical formulae that offered state-of-the-art precision to predict defaults and recovery rates.[105] The mathematical formulae were also used to explain how particular tranches had more value than the aggregated value of their component mortgages.[106] This arbitrage arose, some asserted, because either the underlying assets were originally mispriced or the weaker ones would have more value when mixed with stronger properties.[107] One commentator fancifully compared this financial alchemy to the ability of "a pastry chef [to] take a motley assortment of old fruit and turn it into a delicious pie."[108]

For these organizational services and for continuing to manage the underlying collateral, the bankers[109] and their lawyers garnered substantial fees.[110] Such remuneration was justified by the increased value those securities gave investors over direct pur-

---

101. *Id.* at 1027–28.

102. *See generally* Prins, *supra* note 90.

103. *Mortgage-Backed Securities*, *supra* note 88; *see* John Waggoner & Matt Krantz, *Weighing the Value of the Unwanted; Pricing Mortgage-Backed Securities Will Be Tough*, USA TODAY, Sept. 24, 2008, at 1B.

104. *See* Partnoy & Skeel, *supra* note 72, at 1027.

105. Prins, *supra* note 90. Experts from the fields of science nicknamed "quants" migrated to financial companies and began applying mathematical models to investing strategies. The recent economic collapse however has proven that their theories are anything but fool-proof, prompting Warren Buffett to wryly remark "beware of geeks bearing formulas." Dennis Overbye, *They Tried to Outsmart Wall Street*, N.Y. TIMES, Mar. 10, 2009, at D1.

106. Partnoy & Skeel, *supra* note 72, at 1029.

107. *Id.* at 1028.

108. Prins, *supra* note 90.

109. *Id. But see* Penny Crosman, *Collateral Damage*, WALL STREET & TECH., Dec. 1, 2008 (identifying the poor quality of management that the bankers provided for the valuing and managing of such collateral).

110. Until recently, major law firms in cities like New York and Chicago had half their attorneys working on these "structured finance" operations. *See* Ameet Sachdev, *Chicago Law Firm Adds 100 in New York*, CHICAGO TRIB., Dec. 23, 2008, at 23.

chases of the underlying assets.[111] In addition, the bankers who assembled the portfolios of assets held themselves out as having special expertise in evaluating the collateral. They claimed it would give investors the ability to increase their profits by pooling their resources "with other investors to obtain a divided ownership interest in a diverse portfolio of bonds."[112]

C. *Credit Default Swaps*

In its simplest form, a credit default swap is a contract that a lender makes with another party providing that in the event of the borrower's default, the other party will allow the lender to trade the loan instrument to it for its full payment.[113] In essence then, a CDS is a form of insurance that a lender purchases to mitigate the risk of a borrower's failure to pay back its loan.[114] The lender pays a fee to its counterparty who sells it this protection. In the event of a default, the lender gets to swap its loan to the counterparty who sold it the right to be indemnified by treasury bills worth the full amount of the note.[115] If there is no default, the seller/counterparty has made a profitable arrangement and the original lender's payments diminish its profit on the loan.[116]

CDSs are therefore hedges,[117] and as such they were once called "wonder[s] of modern finance."[118] By the same token they were hailed by Greenspan, among others, as needed shock absorbers in our financial system. For instance, because many of the banks lending to companies like Enron and WorldCom had such agree-

111. *See supra* notes 104–08 and accompanying text.

112. Partnoy & Skeel, *supra* note 72, at 1030.

113. Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 175 (2007).

114. *But see id.* at 181–88 (explaining how credit default swaps are structured so as not to come under regulation as insurance).

115. Martin Mayer, *A Credit-Default Solution*, BARRON'S, Nov. 24, 2008, at 41; *see also* Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008, *available at* http://www.time.com/time/business/article/0,8599,1723152,00.html.

116. Partnoy & Skeel, *supra* note 72, at 1019. One commentator has noted that CDSs are prime examples of "'asymmetric risk positions.' These are products or contracts that, in general, generate small gains and very rarely have losses. But when they do have losses, they are huge." As such, they can present a false picture of a money manger's performance using conventional "Value-at-Risk" standards. Joe Nocera, *Risk Mismanagement*, N.Y. TIMES, Jan. 4, 2009 (Magazine), at 24.

117. Schwartz, *supra* note 113, at 169.

118. *Credit Derivatives: The Great Untangling*, ECONOMIST, Nov. 6, 2008, at 12.

ments, they were said to have been able to limit their exposure in those financial scandals.[119]

The outstanding amount of CDS protection and liability has grown from virtually nothing a decade ago, to an estimated $62 trillion at the end of 2007.[120] Typical sellers have been banks, insurance companies, and hedge funds with the top twenty-five banks being on either side of $13 trillion in these contracts at the end of the third quarter in 2007.[121] Such arrangements, however, are not limited to actual lenders but can be entered into by anyone who is interested in making a bet about the creditworthiness of an entity. Along those lines, any investors can make or purchase these contracts as speculative wagers on the direction of credit spreads.[122]

CDSs are all traded over-the-counter in private arrangements, and thus no central platform or exchange monitors or records these transactions.[123] In addition, under the Commodities Futures Modernization Act of 2000, it is illegal to regulate CDSs.[124] In that regard, Sections 2A(a)–(b) and 3A(a)–(b)[125] of the Securities Act and the Securities Exchange Act, respectively, provide that CDSs are not securities. But for that, they would easily come under the "investment contract" definition of a security[126] because in such dealings, profit is expected solely from the efforts of others,[127] spe-

---

119. *See* Alan Greenspan, Chairman, Fed. Reserve, Before the Council on Foreign Relations (Nov. 19, 2002) (transcript available at http://www.federalreserve.gov/boarddocs/speeches/2002/20021119/default.htm).

120. *Credit Derivatives: The Great Untangling, supra* note 118.

121. *See* Morrissey, *supra* note 115.

122. David Bogoslaw, *Regulating Credit Default Swaps: Will It Work?*, BUS. WK., Nov. 21, 2008, *available at* http://www.businessweek.com/investor/content/nov2008/pi20081119_756744.htm.

123. *Id.*

124. Pub. L. No. 106-554, 114 Stat. 2763A. SEC Chairman Christopher Cox acknowledged that in testimony before Congress calling the CDS market "completely lacking in transparency and completely unregulated." *Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, Testimony Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 2 (2008) (testimony of Christopher Cox, Chairman, SEC).

125. 15 U.S.C. § 77b-1 (2006); *id.* § 78c-1. These provisions were part of the Gramm-Leach-Bliley Act of 1999. The law's namesake and principal sponsor, former Senator Phil Gramm, continues to defend the Act against charges that it contributed to the financial meltdown. Phil Gramm, *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17, *available at* http://online.wsj.com/article/SB123509667125829243.html.

126. Securities Act § 2(a)(1), 15 U.S.C. § 77b(a)(1); Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10).

127. SEC v. W.J. Howey, 328 U.S. 293, 301 (1946).

cifically the bankers who package, sell, and manage those arrangements.

When CDSs were originally created in the strong economy of the late 1990s, they were seen as lucrative and safe investments when offered as swap protection to holders of municipal and corporate bonds that rarely defaulted.[128] In recent years, however, they have been more often sold to CDOs and freely traded among banks, hedge funds,[129] and other investors who did not know the resources or potential liabilities of their counterparties or the original obligors on those instruments.[130]

D. *Easy Money, Inflated Real Estate, and Hedge Funds*

A description of how these unregulated credit derivatives precipitated the economic collapse of 2008 is incomplete without some further background on three conditions that enabled them to become the tools for rampant risk-taking. Beginning early this decade, unregulated pools of capital called hedge funds and other investment firms borrowed huge amounts of money at very little cost. Much of those resources were then used to buy high-yielding CDOs backed by subprime mortgages, that is, loans made to homebuyers of questionable creditworthiness and secured only by their overvalued residences.[131]

Fearing an economic slowdown after the dot-com bust and the 9/11 attacks, the Federal Reserve Bank, under the leadership of Chairman Greenspan, cut the key interest rate under its control early in this decade from 3.5% to 1%, the lowest since the

---

128. Morrissey, *supra* note 115.

129. *Id.*

130. As one authority noted, even before the credit collapse of 2008,

> [t]he market for credit default swaps is quite opaque. . . . Thickening the informational fog still further is the frequency with which one of the original parties sells its stake to someone else without notifying the other party. "Recording-keeping, documentation and other practices have been so sloppy," as a recent article put it, "that no firm could be sure how much risk it was taking or with whom it had a deal."

Partnoy & Skeel, *supra* note 72, at 1036.

131. *See* LAURIE S. GOODMAN ET AL., SUBPRIME MORTGAGE CREDIT DERIVATIVES 299–300 (2008); PAUL MUOLO & MATTHEW PADILLA, CHAIN OF BLAME: HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS 219–13 (2008).

1950s.[132] Only in 2004 did the Federal Reserve Bank begin raising it; however, it did so slowly and only in small increments.[133]

But early in the decade, a housing boom had already begun, thanks in part to the repeal of capital gains taxes on almost all home sales during the Clinton years[134] and policies undertaken at the onset of the Bush administration to encourage home ownership.[135] Those factors, when coupled with historically low interest rates, began "'fueling the mother of all housing bubbles.'"[136] Home prices spiked to such a level that Time Magazine's cover on June 13, 2005, declared, "Home $weet Home: Why We're Going Gaga over Real Estate."[137]

With cheap money and home prices soaring, banks and other mortgage-makers eased their lending policies, creating the "liar loan" phenomenon where "mortgages [were] approved without requiring proof of the borrower's income or assets."[138] As one commentator described the ensuing frenzy, "Families bought homes they couldn't have afforded at higher interest rates; speculators bought properties to flip; people with modest incomes or poor credit took out . . . sub-prime loans, interest-only loans, and 'Alt-A' loans."[139]

---

132. John Cassidy, *Anatomy of a Meltdown: Ben Bernanke and the Financial Crisis*, THE NEW YORKER, Dec. 1, 2008, at 49, 52.

133. *Id.*

134. *See* Vikas Bajaj & David Leonhardt, *1997 Tax Break on Home Sales May Have Helped Inflate Bubble*, N.Y. TIMES, Dec. 19, 2008, at A1.

135. *See* Jo Becker et al., *Ambition of Bush on Housing*, INT'L HERALD TRIB., Dec. 22, 2008, at 11.

136. Bajaj & Leonhardt, *supra* note 134 (quoting Vernon L. Smith, a winner of the Nobel Prize for Economics).

137. *See* James Poniewozik, *America's House Party: Record Home Prices Are Inflaming Passions—and Pocketbooks—as Never Before: Inside Our Raucous Obsession with Real Estate*, TIME, June 13, 2005, at 16.

138. Associated Press, *"Liar Loans" Threaten to Prolong Mortgage Mess: Mortgages Allowed Without Proof of Pay, Assets Default in Record Numbers*, Aug. 18, 2008, http://www.msnbc.msn.com/id/26270434/. For a piece describing how the mortgage industry encouraged deceit in this practice, see Mark Gimein, *Inside the Liar's Loan: How the Mortgage Industry Nurtured Deceit*, SLATE, Apr. 24, 2008, http://www.slate.com/id/2189576.

139. Cassidy, *supra* note 132, at 52. Michael Lewis provides a graphic description of the worst of these loans:

> They'd be in what Wall Street people were now calling the sand states: Arizona, California, Florida, Nevada. The loans would have been made by one of the more dubious mortgage lenders; Long Beach Financial, wholly owned by Washington Mutual, was a great example. Long Beach Financial was moving money out the door as fast as it could, few questions asked, in loans built to self-destruct. It specialized in asking homeowners with bad credit and no

Originators were hardly bothered by this lack of creditworthiness because they were able to sell the loans they made to promoters who bundled them to back CDOs that were sold by Wall Street firms.[140] Their ultimate purchasers were not just hedge funds, but supposedly conservative institutions like government agencies "hoping for fast gains to cover growing pension costs and budgets without raising taxes."[141]

Recent decades also saw the rise in such unregulated investment pools that were given the generic name of "hedge funds"[142] because of their supposed usage of diversified strategies to protect their holdings.[143] For a time, these companies appeared to generate "alpha" profits for their investors, principally through bor-

---

> proof of income to put no money down and defer interest payments for as long as possible. In Bakersfield, California, a Mexican strawberry picker with an income of $14,000 and no English was lent every penny he needed to buy a house for $720,000.

Michael Lewis, *The End*, PORTFOLIO.COM, Nov. 11, 2006, http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom/index.html. Even George Bailey would not make a mortgage for such an applicant. *See* IT'S A WONDERFUL LIFE (Liberty Films 1946) (a 1946 motion picture by Frank Capra that starred Jimmy Stewart as George Bailey, a compassionate president of a building and loan who helped working people buy homes).

140. *See* Cassidy, *supra* note 132, at 52. For two well-researched and written exposés of how once reputable financial houses like Merrill Lynch and Bear Stearns created this investing travesty, see generally MUOLO & PADILLA, *supra* note 131; MARK ZANDI, FINANCIAL SHOCK (2009).

141. Charles Duhigg & Carter Dougherty, *From Midwest to M.T.A., Pain From Global Gamble*, N.Y. TIMES, Nov. 2, 2008, at A1.

142. For a good explanation of why hedge funds were unregulated, see Sargon Daniel, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247 (2007).

The SEC made an attempt in 2004 to require hedge fund managers to register under the Investment Advisors Act of 1940 under Rule 203(b)(3)-2 of that Act. 17 C.F.R. § 275.203(b)(3)-2(a) (2009). Advisors with fewer than fifteen clients were exempt from that mandate but the SEC's modified rule would have "looked through" institutional entity investors to count each of their members as clients. 15 U.S.C. § 80b-3(b)(3) (2006). The U.S. Court of Appeals for the District of Columbia, however, struck down that interpretation of the rule. Goldstein v. SEC, 451 F.3d 873, 884 (D.C. Cir. 2006).

143. THOMAS P. LEMKE ET AL., HEDGE FUNDS & OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE § 1.1 (2008); *see also* STAFF REPORT TO THE U.S. SEC. AND EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, at 33–37 (2003).

Former SEC chairman William Donaldson called hedge funds the "'catch-all classification for many unregistered privately managed pools of capital.'" Jessica Natali, Comment, *Trimming the Hedges is a Difficult Task: The SEC's Attempt to Regulate Hedge Funds Falls Short of Expectations*, 15 U. MIAMI BUS. L. REV. 113, 116 (2006). Fashioning perhaps a more direct definition, one author has called hedge funds "private and largely unregulated investment pools for the rich." ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 24 (2000).

rowed funds to buy CDOs that offered hefty returns.[144] Companies also gained what appeared to be easy income from selling CDS protection.[145] Managers of these funds charged their clients exorbitant fees, which sometimes totaled thirty-three percent of their gains,[146] and structured those compensation arrangements so that their income was only taxed at the capital gain rate of fifteen percent rather than as ordinary income at thirty-five percent.[147]

In 2007, several hedge-fund operators made over an astounding $1 billion in compensation each,[148] and at their height, there were over 10,000 of those entities.[149] As a public official said recently, "'For the past five or six years, it seemed like anybody could go to their computer and print up a business card and say they were in the hedge fund business, and raise a pot of money' . . . ."[150]

Nor did old-line established investment banks eschew those speculative maneuvers. In 2004, they requested that the SEC loosen the net capital rules that required their brokerage units to maintain certain levels of reserves.[151] Leaders of those prestigious institutions, including Henry Paulson, then-CEO of Goldman Sachs, assured the SEC that their firms had the sophisticated

---

144. As one commentator wrote,

> The new secret of accumulation was presumed to be leverage and risk management, which allowed . . . the borrowing of many times the amount the investor had in equity capital—perhaps ten, twenty, thirty, or in some cases a hundred times as much. When so highly leveraged, even a small rise in value could return great profit on the initial investment.

William K. Tabb, *Four Crises of the Contemporary World Capitalist System*, MONTHLY REV., Oct. 2008, at 43, 44–45.

145. *See supra* notes 113–16 and accompanying text.

146. John Cassidy, *Hedge Clipping: Is There a Way to Get Above-Market Returns on the Cheap?* THE NEW YORKER, July 2, 2007, at 28.

147. *See* David Cay Johnston, *Tax Loopholes Sweeten a Deal for Blackstone*, N.Y. TIMES, July 13, 2007, at A1; Paul Krugman, Op-Ed., *An Unjustified Privilege*, N.Y. TIMES, July 13, 2007, at A19. One formidable advocate for such privileges has been Senator Charles E. Schumer. *See* Eric Lipton & Raymond Hernandez, *A Champion of Wall Street Reaps the Benefits*, N.Y. TIMES, Dec. 14, 2008, at A1.

148. Jesse Eisinger, *The Hedge Fund Collapse*, PORTFOLIO.COM, Nov. 11, 2008, http://www.portfolio.com/views/columns/wall-street/2008/11/11/Collapsing-Hedge-Fund-Industry/index.html.

For the author's views on the implications such excessive compensation has on concerns of social justice, see Daniel J. Morrissey, *American Catholics in the New Gilded Age*, AMERICA, Jan. 7–14, 2008, at 22.

149. Cassidy, *Hedge Clipping*, *supra* note 146.

150. Louise Story, *Hedge Funds' Steep Fall Sends Investors Fleeing*, N.Y. TIMES, Oct. 23, 2008, at A1 (quoting Richard H. Moore, the treasurer of North Carolina).

151. *See* Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. TIMES, Oct. 3, 2008, at A1.

computer models needed to assess the riskiness of their portfolios.[152] "Those funds," noted one observer, "could then flow up to the parent company enabling it to invest in the fast-growing but opaque world of mortgage-backed securities; credit derivatives, a form of insurance for bond holders [CDSs]; and other exotic instruments."[153]

The SEC's actions had their intended effects, with many investment banks substantially increasing their borrowing.[154] The firm of Bear Stearns, for instance, ultimately had thirty-three dollars in debt for every one dollar it maintained in reserves.[155] In exchange for its relaxation of the net-capital rules, the SEC invited the banks to participate in a voluntary program to disclose their investments—Consolidated Supervised Entities[156]—but it had only spotty involvement by those firms and was given low priority by the SEC.[157]

However, investors in CDOs and other exotic, unregulated securities received assurance from apparently reputable agencies that graded the quality of corporate debt—most often they certified those instruments as highly creditworthy.[158] It appears now, however, that those firms were so handsomely paid for their rat-

---

152. *See id.*

153. *Id.* (alteration in original).

154. *See id.*

155. *Id.* Such outrageous speculation would not have happened if these bankers had "skin in the game." According to prize winning author Michael Lewis,

> The moment Salomon Brothers demonstrated the potential gains to be had by the investment bank as a public corporation, the psychological foundations of Wall Street shifted from trust to blind faith. No investment bank owned by its employees would have levered itself 35 to 1 or bought and held $50 billion in mezzanine C.D.O.'s. I doubt any partnership would have sought to game the rating agencies or leap into bed with loan sharks or even allow mezzanine C.D.O.'s to be sold to its customers. The hoped-for short-term gain would not have justified the long-term hit.

Lewis, *supra* note 139.

156. Stephen Lebaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, at A1.

157. *See id.* On September 26, 2008, SEC Chairman Cox announced that the CSE program would be abandoned because it was unsuccessful. U.S. Sec. & Exch. Comm'n, Statement of Chairman Cox on IG Reports Regarding CSE Program (Sept. 26, 2008), http://www.sec.gov/news/press/2008/2008-231.htm.

158. *See* Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping?*, N.Y. TIMES, Dec. 7, 2008, at A1. As a report in the Wall Street Journal put it, "Most credit-rating firms are paid by underwriters issuing the same debt they rate, and critics say they had an incentive to give the debt products favorable ratings to win future business." Damian Paletta & Kara Scannell, *Ten Questions for Those Fixing the Financial Mess*, WALL ST. J., Mar. 10, 2009, at A10.

ing services there that they "either underestimated the risk of mortgage debt or simply overlooked its danger."[159]

Internal skepticism about the generosity of those investment grades was ignored at the rating agencies. An email exchange between two analysts at one firm said it all. One wrote, "'That deal is ridiculous,' . . . 'We should not be rating it.' 'We rate every deal,' came the response. 'It could be structured by cows and we would rate it.'"[160] Another analyst wrote this in an email about securities backed by subprime mortgages, "'Let's hope we are all wealthy and retired by the time this house of cards falters.'"[161]

Nobel Prize winning economist Paul Krugman summed up all these practices quite well:

> Consider the hypothetical example of a money manager who leverages up his clients' money with lots of debt, then invests the bulked-up total in high-yielding but risky assets, such as dubious mortgage-backed securities. For a while—say, as long as a housing bubble continues to inflate—he (it's almost always a he) will make big profits and receive big bonuses.[162]

IV. WALL STREET'S COLLAPSE AND THE MADOFF FIASCO

A. *Unheeded Predictions*

Professor Krugman, however, finished the description of his hypothetical money manager with this conclusion, "Then, when the bubble bursts and his investments turn into toxic waste, his investors will lose big—but he'll keep those bonuses."[163] That is exactly what happened in the Great Meltdown of '08, which was

---

159. Morgenson, *supra* note 158.

160. Gretchen Morgenson, *They're Shocked, Shocked About the Mess*, N.Y. TIMES, Oct. 26, 2008, at BU1; *see also* Lewis, *supra* note 139 and accompanying text.

161. Michael M. Grynbaum, *Study Finds Flawed Practices at Ratings Firms*, N.Y. TIMES, July 9, 2008, at C1.

162. Paul Krugman, Op-Ed., *The Madoff Economy*, N.Y. TIMES, Dec. 19, 2008, at A45.

163. *Id.* A recent commentator pointed out that almost a century ago the great corporate reformer and later Supreme Court Justice Louis Brandeis had described the same type of reprehensible behavior on Wall Street. "Our current crisis, after all, was in part fueled by bankers making big gambles with other people's cash. They bundled and sold sub-prime mortgages, took their profits, and then left others holding portfolios full of worthless, even toxic, paper. This was exactly the kind of behavior that Brandeis despised." Melvin I. Urofsky, *The Value of 'Other People's Money'*, N.Y. TIMES, Feb. 7, 2009, at A21.

precipitated by a drastic decline in the value of residential real estate that backed many of the CDOs.

Michael Lewis tells the story of a skeptical market analyst who knew of the untrustworthiness of sub-prime loans and tried to figure out "how the rating agencies justified turning BBB loans into AAA-rated bonds."[164] Whenever he would talk to people at a rating agency and ask what would happen to default rates if real estate prices fell, he always got the same answer:[165] the models "for home prices had no ability to accept a negative number. 'They were just assuming home prices would keep going up.'"[166]

No less an esteemed investor than Warren Buffett had been warning for years about the dangers of financial derivatives. In 2003 he wrote, "'No matter how financially sophisticated you are, you can't possibly learn from reading the disclosure documents of a derivatives-intensive company what risks lurk in its positions."[167] The self-same sage of Omaha also prophetically called CDOs "'financial weapons of mass destruction.'"[168]

However, with Alan Greenspan both fueling the housing boom with cheap money[169] and actively discouraging any regulation of financial derivatives,[170] it was difficult for any critics to point out potential problems with "the Maestro's" rosy scenarios.[171] In 2004, his last full year as Federal Reserve Bank Chairman, Greenspan was saying that it was unlikely a housing bubble was building.[172] In 2005, Greenspan's successor Benjamin Bernanke also denied that the real estate market was inflated.[173] In addition, Bernanke spoke out in May 2006 against regulation of hedge funds, saying

---

164. Lewis, *supra* note 139.

165. *Id.*

166. *Id.*

167. Lanchester, *supra* note 75, at 83.

168. *See* Mortimer B. Zuckerman, *The Credit Crisis Grows*, U.S. NEWS & WORLD REPORT, Dec. 24, 2007, at 68. For others who predicted the collapse of economic meltdown, see Lanchester, *supra* note 75, at 83–84; *All Things Considered: The Man Who Predicted the Economic Meltdown* (NPR broadcast Dec. 4, 2008), *available at* http://www.npr.org/templates/story/story.php?StoryId=97801606.

169. *See* Cassidy, *supra* note 132, at 52.

170. *See Credit Derivatives: The Great Untangling*, *supra* note 118.

171. Cassidy, *supra* note 132, at 53 (quoting William White, an economist for the Bank of International Settlements in Basel, Switzerland who had been warning about credit and real estate bubbles since 2003).

172. *Id.* at 52.

173. *Id.*

such action would "stifle innovation" and praising the mathematical models those funds had developed "'for identifying, measuring, and managing their risks.'"[174]

B. *The Death of Wall Street*

It is now painfully apparent that Greenspan, Bernanke, and almost the entire financial establishment were dead wrong. In the succinct words of one commentator, "By extending mortgages to unqualified lenders and accumulating large inventories of subprime securities, banks and other financial institutions took on enormous risks, often without realizing it."[175] Experts are debating whether this enormous overextension resulted from just a failure of Wall Street's mathematical models or whether it was attributable to something far worse: that the people responsible for those "excessive and foolhardy" investments were recklessly endangering the entire financial system.[176]

The latter view is the correct one. As one commentator has stated, "Human beings did these things."[177] "Simply put, the lenders lent with unimaginable foolishness and made incredibly risky bets. And the bets busted."[178] The housing bubble peaked in 2005 and 2006. As Greenspan himself admitted in later testimony to Congress, "The whole intellectual edifice [of the theories behind derivative pricing and risk management] . . . collapsed in the summer of [2007] because the data input into the risk-management models generally covered only the past two decades, a period of euphoria."[179]

One English observer described the situation with greater precision:

> [A]s markets that were crucial for raising funds started to dry up [in] August [2007], a network of financial vehicles slid into crisis, causing the price of many debt securities to collapse. That[ ]started a chain reaction that created liquidity and solvency crises at US and Euro-

174. *Id.* at 54.
175. *Id.*
176. *See* Nocera, *supra* note 116.
177. Ben Stein, *You Don't Always Know When the Sky Will Fall*, N.Y. TIMES, Oct. 26, 2008, at BU7.
178. Ben Stein, *Before the Fear, There Was Foolishness*, N.Y. TIMES, Dec. 14, 2008, at BU8.
179. Nocera, *supra* note 116.

> pean banks[—]on a scale last seen in Japan almost exactly a decade ago.[180]

This concatenation of events seemed to culminate in the collapse and fire-sale of Bear Stearns, a major investment bank, on St. Patrick's Day weekend in 2008.[181]

After the rescue of Bear Stearns, the financial system appeared to settle for a while.[182] In reality, however, the situation continued to deteriorate since the market in mortgage-backed securities had effectively collapsed the previous summer. All that was left of that sector were two federally chartered corporations, Fannie Mae and the Federal Home Loan Mortgage Corporation ("Freddie Mac").[183] When the shares of those two companies began to fall precipitously in the summer of 2008,[184] the Federal Reserve Bank at first announced plans to invest money in them to keep them afloat.[185] By Labor Day, however, they stood so perilously close to defaulting on their obligations that the U.S. Treasury announced a complete government takeover.[186]

Yet this "finger-in-the-dike" strategy failed miserably just a few days later when the major investment bank, Lehman Brothers, started to go down.[187] This time there was no government-sponsored rescue plan. As the Wall Street Journal put it, "It was a weekend unlike anything Wall Street had ever seen: In past crises, its bosses had banded together to save their way of life. This time, the financial hole they had dug for themselves was too

---

180. Gillian Tett, *The Big Freeze: A Year That Shook Faith in Finance*, FINANCIAL TIMES (London), Aug. 3, 2008.

181. For a good description of the unfolding of these events, see Kate Kelly, *Lost Opportunities Haunt Final Days of Bear Stearns*, WALL ST. J., May 27, 2008, at A1. Just days before that firm's collapse, SEC Chairman "Christopher Cox was told by his staff that Bear Stearns had $17 billion in cash and other assets—more than enough to weather the storm." Labaton, *supra* note 151. Cox's misinformation was a result of the SEC's own action in 2004 that relaxed the amount of capital investment firms like Bear Stearns had to maintain in reserves. *Id.*

182. Cassidy, *supra* note 132, at 60.

183. *Id.* at 60–61.

184. James R. Haggerty, Deborah Solomon, & Damian Paletta, *U.S. Mulls Future of Fannie, Freddie—Administration Ramps Up Contingency Planning As Mortgage Giants Struggle*, WALL ST. J., July 10, 2008, at A1; *see also* Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A1.

185. Cassidy, *supra* note 132, at 61.

186. James R. Hagerty, Ruth Simon & Damian Paletta, *U.S. Seizes Mortgage Giants*, WALL ST. J., Sept. 8, 2008, at A1.

187. Cassidy, *supra* note 132, at 61–62.

deep."[188] Lehman went bankrupt on Monday, September 15, 2008.[189]

The financial system, however, did not stop unraveling and at the heart of the turmoil were credit default swaps. Bear Stearns had been a big dealer in them—it reportedly had more than five thousand institutional partners with whom it had traded CDSs.[190] That was a good part of the reason it was not allowed to fail.[191] Lehman's bankruptcy, however, caused renewed panic in the credit markets because it too had been a major dealer in CDSs.[192] The next day a prominent money-market fund, Reserve Primary, announced it had "broken the buck"—the value of its assets had fallen below $1 per share.[193] That meant in effect that the country's short-term credit markets had frozen up.[194]

Soon after that the Federal Reserve Bank had to agree to loan up to $85 billion to the giant insurance company, A.I.G.,[195] whose London office was on the hook for hundreds of billions of dollars of CDSs protection.[196] Immediately after that, Federal Reserve Bank Chairman Bernanke and Treasury Secretary Paulson met with congressional leaders and reportedly told them that if they did not pass a massive bailout bill "there might not be an economy on Monday."[197]

Congress eventually appropriated up to $700 billion under the bailout bill.[198] After initially planning to have those funds buy up distressed mortgage-backed securities,[199] Bernanke and Paulson

188. Susanne Craig et al., *The Weekend That Wall Street Died*, WALL ST. J., Dec. 29, 2008, at A1 (examining the excruciating attempts by Lehman to survive).

189. *Id.*

190. Cassidy, *supra* note 132, at 59.

191. *See id.*

192. *The Great Untangling*, THE ECONOMIST, Nov. 8, 2008, at 85.

193. Cassidy, *supra* note 132, at 62.

194. Joe Nocera, *36 Hours of Alarm and Action as Crisis Spiraled*, N.Y. TIMES, Oct. 2, 2008, at A1.

195. Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1.

196. *The Great Untangling*, *supra* note 192, at 85. After a $62 billion loss in its fourth quarter—the biggest quarterly loss in history—the U.S. government offered another $30 billion in assistance to AIG. Andrew Ross Sorkin & Mary Williams Walsh, *U.S. Said to Offer $30 Billion More to Help Insurer*, N.Y. TIMES, Mar. 2, 2009, at A1.

197. Nocera, *supra* note 194.

198. Greg Hitt & Deborah Solomon, *Historic Bailout Passes As Economy Slips Further*, WALL ST. J., Oct. 4, 2008, at A1.

199. Cassidy, *supra* note 132, at 62.

decided to use them instead to provide more direct liquidity to the financial system by making direct investments in commercial banks.[200] However, in the first months of 2009, both the country's housing market and the financial system continued to remain in great distress.[201] One analyst estimated that the combined economic rescue actions could cost the federal government $8.5 trillion and "higher interest rates and soaring inflation will be risks."[202] Another noted about the bailouts that "[i]t's anybody's guess what will ultimately be gained or lost. . . . If the recession deepens and the markets don't heal, the losses one day could get very large."[203]

C. *The World's Biggest Ponzi Scheme*

During the last weeks of 2008 came the *piece de resistance* of the financial collapse. Bernard Madoff, a long time lion of Wall Street, appeared to admit that his successful money-management firm was "'all just one big lie'" and "'basically a giant Ponzi scheme.'"[204] Total losses from Madoff's blue-chip clientele may amount to $50 billion.[205] Madoff's firm incredibly reported steady gains of approximately one percent each month for over twenty

---

200. Jon Hilsenrath, *The Key Numbers Behind the Bailouts*, WALL ST. J., Dec. 13, 2008, at A3.

201. Editorial, *The Government and the Banks*, N.Y. TIMES, Feb. 22, 2009, at WK9. The N.Y. Times made this telling comment about the precarious position of major banks like Citigroup and Bank of America: "Rescue measures have so far prevented a system-wide meltdown, but they have not reversed the downward slide or revived bank lending." *Id.*

As another commentator described the dismal situation,

> We now have a giant margin call and painful deleveraging following the mother of all credit cycles. The resulting widespread insolvency in financial institutions was magnified by the over-the-counter derivatives subject to counterparty risk creating uncertainty about who was or might quickly become insolvent. The tardy Treasury and Fed recognition, ad hoc bailouts, and letting Lehman fail added confusion. Private capital fled and even interbank lending froze.

Michael Boskin, *Investors Want Clarity Before They Take Risks*, WALL ST. J., Jan. 23, 2009, at A15.

202. Jim Puzzanghera, *Bailout: Pay Now, Worry Later*, L.A. TIMES, Nov. 30, 2008, at A1.

203. Hilsenrath, *supra* note 200.

204. Diana B. Henriques & Zachery Kouwe, *Prominent Trader Accused of Defrauding Clients*, N.Y. TIMES, Dec. 12, 2008, at A1.

205. Diana B. Henriques & Alex Berenson, *The 17th Floor, Where Wealth Went to Vanish*, N.Y. TIMES, Dec. 15, 2008, at A1. For a good description of how Madoff fleeced the members of an exclusive club, see Ian Urbina, *A Palm Beach Enclave, Stunned by an Inside Job*, N.Y. TIMES, Dec. 15, 2008, at B1.

years, never once suffering a loss.[206] Even investors who should have known that such returns were too good to be true, like Henry Kaufman, the former chief economist of Salomon Brothers, placed some of their funds with Madoff.[207]

SEC Chairman Christopher Cox was forced to admit that his agency had received "credible and specific" allegations about the scheme for a decade.[208] One such complainant, Harry Markopolos, a former officer with a Boston investment company, had been trying for nine years to explain to the SEC how "'Madoff Securities is the world's largest Ponzi Scheme.'"[209] It seems even some of Madoff's investors may have sensed that he was not on the level but did not want to end an operation that was profiting them.[210]

The episode represented another black eye for the SEC, a once well-reputed agency renowned for its diligence and integrity.[211] As one Congressman said angrily, "'We now know that our securities regulators have not only missed opportunities to protect investors against massive losses from the most complex financial instruments like derivatives, they have also missed the chance to protect them from the simplest of scams, the Ponzi scheme.'"[212]

Commentators speculated that the SEC's zeal had been compromised by reluctance to take any actions that might undermine short-term profitability in the stock market.[213] Worse yet, its staff could be going easy on Wall Street because so many of them were planning to leave the agency to take high-paying jobs with its firms.[214] Data also confirmed that the number of criminal prosecu-

---

206. Jason Zweig, *The Intelligent Investor: How Bernie Madoff Made Smart Folks Look Dumb*, WALL ST. J., Dec. 13, 2008, at B1.

207. Jenny Strasburg, *The Madoff Fraud Case: 'Dr. Doom' Didn't Predict Madoff Blowup*, WALL ST. J., Dec. 31, 2008, at C1.

208. Editorial, *You Mean That Bernie Madoff?*, N.Y. TIMES, Dec. 19, 2008, at A44. Madoff's firm was investigated at least eight times by the SEC and other regulators over the years, but they never caught his fraud. Kara Scannell, *Madoff Chasers Dug for Years, to No Avail*, WALL ST. J., Jan. 5, 2009, at C1.

209. Michael Lewis & David Einhorn, Op-Ed., *The End of the Financial World As We Know It*, N.Y. TIMES, Jan. 4, 2009, at WK9.

210. *Id.*

211. Stephen Labaton, *S.E.C. Image Suffers in a String of Setbacks*, N.Y. TIMES, Dec. 16, 2008, at B6.

212. Edmund L. Andrews & David Stout, *SEC Accused of Failing to Follow Madoff Warnings*, N.Y. TIMES, Jan. 5, 2009 (quoting Rep. Paul Kanjorski).

213. Lewis & Einhorn, *supra* note 209, at WK9.

214. *Id.*

tions for stock fraud have dropped off precipitously in recent years.[215]

V. THE REFORMS OF THE 1930S DID NOT GO FAR ENOUGH

A. *Antecedents of the Federal Statutes*

As was put cleverly by the great securities scholar Louis Loss, the landmark federal legislation of the 1930s "did not spring full grown from the brow of any New Deal Zeus,"[216] but took much of its inspiration from the then-current version of Great Britain's Companies Act,[217] which "was a pattern of enforcing a certain amount of disclosure going considerably beyond the negative injunction against fraud."[218]

Although there had been calls in the U.S. for national regulation of the securities markets even back into the 19th century,[219] the initial legislation in that area came from the states. Kansas, a stronghold of populist sentiment before World War I,[220] led the way in 1911 by enacting the first of the "blue sky" laws, which were given that name because their purpose was to check promo-

215. Eric Lichtblau, *Federal Cases of Stock Fraud Drop Sharply*, N.Y. TIMES, Dec. 25, 2008, at A1.

216. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1 (4th ed. 2001).

217. LOUIS LOSS & EDWARD M. COWETT, BLUE SKY LAW 18 (1958).

218. LOSS & SELIGMAN, *supra* note 216, at 3.

219. In America, industrialization got going in earnest in the decades after the Civil War, with much of the capital coming from middle class investors. Although the nation experienced prodigious economic expansion then, two downturns, the panics of 1873 and 1907, produced substantial losses for investors believed to be engineered to some extent by the notorious "robber barons" of that era. *See generally* JOHN STEELE GORDON, AN EMPIRE OF WEALTH: THE EPIC HISTORY OF AMERICAN ECONOMIC POWER 223–28 (2004).

In 1902 the U.S. Industrial Commission concluded in a report to Congress, "'[t]here seems to be no doubt that in many instances the promoters of combinations have been able to unload large blocks of stock at prices far above their values, as shown by later experience.'" Seligman, *supra* note 3, at 19.

After the Panic of 1907, President Teddy Roosevelt asked Congress for federal legislation "'to prevent at least the grosser forms of gambling in securities and commodities, such as making large sales of what men do not possess and "cornering" the market.'" Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 396 (1990).

220. For a contemporary twist on early twentieth century populism in Kansas, see generally THOMAS FRANK, WHAT'S THE MATTER WITH KANSAS? HOW CONSERVATIVES WON THE HEART OF AMERICA (2004).

ters who were so barefaced that they would "sell building lots in the blue sky in fee simple."[221]

The Kansas Act required that anyone selling securities there must first receive a permit from the state's bank commissioner who had broad discretion not to issue one if he did not approve of the merits of the offering.[222] In just two years, twenty-three states followed Kansas's lead with a large number of them modeling their securities law on Kansas's theory of "merit" regulation.[223] All told, in the two decades before the Great Depression, almost every state enacted some form of securities regulation.[224]

B. *The Battle of the Philosophies*

The stock market crash of 1929 and the resulting Great Depression, however, provided the final impetus for the passage of federal financial regulation.[225] When President Franklin D. Roosevelt took office in March 1933 he found the nation's economy in a state of almost total collapse. He put the cause bluntly in his inaugural address:

> [T]here must be an end to a conduct in banking and in business which too often has given to a sacred trust the likeness of callous and selfish wrongdoing. . . . [T]here must be a strict supervision of all

---

221. Thomas Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37, 37 (1916). For an interesting commentary that the purpose of Kansas's blue sky law had as much to do with protecting local banks from competition as in safeguarding investors from fraud, see Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 351 (1991). *See also* Paul G. Mahoney, *The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses*, 46 J.L. & ECON. 229, 230 (2003) (arguing that the influence of small banks was most striking in states that adopted merit review standards).

222. The Kansas Bank Commissioner could deny a permit when, among other reasons, the offering contained provisions that were "unfair, unjust, inequitable, or oppressive to any class of contributors" or the company did "not intend to do a fair and honest business, and in his judgment [did] not promise a fair return on the stocks, bonds or other securities . . . it offered for sale," 1911 Kan. Sess. Laws 212. The driving force behind the Kansas Act was one J.N. Dolley, the state's bank commissioner. As one commentator has noted, "Dolley's efforts, both in Kansas and throughout the country, combined with the economic conditions of the time and pervasive public revulsion against fraudulent securities practices, helped blue-sky legislation gain national attention." Stefania A. Di Trolio, *Public Choice Theory, Federalism, and the Sunny Side to Blue-Sky Laws*, 30 WM. MITCHELL L. REV. 1279, 1285 (2004).

223. LOSS & COWETT, *supra* note 217, at 10.

224. *Id.* at 17.

225. LOSS & SELIGMAN, *supra* note 216, at 28.

banking and credits and investments; there must be an end to speculation with other people's money.[226]

The passage of an act to regulate the sale of securities thus became a central focal point of President Franklin D. Roosevelt's first one hundred days, aimed at restoring confidence in the nation's economy. At that time there was a "wide demand" for the creation of a government agency that would have controlled, "not only the manner in which securities could be issued but the very right of any enterprise to tap the capital market."[227]

The original draft of that legislation, following the states' example, was premised on a merit standard. It provided for the revocation of an issuer's registration upon a finding that "the enterprise or business of the issuer, or person, or the security is not based upon sound principles, and that the revocation is in the interest of the public welfare," or that the issuer "is in any other way dishonest" or "in unsound condition or insolvent."[228] Given the interstate nature of business, the blue sky laws proved inadequate to protect investors from fraud.[229] The original draft of the proposed federal legislation, however, went beyond the state's existing powers "in lodging extensive powers to control the issuance and sale of securities in the federal government."[230]

President Roosevelt shied away from such a comprehensive approach. In a message to Congress early in this legislative process he said that the federal government should not take any action as "approving or guaranteeing" the soundness of any issuances of securities.[231] Instead, he promoted a regime where every issue "shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public."[232]

---

226. President Franklin D. Roosevelt, First Inaugural Address (Mar. 4, 1933), *available at* www.bartleby.com/124/pres49.html.

227. James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

228. S. 875 & H.R. 4314, 73d Cong. 1st Sess. §§ 6(c), (e), (f) (1933), *reprinted in* 3 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at Item 28 & 22, at 13 (1973).

229. Di Trolio, *supra* note 222, at 1289–90.

230. Landis, *supra* note 227, at 31.

231. H.R. REP. NO. 73–85, at 2 (1933).

232. *Id.*

Professor Raymond S. Moley, the reputed head of President Roosevelt's "Brain Trust," then asked Harvard Law Professor (and later Supreme Court Justice) Felix Frankfurter to draft a revision to the original bill.[233] Frankfurter was a protégé of then-Supreme Court Justice Louis D. Brandeis[234] who was well-respected for his public interest advocacy and known for his theory of regulating business by compelling disclosure of all its significant aspects. It was an approach he summed up in this memorable aphorism from his book on investment fraud, *Other People's Money*: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[235]

Professor Frankfurter assembled a team of young legal scholars who produced a new draft in a whirlwind weekend session.[236] A distinguished member of that group, James M. Landis, later described how Frankfurter's version, which adopted the disclosure theory of regulation,[237] required the filing of a registration statement[238] and a waiting period before the securities could be sold.[239] While the legislation did not give the federal government the authority to pass on the investment quality of the offering, an overseeing commission would be granted the power to keep issues off the market if the data in the registration statement were inadequate or false.[240] After some legislative vetting, the bill quickly passed both houses of Congress and was signed into law by President Roosevelt on May 27, 1933.[241]

---

233. Landis, *supra* note 227, at 33.

234. On the Brandeis-Frankfurter relationship, see BRUCE ALLEN MURPHY, THE BRANDEIS/FRANKFURTER CONNECTION: THE SECRET POLITICAL ACTIVITIES OF TWO SUPREME COURT JUSTICES (1982).

235. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT, 92 (1914). For the continuing relevance of Justice Brandeis views to today's economic crisis, see *supra* note 165.

236. Landis, *supra* note 227, at 33–34.

237. *Id.* at 34–35.

238. Securities Act § 5, 15 U.S.C. § 77e(c) (2006).

239. Securities Act § 8, 15 U.S.C. § 77h(a).

240. Landis, *supra* note 227, at 34–35. Provisions for criminal and civil liability were also included to make sure that corporate officials would be honest and forthright with their investors. *See* Securities Act §§ 11, 15, 24, 15 U.S.C. § 77k, 77o, 77x.

241. Securities Act of 1933, 15 U.S.C. §§ 77a–77bbbb.

C. *Inadequate from Its Inception*

As one commentator wryly described the disclosure orientation of the federal act, "a promoter may ask the public to invest in a hole in the ground so long as he does not describe it as a uranium strike without supporting geological data."[242] It was this minimalist approach that provoked an immediate rejoinder from another future Supreme Court Justice, William O. Douglas, who was then a law professor at Yale. While he approved of the legislation as "symbolic of a shift of political power . . . from the bankers to the masses; from the promoter to the investor,"[243] Douglas also characterized the Act as "a nineteenth-century piece of legislation."[244] What was needed in the regulation of corporate finance, he said, was "a more thoroughgoing and comprehensive control."[245]

For Douglas, "Truth in Securities" was not enough, because he foresaw that investors would either not understand it or, even worse, would be so taken with speculative concerns that they would find it irrelevant.[246] Douglas's ultimate concerns with the inadequacy of the Securities Act, however, were even more trenchant. He saw nothing in it that would make the industry plan and organize for the common good. Access to the capital markets, he said, should be lodged "in the hands not only of the new self-disciplined business groups but also in the hands of governmental agencies whose function would be to articulate the public interest with the profit motive."[247]

D. *Concurrent Jurisdiction and Its Virtual Repeal*

While the Securities Act established a separate federal system of securities regulation based on the disclosure model, it took pains not to preempt the states' jurisdiction there.[248] As one fed-

---

242. LOSS & COWETT, *supra* note 217, at 36–37.

243. Douglas, *supra* note 8, at 522.

244. *Id.* at 529.

245. *Id.*

246. *See id.* at 526–27.

247. *Id.* at 531.

248. As former Section 18 of the Securities Act provided, "Nothing in this title shall affect the jurisdiction of the securities commission . . . of any State or Territory of the United States, or the District of Columbia, over any security or any person." Securities Act of 1933, ch. 38, § 18, 48 Stat. 74, 85 (1934) (codified as amended at 15 U.S.C. § 77r (2000)).

eral official testified, the saving clause would "'assure the states that the [Securities Act] was not an attempt to supplant their laws, but an attempt to supplement their laws and to assist them in enforcing their laws in those cases where they have no control.'"[249] For over sixty years, therefore, the blue sky laws coexisted with the federal act giving our country a dual regime of securities regulation.[250]

Over time, however, criticism that this system was duplicative and unduly burdensome to the process of capital formation mounted.[251] Efforts were made to minimize that problem by coordinating the various systems of the states with each other and with the SEC's system.[252] With a change in political control of Congress, however, the federal legislature in 1996 drastically cut back on the reach of the blue sky laws by substantially preempting their operation.[253]

Not only did the new law confirm a long-standing state practice that issuances of securities listed on a national exchange be excluded from registration,[254] it even precluded the states from any review of offerings that were exempt as federal private placements under the SEC's Regulation D.[255] As a result, the states maintained review power over only the smallest and most limited offerings.[256]

---

249. Di Trolio, *supra* note 222, at 1293 (quoting *Federal Securities Act: Hearing Before the Comm. on Interstate and Foreign Commerce on H.R. 4314*, 73d Cong. 116–17 (1933) (statement of Ollie M. Butler, Foreign Service Div., Dep't of Commerce)).

250. During that time in 1956, the Uniform Securities Act was promulgated and became the basis for the blue sky laws of many states. *Id.* at 1293–94.

251. That criticism was aptly summarized in Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 498. (1984). *See also* Conference Report on National Securities Markets Improvement Act of 1996, H.R. REP. 104-864, 104th Cong. (2d Sess. 1996), *reprinted in* Fed. Sec. L. Rep. (CCH) ¶ 85,847 at 88,650 (1996).

252. This included the promulgating of a Uniform Limited Offering Exemption. *See generally* HAZEN, *supra* note 31, at 322–23.

253. This occurred in the passage of the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

254. Securities Act § 18(b)(1)(A), 15 U.S.C. § 77r(b)(1)(A) (2006).

255. Securities Act § 18(b)(4), 15 U.S.C.§ 77r(b)(4)(A).

256. *See* HAZEN, *supra* note 31, at 324.

VI. THE ROAD NOT TAKEN

A. *Woulda, Coulda, Shoulda*

Our financial system collapsed in 2008 owing in large part to the opaque and exotic derivative instruments that had come to dominate our capital markets.[257] Although almost all of those were sold as unregistered, exempt securities,[258] it is hard to see how our current regime of requiring mere disclosure would have forestalled their issuance or protected the investors who eagerly snapped them up. It is tempting therefore to speculate whether the alternative approach that Justice Douglas and others proposed would have worked better.

What if President Roosevelt and Congress had followed through with the original proposed legislation that gave a federal agency the power to prohibit the sale of securities not based on "sound principles"?[259] Guardians of the public interest would then have been able to scrutinize the CDOs that completely disconnected the ultimate lenders from the original borrowers.

They would then have found that the CDOs were tantamount to a Ponzi scheme since they would only have value in a real estate market whose escalation never ended.[260] Likewise, the financial institutions that entered into credit default swaps to insure those instruments would have been precluded from creating a "daisy chain" of enormous leveraged liability.[261]

Federal officials then could have prohibited the sale of securities because they were not based on "sound principles" and their sale would endanger the public interest. The discretion thus af-

---

257. *See supra* notes 175–81 and accompanying text.

258. *See supra* notes 38–71 and accompanying text.

259. *See supra* note 228 and accompanying text.

260. *See supra* notes 163–66 and accompanying text.

261. *See supra* notes 128–30 and accompanying text. Warren Buffett has picked up on this metaphor comparing the recklessness of financial companies with those who spread venereal disease. As he wrote in a recent newsletter about the spread of this toxic liability, "'[I]t's not just whom *you* sleep with' but also 'whom *they*'—unnamed huge financial institutions—'are sleeping with.'" Frank Rich, *Some Things Don't Change in Grover's Corners*, N.Y. TIMES, Mar. 8, 2009, at WK 11 (emphasis added).

Rich continued the analogy: The financial firms like Citibank and Goldman Sachs "spread V.D. with esoteric derivatives, then hudged their wild gambles with A.I.G. 'insurance' (credit-default swaps) that proved to be the most porous prophylactics in the history of finance." *Id.*

forded to those authorities would have been similar to that exercised by state officials under the "fair, just, and equitable" standards.

In light of the abysmal failure of the current system, regulatory reform requires another look at merit review. How feasible would it be at the national level? Part of the answer to that question lies in an examination of how workable it was when used by the states.

B. *Merit Review by the States Was Effective*

Until virtual federal repeal of their review authority, blue sky officials were consistent in their contentions that merit regulation provided substantial protection to investors and bolstered the integrity of the capital markets in their states. As one state commissioner put it, "[O]ur files in Michigan and undoubtedly the files in most other states, are replete with cases where securities applications were withdrawn or never filed because of objections involving soundness or fairness and where the issuer subsequently met financial disaster."[262]

An American Bar Association subcommittee that reported on state merit regulation in the 1980s found that it was "an ambitious attempt to redefine the relations of promoters and public investors."[263] It assumed that both market forces and private actors such as underwriters were unable to affect the structure of the issue because of the sway promoters and brokers hold over the often credulous expectations of investors.[264] In addition, state merit review was premised on the belief that disclosure alone was insufficient.[265] Most often, the disclosure document was not read by investors.[266] Even if investors read it, they found it incomprehensible or gave it little effect in their decisions.[267] Defenders of state regulation, the study found, believed that the fairness of an

262. Warren, *supra* note 251, at 529 n.282 (quoting Hueni, the former Director of Michigan's Securities Bureau, Department of Commerce).

263. Ad Hoc Subcomm. on Merit Regulation of the State Regulation of Securities Comm., *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 830 (1985–1986).

264. *Id.* at 851.

265. *Id.* at 829–30.

266. *Id.* at 830.

267. *Id.*

offering could be judged by "conscientious, experienced, and impartial administrators."[268] Merit regulation, accordingly, established "market norms that benefit[ed] the economy and the public generally."[269]

Professor Louis Loss and his colleagues at Harvard Law School did extensive field work in the mid-1950s on the actual operations and practices of the blue sky officials.[270] In the decade after World War II, there had been a "tremendous growth in the securities business."[271] In almost all the states, Loss observed blue sky offices that were "far too small and too loosely organized to allow a full administration of the statutes."[272] Given those realities, as well as the loosely-worded mandates empowering those officials, Loss found that even fifty years ago "a substantial degree of administrative flexibility is essential in regulating a feature of modern life which is as complex as the world of securities."[273]

Yet despite running departments that were "understaffed and underpaid," Loss hailed the "relative workability of the statutes," and the "common-sense approach" that the blue sky officials took in working with lawyers for issuers.[274] To a large extent, this required devising various "rules of thumb" and taking a holistic approach to judging the fitness of an offering.[275] Drawing on his own experience, no doubt, Loss analogized that the process was at least as effective and honest as a law professor who reads an exam answer and then, without further ado, puts a grade on it.[276]

C. *A National Platform for Merit Review*

How workable would such an approach be today at the national level? Skepticism is warranted here. The SEC's limited resources are well-known,[277] and its inadequate response to our financial

---

268. *Id.*
269. *Id.*
270. LOSS & COWETT, *supra* note 217, at v.
271. *Id.* at 57.
272. *Id.*
273. *Id.* at 63.
274. *Id.* at 45.
275. *Id.* at 67–68.
276. *Id.* at 68.
277. As three former chairmen of the SEC wrote recently, "The problem with the S.E.C. today is that it lacks the money, manpower and tools it needs to do its job." William Donaldson, Arthur Levitt, Jr. & David Ruder, *Muzzling the Watchdog*, N.Y. TIMES, Apr. 29,

scandals is disturbingly well documented.[278] For some time, it has not performed even a limited review of all registration statements that are filed with it.[279] Even that meager protection for investors was undercut by the wide-ranging exemptions to registration that have been carved out over the last quarter century.[280]

Yet with rueful hindsight we can only wish that some type of scrutiny would have been applied to the exotic and opaque financial instruments that grew up during the last two decades that go by the name of securitized assets.[281] The Commission, however, was not only precluded from exercising any control over the merits of those issuances, but also prohibited from reviewing them, even on a disclosure basis, because they were structured to qualify as exempt from registration.[282]

The only guarantees of their bona fides that purported to be independent from their promoters were furnished by agencies that supposedly judged their credit worthiness.[283] Yet investigations have revealed that many of those firms were so compromised that their opinions failed to adequately reflect the risks of the financial instruments they rated.[284]

VII. CONCLUSION

As President Obama's Chief of Staff Rahm Emanuel said recently of the financial meltdown, "'You never want a serious crisis to go to waste'. . . ."[285] Since that situation became a full-blown economic collapse in the fall of 2008, it has been apparent that the nation needs new, stronger laws regulating its financial mar-

---

2008, at A19.

278. *See supra* notes 208–15 and accompanying text.

279. Since the SEC does not have the resources to examine all registration statements, it engages in selective review of those and other documents filed with it. Registration statements filed by first-time issuers get a full review and other filings are selected for scrutiny on an "as needed" basis. William W. Barker, *SEC Registration of Public Offerings Under the Securities Act of 1933*, 52 BUS. LAW. 65, 73 (1996–1997).

280. *See supra* notes 38–71 and accompanying text.

281. *See* F. Williams Engdahl, *Colossal Collateral Damage—Financial Tsunami Part V*, THE MARKET ORACLE (United Kingdom), http://www.marketoracle.co.uk/Article3796.html (last visited Dec. 18 , 2009).

282. *See supra* notes 72–87 and accompanying text.

283. *See* Grynbaum, *supra* note 161.

284. *See supra* notes 158–61 and accompanying text.

285. David Leonhardt, *The Big Fix*, N.Y. TIMES, Feb. 1, 2009, at MM22.

kets.[286] Even former anti-regulatory hardliners like Treasury Secretary Henry Paulson have become advocates for more stringent government control of the financial markets,[287] and there has been much discussion about the need for some type of "supercop" to oversee the entire sector of financial services.[288]

During this national discussion and debate, policymakers should focus on granting the SEC, or whoever ends up as the country's ultimate financial czar, the power to review the merits of securities offerings. Professor Elizabeth Warren of Harvard Law School has proposed similar legislation along those lines.[289] It would authorize a federal agency to flat-out prohibit the sale of certain investments that pose undue risks to our entire economic system. Events have also confirmed Warren Buffett's apt description of credit derivatives as "'financial weapons of mass destruction'"[290] and such an approach would prohibit like instruments from wreaking havoc in the future.

The strongest objection to vesting such control in the government, however, may come from the current, sorry history of regulatory failure.[291] Why should an agency be entrusted with that power when the SEC's recent failures to protect investors have been so glaring? The point is well taken, but during most of its seventy-five-year history, the SEC has been quite successful in "maintaining investor confidence, helping to make our markets the envy of the world."[292] There is no reason why a reinvigorated

---

286. As the Wall Street Journal succinctly put it, "The government is about to rewrite the rules for the nation's financial markets." Paletta & Scannell, *supra* note 158.

287. Julia Werdigier, *Paulson Calls for Giving Regulators More Powers*, N.Y. TIMES, July 3, 2008, at C2.

288. *See* Jackie Calmes, *Both Sides of the Aisle See More Regulation, and Not Just of Banks*, N.Y. TIMES, Oct. 14, 2008, at A15; Arthur Levitt, *How to Restore Confidence in Our Markets*, WALL ST. J., Oct. 22, 2008, at A15.

289. *See* Elizabeth Warren, *Unsafe at Any Rate*, 5 DEMOCRACY 8, 9 (2007), *available at* http://www.democracyjournal.org/article.php?ID=6528 (proposing a Financial Product Safety Commission to test and implement alternative forms of regulations); *see also* Elizabeth Warren & Amelia Warren Tyagi, *Protect Financial Consumers*, HARPER'S MAGAZINE, Nov. 2008, at 39.

290. Buffett made those remarks describing securities backed by subprime mortgages and the turmoil they have wrought on the credit markets. *See supra* note 170 and accompanying text.

291. *See supra* notes 208–15 and accompanying text.

292. The comment is from Arthur Levitt, a former chairman of the SEC. Levitt, *supra* note 288.

agency, one with the powers it needs to fully protect the public interest, could not accomplish that important mission once again.[293]

Faith in the integrity of our capital markets is essential if businesses are to receive the funding they need from investors.[294] European governments are pushing for similar regulatory reforms,[295] and prosperity in our global economy depends on such uniformly honest financial systems. Back in 1933, the first draft of the Securities Act was correct when it would have disallowed the sale of securities that are not "based upon sound principles."[296] The New Dealers unfortunately settled for an inadequate response in that landmark legislation, and current policymakers should set the matter right.

293. The original New Deal brought many young people to government eager to advance the public interest. *See* WILLIAM O. DOUGLAS, GO EAST, YOUNG MAN 257 (1974). Commentators have found the same spirit alive again. New York Times columnist Thomas Friedman quoted Michael Sandel speaking of the common good: "'It must also be about a new patriotism—about what it means to be a citizen.'" Sandel goes on to say, "'Obama's campaign tapped a dormant civic idealism, a hunger among Americans to serve a cause greater than themselves, a yearning to be citizens again.'" Thomas L. Friedman, Op-Ed., *Finishing Our Work*, N.Y. TIMES, Nov. 5, 2008, at A35.

294. Steven Abernathy, *The Coefficient of Greed,* DAILY DEAL (New York, N.Y.), Mar. 14, 2002.

295. Paletta & Scannell, *supra* note 158.

296. *See supra* note 259 and accompanying text.