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

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THE ROAD NOT TAKEN: RETHINKING SECURITIES REGULATION
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“Financial Service Regulation has failed at its most basic task, protecting the soundness of the system.”

I. Introduction: Inadequate Financial Regulation Past and Present

The severe recession that began in 2008 appears to have been brought about, at least in part, by the same failure of financial regulation that contributed substantially to the Great Depression more than 75 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 has been this wanton misdirection of the capital resources of the Nation.” 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 interstate basis 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 and the Securities Exchange Act of

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While the former required pre-sale registration of securities, the latter more broadly regulated the securities industry and set up a regime compelling on-going disclosure by large, publicly-traded firms. Although some critics on the left said those measures did not go far enough to assure the financial well-being of the nation, they seemed to work well enough in the decades of prosperity that followed the Second World War. During the last three decades however critics from the conservative side claimed that much of this legislation was not only unnecessary to protect investors but also hampered capital formation by businesses. In response to those pressures, Congress and the Securities and Exchange Commission, (SEC) the federal agency set up to enforce and administer those law, progressively deregulated the financial markets.

As a result, far too much debt came to be packaged in exotic securities and ill-informed investors began to blindly speculate in those complex, privately-traded instruments, many of which were connected to an inflated housing market. When that bubble burst, it took surprisingly little to destabilize the world market in debt securities. The resulting collapse of commercial credit wreaked havoc in the economy. It endangered not just the livelihoods of

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6 See e.g., William O. Douglas, Protecting the Investor, 23 YALE REV. (N.S.) 521 (1934).
7 As Dean (now Rochester University President) Seligman has 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.
8 See infra note 14 and accompanying text.
9 See infra notes 50-67 and accompanying text.
10 See infra notes 129-30 and accompanying text.
11 See infra notes 173-76 and accompanying text.
wealthy investors, but those of almost everyone else as well. 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.\textsuperscript{12}

Perhaps economic historians will eventually explain in complete fashion how an apparently thriving economy could come so quickly to a near meltdown.\textsuperscript{13} In the meantime, policy makers 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. They must include a reassessment of those first put into place in the 1930s and a rethinking of how they have been applied over the succeeding 75 years, most particularly during the deregulatory zeal of the last three decades.\textsuperscript{14}

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

\textsuperscript{12} See infra notes 180-81 and accompanying text.

\textsuperscript{13} 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, Revenge of the Glut, N.Y. TIMES, Mar. 2, 2009 at A21.

\textsuperscript{14} 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 to more market forces, and above all, cut income taxes.” David Leonhardt, Obamanomics, N.Y. TIMES, Aug. 24, 2008 (Magazine) at 32 (quoting historian Sean Wilentz).
exercise more meaningful control over the quality of securities by a regime of merit regulation.\textsuperscript{15}

The weaknesses in such a half-measured approach however were compounded when even that flawed system of financial regulation was undermined by an expansion of exemptions to its central requirement that securities first be registered before they are sold.\textsuperscript{16} In addition, those serious flaws became more acute in recent years as highly complex and speculative investments gained dominance in the capital markets.\textsuperscript{17}

As a prelude therefore to proposing that a merit based system of securities regulation replace the current disclosure based laws, this Article will lay 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.\textsuperscript{18} This Article will then examine the most prominent of those new financial arrangements which are credit derivatives, collateralized debt obligations and credit default swaps.\textsuperscript{19}

The values of those 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.\textsuperscript{20} Not only did their holders then see much of their portfolios wiped out, but the whole country was pushed into a brutal recession leaving ordinary citizens

\textsuperscript{15} See infra notes 206-21 and accompanying text.
\textsuperscript{16} See infra notes 34-67 and accompanying text.
\textsuperscript{17} See infra notes 68-123 and accompanying text.
\textsuperscript{18} See infra notes 34-67 and accompanying text.
\textsuperscript{19} See infra notes 68-123 and accompanying text.
\textsuperscript{20} See infra notes 158-84 and accompanying text.
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 was designed “to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.”21 Building on that premise the SEC has made this statement about the Act’s central provision requiring registration of securities before they can be offered and sold, “The primary means for accomplishing these goals (investor protection) is the disclosure of important financial information through the registration of securities.”22

The contents of a registration statement are prescribed by the Act. It must contain a prospectus providing specific items of factual information to investors.23 The Commission has promulgated specific regulations which govern those disclosures and forms which the issuer must employ in this process.24

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The completion of a successful registration is a rather complicated matter requiring the skills of attorneys, accountants, investment bankers and the active cooperation of the issuer’s officials. The prospectus must contain all the information called for by the Commission’s regulations and forms. Such disclosure however is necessary but not sufficient because the anti-fraud provisions of the Act compel the revelation of all facts that an investor would consider important in making a decision to purchase the securities. In the end, all this activity is


Professor C. Steven Bradford lists these direct costs of registration: (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. He also discusses certain 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 required by the Securities Exchange Act of 1934. C. Steven Bradford, Transaction Exemptions in the Securities Act: An Economic Analysis, 45 EMORY L. J. 591 at 602.

26 See supra note 24 and accompanying text.

The Commission has summarized the essential facts that a prospectus must contain in these four categories: (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) Financial 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.


Two sections of the Securities Act, §§ 11 and 15, provide for civil liability for material false statements made in the sale of securities, 15 U.S.C. §§ 77k and 77o.

Section 11 sets forth a detailed scheme listing those defendants who may be liable to purchasers for any material misstatements or omissions in an effective registration statement. The statute also enumerates certain affirmative defenses which those individuals may maintain, most importantly the “due diligence” defense. Such provisions allow certain 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 (S.D.N.Y. 1968).

Section 15 provides that a person who controls a person liable under Section 11 or 12 shall be jointly and severally liable with that controlled person, unless such controlling person did not have knowledge of the facts or reasonable grounds to believe in the existence of such facts upon which the controlled person’s liability 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.\textsuperscript{28}

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. In response, the SEC has streamlined the process for small issuers\textsuperscript{29} and companies already public\textsuperscript{30} and initiated “shelf registration” so that companies may register securities for later sales.\textsuperscript{31} Most recently in 2005 the Commission also substantially liberalized the activities that companies may undertake while in registration.\textsuperscript{32}

As former Professor (and former SEC Commissioner) Roberta Karmel has noted, predicated.

Section 12(a)(2) of the Securities Act, 15 U.S.C. §77l(a)(2) imposes civil liability on any person who offers or sells securities by means of a written or oral communication containing material misstatements or omissions. Similar to Section 11 liability, however, this remedy is limited to purchasers of securities in public offerings. Gustafson v. Alloyd Company, 513 U.S. 561 (1995).

Courts have also long recognized an implied right of action for securities fraud under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j(b) (2008) and 17 C.F.R. § 240.10b-5 (2008). It exists despite the express remedies of Sections 11 and 12 of the Securities Act and is not limited to securities sold in a public offering. Herman & MacLean v. Huddleston, 459 U.S. 375 (1983).

\textsuperscript{28} Section 8 of the Securities Act, 15 U.S.C. § 77h provides that a registration statement will become effective 20 days after it is filed or earlier if the SEC accelerates the effective date. In practice issuers always seek acceleration by the Commission and for that cooperation the SEC may seek to have the issuer make changes in its registration statement as provided in Securities Act Rule 461, 17 C.F.R. § 230.461 (2007). For more on this process of SEC review, see THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 125-32 (5th ed. 2005).

\textsuperscript{29} These are registration Forms SB-1 and SB-2. As to the standards for their use, see generally, MARC STEINBERG, UNDERSTANDING SECURITIES LAW 131-32 (4th ed. 2007).


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. 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 Reg. D

Not every offering of securities must be registered with the SEC. Certain classes are deemed “exempt securities” in Section 3 of the Act and certain specific transactions are freed from the registration mandate by Section 4. The Commission summarizes the most important of these in four categories in this fashion: (1) private offerings to a limited number of persons or institutions; (2) offerings of limited size; (3) intrastate offerings; and (4) securities of municipal, state, and federal governments. The Commission then goes on to state “[B]y exempting many small offerings from the registration process, the SEC seeks to foster capital formation by lowering the costs of offering securities to the public.” Contrary to the SEC’s implication, however, exempt offerings are not required to be small, either in the dollar amounts they raise or in the number of investors they

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36 U.S. Securities and Exchange Commission, supra note 26, at 1.
37 Id.
involve. The exemption for transactions “not involving a public offering,” for instance, the so-called private placements of securities, literally contains no such limits on its applicability. The legislative history on the provision is rather terse stating that it is intended for situations “where there is no practical need for (the Act’s) application (or) where the public benefits are too remote.”

The orthodox interpretation of the exemption comes from a seminal Supreme Court case, SEC v. Ralston Purina. There the Court refused to impose a numerical limit on the number of offerees or purchasers who could participate in a valid private placement. 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.”

In Ralston Purina, the Court 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. 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 the issuer. It would have been better if that is where the law had remained.

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40 Ralston Purina, 346 U.S. at 125-26.
41 Id. at 125.
42 Id. at 124.
43 See, e.g., Hill York Corp. v. American International Franchises, 448 F.2d 680 (5th Cir. 1971); SEC v. Continental Tobacco Co., 463 F. 2d 137, 158 (5th Cir. 1972).
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. 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.

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 small business. Congress, responding to the small business lobby, then added Section 4(6) to the Act in 1980 to prod the SEC into further liberalizing the private placement exemption. It freed offerings under $5 million from registration if they were made only to “accredited investors.”

Congress defined that term to include certain financial institutions and other persons that the SEC might so designate “based on such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management.”

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44 Section 19(a) of the Securities Act, 15 U.S.C. §77s(a), empowers the Commission to prescribe rules and regulations to carry out provisions of the Act and makes good faith compliance with those administration pronouncements a defense to any civil liability imposed by the Act.

45 Securities Act Rule 146, 17 C.F.R. § 230.146(g) was the first of these. It was repealed at 47 Fed. Reg. 11,261 when the SEC promulgated Reg. D.


48 Karmel, supra note 33, at 8.

49 See supra notes 52-57 and accompanying text.

Taking its cue from that legislation, as well as the deregulatory fervor of the Reagan administration, the Commission 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 other exemptions as well for small and limited offerings.\(^51\)

C. **Enter the Accredited Investor**

Reg. 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. According to former SEC Commission Roberta Karmel, this new concept has created a “huge exemption from (the SEC’s) regulatory scheme”\(^52\) and helped create “an enormous private placement market.”\(^53\) Included in the definition of that term are not only certain institutional investors\(^54\) and insiders of the issuer,\(^55\) but also individuals with net worths of at least $1 million\(^56\) 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.\(^57\)

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\(^{52}\) Karmel, *supra* note 33, at 1.

\(^{53}\) *Id.* at 2.

\(^{54}\) Securities Act Rule 501(a)(1)-(3), (7-8), 17 C.F.R. § 230.502(a)(1)-(3), (7-8).


\(^{56}\) Securities Act Rule 501(a)(5), 17 C.F.R. § 230.502(a)(5). That total can include assets of both spouses.

\(^{57}\) Securities Act Rule 501(a)(6), 17 C.F.R. § 230.502(a)(6). For joint income of spouses that figure must be at least $300,000.
Under Rule 506 then, the SEC allowed 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. Registration was therefore unnecessary, according to the Commission’s Reg. D reasoning, if an investor has a certain amount of personal wealth. Such individuals regardless of their business acumen are automatically considered able to “fend for themselves” when it comes to decisions about securities. Some questioned however whether that is actually the case and correspondingly whether the Commission had gone beyond its statutory authority in promulgating Reg. D.

*Ralston Purina* interpreted the 4(2) exemption as requiring that both offerees and purchasers be among “the particular class of persons (who do not) need the protection of the Act.” Rule 506 however, with its focus solely on purchasers of the securities, dispenses with the need for any inquiry into the suitability of those to whom the investment is offered. *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.” Yet Rule 506 has no requirement that accredited investors have such data available to them.

Along those lines, case law following *Ralston Purina* held that for the private placement exemption to be satisfied, all investors would have to have access to the type of information that

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58 Non-accredited investors were also allowed in Rule 506 offerings with certain restrictions remain. There could be no more than 35 of them, they have to be supplied with registration-like written information, and they or their advisors have to be financially sophisticated. Securities Act Rules 506(b)(2)(i), 17 C.F.R. § 230.506(b)(2)(i), 502(b), 17 C.F.R. §502(b), and Securities Act Rule 502(c), 17 C.F.R. § 230.502(d).

59 See infra note 63-64 and accompanying text.

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

61 *Id.* at 125-26.
registration would provide. Yet it did not follow that wealthy individuals would necessarily have such investment data. Even if they did, there was no assurance that they on their own would have the sophistication to analyze it appropriately. Put starkly it seemed that with Reg. D the SEC was abandoning attempts to safeguard investors with a certain amount of personal assets from fraud.

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,” which would encompass many retirees even though the SEC’s own website warns that “Senior Investment Fraud” is rampant. As Commissioner Karmel has suggested, the Commission was perhaps giving ground again on registration’s coverage to preserve its “jurisdictional grip and ideological purity with respect to the regulation of initial

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

63 As one contemporary observer remarked of Reg. D., “The 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 evaluate the merits and risks of prospective investment. Consequently they frequently fail to seek professional advice.” Manning Gilbert Warren III, *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).

The Madoff affair has proven the contemporary relevance of those remarks. See supra notes 186-96 and accompanying text.

64 As one commentator stated ruefully, “It is important to note that the categories of ‘wealthy’ investors frequently include the widows and orphans whose protection has traditionally been the sacred trust of the SEC.” Id.

With the evidence of wide-spread investment fraud on the elderly, such concerns are even more pressing today. See infra notes 66 and accompanying text.


public offerings.”  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. When combined with these deregulatory developments they produced a lethal mix for the economy. These novel securities were called credit derivatives because their values were based on debts owed to others. 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.

Those arrangements ostensibly arose to provide more sophisticated risk management for firms and investors. 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. In

67 Karmel, supra note 33, at 681.


69 As one astute commentator said about the complex nature of these arrangements:

“It is difficult for civilians to understand a derivative 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.

70 Kim, supra note 68, at 29.

71 Partnoy, supra note 68, at 1023.
addition, those sellers could enhance their liquidity by getting fresh cash for their loans which would allow them to make new one more rapidly.\textsuperscript{72} Purchasers of those securities were also said to gain by having new, fruitful investment opportunities.\textsuperscript{73}

As recently as 2005 no less a sage than Alan Greenspan was extolling those developments saying: “…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.”\textsuperscript{74} Greenspan then went on to urge Congress not to regulate this derivative market so that it could continue to grow and innovate. By the same token he added, “The history of the development of these (credit derivatives)…encourages confidence that many of the newer products will be successfully embraced by the markets.”\textsuperscript{75}

These credit derivatives were of two general kinds, collateralized debt obligations (CDOs) and credit default swaps (CDSs).\textsuperscript{76} The former were a type of securitized assets, generally structured as complex mortgage backed securities.\textsuperscript{77} The latter were contracts which functioned like an insurance policy against default on a loan. They typically provided that if such a situation occurred, the party who sold this protection for a fee would have to pay the

\begin{itemize}
\item \textsuperscript{72} Id. at 1025.
\item \textsuperscript{73} See infra note 89 and accompanying text.
\item \textsuperscript{75} Id.
\item \textsuperscript{76} Partnoy, supra note 68, at 1019.
\item \textsuperscript{77} See infra notes 90-94 and accompanying text.
\end{itemize}
principle of the loan to the other party who had bought it as a safeguard against that
eventuality.\textsuperscript{78} The two forms became connected when a CDO was not constructed so as to
provide cash flow from actual assets but as rather a “synthetic CDO” whose income was derived
from selling protection on a loan which underlies the CDS.\textsuperscript{79}

\textbf{B. Collateralized Debt Obligations}

CDOs are a type of asset backed securities and as such are, in essence, financial
commodities.\textsuperscript{80} They are contracts that are marketed to investors as offering payouts from an
entity holding certain income producing property.\textsuperscript{81} Such arrangements had their genesis in the
1970s when a corporation, the Federal National Mortgage Association (Fannie Mae), was
chartered by the federal government to buy up residential loans from their originators and issue
bonds to investors promising pay-outs that ultimately came from the home-owner/borrowers.\textsuperscript{82}

These early mortgaged backed securities had the beneficial result that was intended by
their creator, the U.S. government. They increased the money available for borrowers to buy

\textsuperscript{78} See infra notes 104-23 and accompanying text.

\textsuperscript{79} Partnoy, supra note 68, at 1031.

\textsuperscript{80} N. Vardi, \textit{The Next Big Dump}, FORBES, Dec. 8, 2008, at 12; \textit{Mortgage-Backed Securities}, N.Y. TIMES

\textsuperscript{81} The SEC has defined an asset backed security, in part, as follows: “\textit{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.” Securities Act Regulation AB, 17 CFR §229.1101(c)1.

homes and spreading the risk of their default.\textsuperscript{83} 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.\textsuperscript{84}

This process of backing securities with income producing properties, however, crossed over to the general world of finance in the 1990s\textsuperscript{85} when creative investment bankers began taking income generating assets like credit card receivables and auto loans and bundling them into packages.\textsuperscript{86} They then sold them to a specially created entity that would issue securities based on their payouts.\textsuperscript{87} Like mortgage-back securities, those new arrangements were touted as providing an immediate fresh source of capital for the original lenders\textsuperscript{88} while providing investors with new products that would furnish them bountiful income streams.\textsuperscript{89}

In the real estate boom of this decade, however, the market for mortgaged backed securities boomed and those arrangements morphed into more complicated CDOs.\textsuperscript{90} There the bankers would set up special purpose entities (SPEs) to acquire various loan portfolios secured

\textsuperscript{83} Mortgage-Backed Securities, N.Y. TIMES, supra note 80.


\textsuperscript{85} Prins, supra note 82.


\textsuperscript{87} Partnoy, supra note 68, at 1027.

\textsuperscript{88} Id. at 1025; Mortgage-Backed Securities, N.Y. TIMES, supra note 80.

\textsuperscript{89} Mortgage-Backed Securities, N.Y. TIMES, supra note 80.

\textsuperscript{90} Id.
either by parcels of real estate or by corporate debt. They would then sell securities issued by the SPEs in various segments called tranches that would be rated according to the quality of the assets supporting them. 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. Billions of dollars of these negotiable instruments were sold and resold, usually to institutional investors.

This financial engineering was said to have benefits that “complete[d] the market,” by giving investors a wide array of choices of high yield securities. The bankers used mathematical formulae that was said to offer state-of-the-art precision in predicting defaults and recovery rates. It was also used to explain that particular tranches had more value than the aggregated value of their component mortgages. This arbitrage arose, it was asserted, because either the underlying assets were originally mispriced or the weaker ones would have more value when mixed with stronger properties. One commentator fancifully compared this financial

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91 Partnoy, supra note 68, at 1027-28.

92 Id.

93 Prins, supra note 82.


95 Partnoy, supra note 68, at 1027.

96 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 Buffet to wryly remark “Beware of Geeks bearing formulas.” Dennis Overbye, They Tried to Outsmart Wall Street, N.Y. Times, Mar. 10, 2008.

97 Partnoy, supra note 68, at 1029.

98 Id. at 1028.
alchemy to the ability of “a pastry chef to take a motley assortment of old fruit and turn it into a delicious pie.”

For these organizational services and for continuing to manage the underlying collateral the bankers and their lawyers garnered substantial fees. Such remuneration was said to be justified by the increased value those securities gave investors over direct purchases of the underlying assets. In addition, the bankers who assembled the portfolios of assets were said to have special expertise in evaluating the collateral giving 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.”

C. Credit Default Swaps

In its simplest form, a credit default swap (CDS) 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. In essence a CDS is a form of

99 Prins, supra note 82.

100 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).

101 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.

102 See supra notes 97-99 and accompanying text.

103 Partnoy, supra note 68, at 1030.

insurance that a lender purchases as against a borrower’s failure to pay back its loan.\textsuperscript{105} The lender pays a fee to its counter-party who sells it this protection. In the event of a default, the lender then gets to swap its loan to the counter-party who has sold it the right to be indemnified by treasury bills worth the full amount of note.\textsuperscript{106} If there is no default, the seller/counter-party has made a profitable arrangement and the original lender’s payments diminish its profit on the loan.\textsuperscript{107}

CDS are therefore hedges\textsuperscript{108} and as such they were once called “wonders of modern finance.”\textsuperscript{109} 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 agreements, they were said to be able to limit their exposure in those financial scandals.\textsuperscript{110}

The outstanding amount of CDS protection and liability has grown from nothing a decade

\textsuperscript{105} But see id. at 181-88 explaining how credit default swaps are structure so as not to come under regulation as insurance.


\textsuperscript{107} Partnoy, supra note 68, at 1019.

\textsuperscript{108} Schwartz, supra note 104, at 174.

\textsuperscript{109} Credit Derivatives: The Great Untangling, ECONOMIST, Nov. 6, 2008 at 12.

ago to an estimated $62 trillion at the end of 2007.\textsuperscript{111} Typical sellers have been banks, insurance companies and hedge funds with the top 25 banks being on either side of $13 trillion in these contracts at the end of the third quarter in 2007.\textsuperscript{112} Such arrangement, 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.\textsuperscript{113}

CDSs are all traded over-the-counter in private arrangements and as such there has been no central platform or exchange monitoring or recording these transactions.\textsuperscript{114} In addition, under the Commodities Futures Modernization Act of 2000,\textsuperscript{115} it is illegal to regulate CDSs.\textsuperscript{116} In that regard, Sections 2A(a)-(b)\textsuperscript{117} and 3A(a)-(b)\textsuperscript{118} of the Securities Act and the Securities Exchange Act respectively provide literally that CDSs are not securities. But for that they would easily

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\item\textsuperscript{111} Credit Derivatives: The Great Untangling, supra note 109.
\item\textsuperscript{112} See Janet Morrissey, supra note 106.
\item\textsuperscript{113} 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.
\item\textsuperscript{114} Id.
\item\textsuperscript{115} Pub. L. No. 110-554, 114 Sat. 2763 (2000).
\item\textsuperscript{116} SEC Chairman Christopher Cox acknowledged that in testimony before Congress calling the CDS market “completely lacking in transparency and completely unregulated.” Christopher Cox, Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Sept. 23, 2008, at 2.
\item\textsuperscript{117} 15 U.S.C. § 77b-1.
\item\textsuperscript{118} 15 U.S.C. § 78c-1.
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come under the “investment contract” definition of a security\textsuperscript{119} because in such dealings profit is expected solely from the efforts of others,\textsuperscript{120} specifically the bankers who package, sell, and manage those arrangements.

When CDSs were originally created in the strong economy of the late 90s they were seen as lucrative and safe investments when offered as swap protection to holders of municipal and corporate bonds that rarely defaulted.\textsuperscript{121} In recent years, however, they have been more often sold to CDOs and freely traded among banks, hedge funds,\textsuperscript{122} and other investors who did not know the resources or potential liabilities of their counter-parties or the original obligors on those instruments.\textsuperscript{123}

\section*{C. Easy Money, Inflated Real Estate, and Hedge Funds}

A description of how these unregulated credit derivatives precipitated the economic collapse of 2008 would be incomplete without some further background on three conditions that enabled them to become the tools for rampant rise-taking. Beginning in the early years of this decade, unregulated pools of capital called hedge funds and other investment firms were able to

\begin{itemize}
  \item \textsuperscript{119} Section 2(a)(1) of the Securities Act, 15 U.S.C.§77b(a)(1) and Section 3(10) of the Securities Exchange Act, 15 U.S.C.§78c(10).
  \item \textsuperscript{120} SEC v. W.J. Howey, 328 U.S. 293 (1946).
  \item \textsuperscript{121} Janet Morrissey, \textit{supra} note 106.
  \item \textsuperscript{122} \textit{Id}.
  \item \textsuperscript{123} As one authority noted, even before the credit collapse of 2008, “[t]he market for credit default swaps is quite opaque…Thickening the information 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, \textit{supra} note 58, at 1036 (citations omitted).
\end{itemize}
borrow huge amounts of money at very little cost. They then used much of those funds to buy CDOs promising high yields which were back by sub-prime mortgages, that is, loans made to home-buyers of questionable creditworthiness and secured only by their overvalued residences.

Fearing an economic slow-down after the dot.com crash 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 it had been since the 1950s. Only in 2004 did the Fed begin raising it. However, it did so slowly then and just in small increments.124

But early in the decade a housing boom had already begun, thanks in part to the repeal of capital gains taxes on almost all homes sales during the Clinton years125 and policies undertaken at the onset of the Bush administration to encourage home ownership.126 Those factors, when coupled with historically low interested rates, began “fueling the mother of all housing bubbles.”127 Home prices spiked to such a level that Time Magazine ran a cover story on June 13, 2005 entitled, “Home Sweet Home: Why We’re Going Gaga over Real Estate.”128

With cheap money and home prices soaring, banks and other mortgage-makers eased their lending policies creating the “liar loan” phenomenon, “mortgages approved without requiring proof of the borrowers’ income or assets.”129 As one commentator described the


126 Jo Becker et al., Ambition of Bush on Housing, INT’L HERALD TRIB., Dec. 21, 2008 at 11.

127 Id. (quoting Vernon L. Smith, a winner of the Nobel Prize for Economics).

128 See James Poniewozik et al., America’s House Party: Record Home Prices are Inflamming Passions-and Pocketbooks-as Never Before, TIME, June 13, 2005 at 24 (cover story).

ensuing frenzy, “Families bought homes they could not have afforded at higher interest rates; speculators brought properties to flip; people with modest incomes or poor credit…took out sub-prime loans, interest-only loans, and ‘Alt-A loans.’”¹³⁰

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.¹³¹ 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.”¹³²

¹³⁰ Cassidy, supra note 124, at 52.

¹³¹ Cassidy, supra note 124, at 52.

Recent decades had also seen the rise in such unregulated investment pools that were given the generic name of “hedge funds” because of their supposed usage of diversified strategies to protect their holdings. For a time these companies appeared to be generating “alpha” profits for their investors, principally by using borrowed funds to buy CDOs that offered hefty returns. They also gained what appeared to be easy income from selling CDS protection. Managers of these funds charged their clients exorbitant fees which sometimes totaled 33% of their gains and were able to structure those compensation arrangements so that their income was only taxed at the capital gain rate of 15% rather than as ordinary income at

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133 For a good explanation of why hedge funds were unregulated, see Sargon Daniel, Hedge Fund Registration: Yesterday’s Regulatory Scheme 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. Advisors with fewer than 15 clients are 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. 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 (D.D.C. 2006).

134 Gerald T. Lins et al., Hedge Funds & Other Private Funds: Regulation and Compliance § 1.1 (2004); see also, U.S. Securities and Exchange Commission, Implications of the Growth of Hedge Funds (2003), at 34-36.


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 24 (2004).

135 As one commentator described this, “The new secret of accumulation was presumed to be leverage and risk management, which allowed…the borrowing of many times the amount the investors had in equity capital—perhaps ten, twenty, thirty or in some case a hundred times as much. When so highly leveraged, even a small rise in value could return great profits on the initial investment.” William K. Tabb, Four Crises of the Contemporary World Capitalist System, MONTHLY REVIEW, Oct. 2008 at 45.

136 See supra notes 106-07 and accompanying text.

137 Cassidy, supra note 124.
In 2006, several hedge-fund operators made over an astounding $1 billion in compensation and at their height there were over 10,000 of those entities. As 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.”

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. Leaders of those prestigious institutions, including Henry Paulson, then CEO of Goldman Sachs, assured the SEC that their firms had the sophisticated computer models needed to assess the riskiness of their portfolios. “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.”

The SEC’s actions had their intended effects with many investment banks substantially

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increasing their borrowing. The firm of Bears, Sterns, for instance, ultimately had 33 dollars in
debt for every one dollar it maintained in reserves. 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. It was called the Consolidated Supervised Entities (CSE), but had only spotty
involvement by those firms and was given low priority by the SEC.

Investors however in CDOs and others of these 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. It appears now however that those
firms were so handsomely paid for their rating services there that they either “underestimated the
risk of mortgage debtor or simply overlooked its danger.”

Internal skepticism about the generosity of those investment grades was ignored at the
rating agencies. An email exchange between two analysts at one firm of those firms said it all.
One wrote, “This deal is ridiculous. We should not be rating it.” “We rate everything,” was the

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.” Michael Lewis, supra note 130.

On Sept. 26, 2008, SEC Chairman Cox announced that the CSE program would be abandoned because it
was unsuccessful. U.S. Securities and Exchange Commission, Statement of Chairman Cox on IG Reports


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
response. “It could be structured by cows and we would rate it.” 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.”

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 received big bonuses.”

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 still keep those bonuses.” That is, of course, what happened in the Great Meltdown of ’08 that was precipitated by a drastic decline in the value of

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146 Gretchen Morgenson, *They’re Shocked, Shocked About the Mess*, N.Y. TIMES, Oct. 26, 2008 at BU 1; see also Lewis, * supra* note 130 and accompanying text.


149 *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 A19.
residential real estate, which backed many of the CDOs.

Michael Lewis tells the story of a skeptical market analyst who knew of the untrustworthiness of sub-primes loans and tried to figure out “how the rating agencies justified turning BBB loans into AAA-rated bonds.” 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. The models “for home prices had no ability to accept a negative number…they just assumed home prices would keep going up.”

No less an esteemed investor than Warren Buffet 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 derivative-intense company what risks lurk in its positions…” The self-same sage of Omaha also prophetically called CDOs “weapons of mass financial destruction.”

However with Alan Greenspan, both fueling the housing boom with cheap money and actively discouraging any regulation of financial derivative it was difficult for any critics to point out potential problems with “the Maestro’s” rosy scenarios. In his last full year as Fed

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150 Lewis, supra note 130.
151 Lanchester, supra note 69, at 83.


153 See supra note 124 and accompanying text.
154 See supra note 110 and accompanying text.
155 Cassidy, supra note 124, at 53 (quoting William White, an economist for the bank of International
Chairman, 2004, Greenspan was saying that it was unlikely a housing bubble was building.\textsuperscript{156} In 2005, Greenspan’s successor Benjamin Bernanke, also denied that the real estate market was inflated. In addition Bernanke spoke out in May, 2006 against regulation of hedge funds saying such action would “stifle innovation” and praising the mathematical models those funds had developed “for identifying, measuring, and managing their risks.”\textsuperscript{157}

\textbf{B. The Death of Wall Street}

As has now however become painfully apparent, Greenspan, Bernanke, and almost the entire financial establishment were dead wrong. In the succinct words of one commentator, “[B]y 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.”\textsuperscript{158} 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.\textsuperscript{159}

The latter view is the correct one. As one commentator has stated, “Human beings did these things.”\textsuperscript{160} “Simply put, the lenders lent with unimaginable foolishness and made

\textsuperscript{156} \textit{Id.} at 52.
\textsuperscript{157} \textit{Id.}
\textsuperscript{158} \textit{Id.}
\textsuperscript{159} Nocera, supra note 107, at 26.
\textsuperscript{160} Ben Stein, \textit{You Don’t Always Know When the Sky Will Fall}, \textsc{N.Y. Times}, Oct. 26, 2008 at BU7.
incredibly risky bets. And the bets busted.”\textsuperscript{161} The housing bubble peaked in 2005-06. Then as Greenspan admitted himself in later testimony to Congress, “The whole intellectual edifice (the theories behind derivative pricing and risk management) … collapsed last summer (2007) because the data input into the risk management models generally covered only the past two years, a period of euphoria.”\textsuperscript{162}

One English observer described the situation with greater precision, “… [a]s markets that were crucial for raising funds started to dry up last 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 U.S. and European banks—on a scale last seen in Japan almost exactly a decade ago.”\textsuperscript{163} This concatenation of events seemed to culminate in the collapse and fire-sale of the Bearn Stearns, a major investment bank, on the St. Patrick’s Day weekend in 2008.\textsuperscript{164}

After the rescue of Bear Stearns, the financial system appeared to settle for a while.\textsuperscript{165} 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

\textsuperscript{161} Ben Stein, \textit{Before the Fear, There was Foolishness}, N.Y. \textsc{Times}, Dec. 14, 2008, at BU8.

\textsuperscript{162} Nocera, \textit{supra} note 107, at 29.

\textsuperscript{163} Gillian Tett, \textit{A Year that Shook Faith in Finance}, \textsc{Financial Times} (London) Aug. 4, 2008 at 9.

\textsuperscript{164} For a good description of the enfolding of these events see Kate Kelly, \textit{The Fall of Bear Stearns: Lost Opportunities Haunt Final Days of Bear Stearns}, \textsc{WALL ST. J.}, May 27, 2008 at C1.

\textsuperscript{165} Cassidy, \textit{supra} note 124, at 60.
two federally chartered corporations, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). When the shares of those two companies began to fall precipitously in the summer of 2008, the Fed at first announced plans to invest money in them to keep them afloat, but by Labor Day they stood so perilously close to defaulting on their obligations that the U.S. Treasury announced a complete government takeover.

This “finger-in-the-dike” strategy failed miserably however just a few days later when the major investment bank, Lehman Brothers started to go down. 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 deep.” Lehman went bankrupt on Monday, September 15.

The financial system however did not stop unraveling and at the heart of the turmoil were

166 Id. at 63-64.

See also, Charles Duhigg, Pressured to Take More Risk, Fannie Reached Tipping Point, N.Y. TIMES, Oct. 5, 2008 at A1.
168 Cassidy, supra note 124, at 61.

Cassidy, supra note 124, at 61.
171 Id.
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. That was a good part of the reason it was not allowed to fail.\textsuperscript{173} Lehman’s bankruptcy, however, caused renewed panic in the credit markets because it too had been a big dealer in CDSs.\textsuperscript{174} The next day a major money-market fund, Reserve Primary, announced it had “broken the buck”—the value of its assets had fallen below $1 per share.\textsuperscript{175} That meant in effect that the country’s short term credit markets had frozen up.\textsuperscript{176}

The day after that the Fed had to agree to loan up to $85 billion to the giant insurance company, A.I.G. whose London office\textsuperscript{177} was on the hook for hundreds of billions of dollars of CDSs protection.\textsuperscript{178} Immediately after that, Fed Chairman Bernanke and Treasury Secretary Paulson met with Congressional leaders and reportedly told them that if they did not pass a massive bail-out bill “we may not have an economy on Monday.”\textsuperscript{179}

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\item\textsuperscript{173} Cassidy, \textit{supra} note 124, at 59.
\item\textsuperscript{174} \textit{The Great Untangling}, ECONOMIST, Nov. 6, 2008, \textit{available at} http://www.economist.com/finance/displaystory.cfm?story_id=12552204.
\item\textsuperscript{175} Cassidy, \textit{supra} note 124, at 62.
\item\textsuperscript{176} Joe Nocera, \textit{As Credit Crisis Spiraled, Alarm Led to Action}, N.Y. \textit{TIMES}, Oct. 1, 2008 at A1.
\item\textsuperscript{177} Gretchen Morgenson, Behind Insurer’s Crisis, Blind Eye to a Web of Risk, N.Y. \textit{TIMES}, Sept. 27, 2008 at A1.
\item\textsuperscript{178} \textit{The Great Untangling}, ECONOMIST, \textit{supra} note 174.
\item After a $62 Billion loss in its 4\textsuperscript{th} 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, \textit{U.S. Said to Offer $30 Billion More to Help Insurer}, N.Y. \textit{TIMES}, Mar. 2, 2009 at A1.
\item\textsuperscript{179} Nocera, \textit{supra} note 176, at A1.
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Congress eventually appropriated this money, up to $700 billion.\(^{180}\) After initially planning to have those funds buy up distressed mortgage-back securities, Bernanke and Paulson decided to use them instead to provide more directly liquidity to the financial system by making direct investments in commercial banks.\(^{181}\) In the first months of 2009, however, both the country’s housing market and the financial system continued to remain in great distress.\(^{182}\) 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.”\(^{183}\) Another noted about the bailouts that “It’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.”\(^{184}\)

C. The World’s Biggest Ponzi


In an editorial on Feb. 22, 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 melt down, but they have not reversed the downward slide or revived bank lending.” Editorial, *The Government and the Banks*, N.Y. TIMES, Feb. 22, 2009 at WK9.

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 counter-party risk creating 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, available at [http://online.wsj.com/article/SB1232670128424308245.html](http://online.wsj.com/article/SB1232670128424308245.html).


\(^{184}\) Hilsenrath, *supra* note 181, at A3.
Then 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.” Total losses from Madoff’s blue-chip clientele may amount to $50 billion. Madoff’s firm incredibly reported steady gains of approximately 1% each month for over twenty years, never once suffering a loss. Even investors who should have know 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.

SEC Chairman Christopher Cox was forced to admit that his agency had received “credible and specific” allegations about the scheme for a decade. 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.” It seems even some of Madoff’s investors may have sensed that he was not on the level, but didn’t

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190 Michael Lewis and David Einhorn, *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 4, 2009 at WK 9.
end an operation that was profiting them. \textsuperscript{191}

The episode represented another black-eye for the SEC, a once well-reputed agency with a reputation of diligence and integrity. \textsuperscript{192} As one Congressman said angrily, “We 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.” \textsuperscript{193}

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. \textsuperscript{194} 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. \textsuperscript{195} Data also confirmed that the number of criminal prosecutions for stock fraud have dropped off precipitously in recent years. \textsuperscript{196}

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

\textsuperscript{191} Id.


\textsuperscript{193} Alex Berenson \textit{et al.}, \textit{Prosecutors Want Madoff’s Bail Revoked}, N.Y. TIMES, Jan. 6, 2009 at A1 (quoting Representative Paul Kanjorski (D. PA)).

\textsuperscript{194} Lewis, \textit{supra} note 190, at WK9.

\textsuperscript{195} Id.

legislation of the 1930s did not “spring full grown from the brow of any New Deal Zeus,” but took much of its inspiration from the then-current version of Great Britain’s Company’s Act which “was a pattern of enforcing a certain amount of disclosure going considerably beyond the negative injunction against fraud.”

Although there had been calls in the U.S. for national regulation of the securities markets even back into the 19th century, the initial legislation in that area came from the states. Kansas, a stronghold of populist sentiment before World War I, 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 promoters who were so barefaced that they would “sell building lots in the blue sky in fee simple.”

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199 Id.
200 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 United States Industrial Commission concluded in a report to Congress, “there 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 Concept of Section 10(b) of the Securities Exchange Act, 42 Stan. L. Rev. 385, 396 (1990).

201 For a contemporary twist on early twentieth century populism in Kansas, see Thomas Frank, What’s the Matter with Kansas? How Conservatives Won the Heart of America (2005).

The Kansas Act required that anyone selling securities there 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. In just two years, twenty-three states had followed Kansas’s lead with a large number of them modeling their securities law on that state’s theory of “merit” regulation. All told, in the two decades before the Great Depression, almost every state enacted some form of securities regulation.

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. When President Franklin D. Roosevelt took office in March, 1933 he found the nation’s economy in a state of almost total collapse. As he put the cause bluntly in his inaugural address: “There must be an end to conduct in banking and in business which too often has given to a sacred trust the likeness of callous and selfish wrongdoing. There must be a strict supervision of all banking and credits

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L. & ECON. 229 (2003) (arguing that the influence of small banks was most striking in states that adopted merit review standards).

203 The Kansas Bank Commissioner could deny a permit for, among other reasons, that the offering contained provisions that were “unfair, inequitable, or oppressive to any class of contributors that 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 offered for sale, Kan. L. 1911, c. 133, §5. The driving force behind the Kansas Act was one J.N. Dolley, that 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 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).

204 Loss & Cowett, supra note 198, at 10.

205 Id. at 17.

206 Loss, supra note 197, at 28.
and investments; there must be an end to speculation with other people’s money.”

The passage of act to regulate the sale of securities thus became a central focal point of FDR’s fame 100 Days aiming 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 markets.”

The original draft of that legislation, following the state’s 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 the security is not based upon sound principles, or 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.” Given the interstate nature of business, the blue-sky laws had proven inadequate to protect investors from fraud. 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.”

President Roosevelt however 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.

207 Franklin D. Roosevelt, First Inaugural Address (March 4, 1933) available at www.bartleby.com/124/pres49.html.


209 S. 875 & H.R. 4314, 73rd Cong., 1st Sess. §§6(c), (e), (f) (1933).

210 De Trolio, supra note 203, at 1289-90.

211 Landis, supra note 208, at 31.
Instead he promoted a regime where very issue “shall be accompanied by full publicity and information, and that no essentially important element shall be concealed from the buying public.”  

FDR then asked Harvard Law Professor (and later Supreme Court Justice) Felix Frankfurter to draft revision to the original bill. Frankfurter was a protégé of then Supreme Court Justice Louis D. Brandeis 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.”

Professor Frankfurter assembled a team of young legal scholars who produced a new draft in a whirlwind weekend session. A distinguished member of that group, James M. Landis, later described how Frankfurter’s version, which adopted the disclosure theory of regulation, required the filing of a registration statement and a waiting period before the

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213 Landis, supra note 208, at 33.
215 LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY, ch.5 (1914).
216 Landis, supra note 208, at 33-34.
217 Id at 34-35.
securities could be sold. 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. After some legislative vetting, the bill quickly passed both House of Congress and was signed into law by President Roosevelt on May 27, 1933.

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.” In 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 a “symbolic shift of political power from the bankers to the masses; from the promoter to the investor,” Douglas also characterized the Act as “a nineteenth century piece of legislation.”

What was needed in the regulation of corporate finance, he said, was “a more thoroughgoing

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219 Section 8 of the Securities Act, 15 U.S.C. § 77h

220 Landis, supra note 208, 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, Section 24 of the Securities Act, 15 U.S.C. § 77x and Sections 11 and 15 of the Securities Act, 15 U.S.C. §§ 77k and 77o, respectively.

221 The Securities Act of 1933 is codified at 15 U.S.C. § 77a et seq.

222 Loss & Cowett, supra note 198, at 36-37.

223 Douglas, supra note 6, at 522.

224 Id. at 529.
and comprehensive control.”

For Douglas, “Truth in Securities” was not enough, because he foresaw that investor
would either not understand it or, even worse, would be so taken with speculative concerns that
they would find it irrelevant. Douglas ultimate concerns with the inadequacy of the
Securities Act, however, were even more trenchant. He saw nothing in it that would make
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.”

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 made pains not to preempt the state's jurisdiction there. As
one federal 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.” For over sixty

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\[226\]
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\[225\] Id.

\[226\] Id. at 527.

\[227\] Id. at 531.

\[228\] As former Section 18 of the Securities Act provided, “Nothing in this Subchapter 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 (codified as amended at 15
U.S.C. § 77r (2000)).

\[229\] Di Trolio, supra note 203, at 1293 (quoting the statement of Ollie M. Butler, Foreign Service Div. Dept of
Commerce, Hearing before the Comm. on Interstate and Foreign Commerce on H.R. 4314, 73d Cong. 117 (1933)).
years, therefore, the blue-sky laws co-existed with the federal act giving our country a dual regime of securities regulation.\footnote{During that time in 1956 the Uniform Securities Act was promulgated and became the basis for the Blue Sky Laws of many states. \textit{Id.} at 1294.}

Over time, however, criticism built that this system was duplicative and unduly burdensome to the process of capital formation.\footnote{That criticism was aptly summarized in Manning Gilbert Warren III, \textit{Reflections on Dual Regulation of Securities: A Case Against Preemption}, 25 B.C. L. REV. 495, 498. (1984).} Efforts were made to minimize that by coordinating the various systems of the states with each other and with the SEC’s.\footnote{See also Conference Report on National Securities Markets Improvement Act of 1996, H.R. 104-864, 104 Cong., 2d Sess., 1996-1997, Fed. Sec. L. Rep. (CCH) ¶ 85,847 at 88, 650 (1996).} 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.\footnote{This included the promulgating of a Uniform Limited Offering Exemption (ULOE). \textit{See generally}, Hazen, \textit{supra} note 28, at 322-33.}

Not only did the new law confirm a long-standing state practice that issuances of securities listed on a national exchange or on NASDAQ be excluded from registration there,\footnote{This occurred in the passage of the National Securities Market Improvement Act of 1996 (NSMIA), Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).} but it even precluded the states from any review of offerings that were exempt as federal private placements under the SEC’s Regulation D.\footnote{Section 18(b)(1)(A) of the Securities Act, 15 U.S.C. § 77r(b)(1)(A).} As a result, the states maintained review power over only the smallest and most limited offerings.\footnote{Section 18(b)(4) of the Securities Act; 15 U.S.C. § 77r(b)(4).}
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.\(^{237}\) Although almost all of those were sold as unregistered exempt securities,\(^{238}\) 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 F.D.R. 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?"\(^{239}\) Guardian of the public interest would then have been able to scrutinize the collateralized debt obligations that completely disconnected the ultimate lenders from the original borrowers.

They would then have found that they were tantamount to a ponzi scheme since they would only have value in a real estate market that never ended its escalation.\(^{240}\) 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.\(^{241}\)

\(^{237}\) See supra notes 158-63 and accompanying text.

\(^{238}\) See supra notes 34-67 and accompanying text.

\(^{239}\) See supra note 209 and accompanying text.

\(^{240}\) See supra notes 148-50 and accompanying text.

\(^{241}\) See supra notes 122-23 and accompanying text.

Warren Buffet has picked up on this metaphor comparing the recklessness of financial companies with
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 afforded 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 therefore 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, "Our 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." 242

An ABA subcommittee that reported on state merit regulation found that it was "an

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242 Warren, supra note 231, at 529 (quoting Hueni, the former Director of Securities Bureau, Department of Commerce, Michigan Corporations & Securities Bureau).
ambitious attempt to redefine the relations of promoters and public investors." 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. In addition, state merit review was premised on the belief that disclosure alone was insufficient. Most often the disclosure document was unread by investors. Even if it was, they found it incomprehensible or give it little effect on their decisions. Defenders of state regulation, the study found, believed that the fairness of an offering could be judged by "conscientious, experienced, and impartial administrators." Merit regulation, accordingly, established "market norms that benefit[ed] the economy and the public generally."

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. In the decade after World War II, there had been a "tremendous growth in the securities business." 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." 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

243 Mark A. Sargent, Report on State Regulation of Securities Offerings, 41 BUS. LAW. 785, 830 (1986).
244 Id. at 851.
245 Id. at 830.
246 Id.
247 Id.
248 Loss & Cowett, supra note 198, at 57.
249 Id.
which is so complex as the world of securities.”

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. To a large extent, this required devising various "rules of thumb" and taking a holistic approach to judging the fitness of an offering. Drawing 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.

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 and its inadequate response to our financial scandals is disturbingly well-documented. For some time, it has not performed even a limited reviewed of all registrations statements that are filed with it. Even that meager

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250 Id. at 63.
251 Id. at 45.
252 Id. at 67.
253 Id. at 68.
254 As three former chairman 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, 2008, at A19.
255 See supra note 189-96 and accompanying text.
256 Since the SEC does not have the resources to examine all registrations 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).
protection for investors was undercut by the wide-ranging exemptions to registration that have been carved out over the last quarter century.\textsuperscript{257}

Yet with some 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. The Commission however was not only precluded from exercising any control over the merits of those issuances, but it was also prohibited from reviewing them even on a disclosure basis because they were structured to qualify as exempt from registration.\textsuperscript{258}

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. 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.\textsuperscript{259}

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.”\textsuperscript{260} Since that situation became a full-blown economic collapse in the fall of 2008, it has been apparent that the nation needs new,

\textsuperscript{257} See supra notes 34-67 and accompanying text.

\textsuperscript{258} See supra notes 68-79 and accompanying text.

\textsuperscript{259} See supra notes 145-47 and accompanying text.

\textsuperscript{260} David Leonhardt, The Big Fix, N.Y. TIMES, Feb. 1, 2009 (Magazine) at 25.
stronger laws regulating its financial markets.\textsuperscript{261} Even former anti-regulatory hard-liners like Treasury Secretary Henry Paulson have become advocates for more stringent government control of the financial markets\textsuperscript{262} and there has been much discussion about the need for some type of “Supercop” to oversee the entire sector of financial services.\textsuperscript{263}

During this national discussion and debate, policy makers 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. It would authorize a federal agency to flat-out prohibit the sale of certain investments that pose undue risks to our entire economic system.\textsuperscript{264} Events have confirmed Warren Buffet apt description of credit derivatives as “weapons of mass financial destruction”\textsuperscript{265} 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.\textsuperscript{266} Why should an agency be entrusted

\textsuperscript{261} As the Wall St. Journal succinctly put it, “The government is about to rewrite the rules for the nation’s financial markets.” Paletta, \textit{supra} note 145.


\textsuperscript{265} Buffet made those remarks describing securities back by subprime mortgages and the turmoil they have wrought on the credit markets. \textit{See supra} note 152 and accompanying text.

\textsuperscript{266} \textit{See supra} notes 189-96 and accompany text.
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 75 year history the SEC has been quite successful in “maintaining investor confidence, helping to make our markets the envy of the world.” There is no reason why a re-invigorated agency, one with the powers it needs to fully protect the public interest, could not accomplish that important mission once again.

Faith in the integrity of our capital markets is essential if businesses are to receive the funding they need from investors. European governments are pushing for similar regulatory reforms, and prosperity in our global economy depends on such uniformly honest financials 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 on sound principles.” The New Dealers unfortunately settled for an inadequate response in that landmark legislation and current policy makers should set the matter right.

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267 The comment is from Arthur Levitt, a former chairman of the SEC. Levitt, supra note 263.

268 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. N.Y. Times columnist Thomas Friedman quotes Michael Sandel speaking of the common good that “It must also be a new patriotism—about what it means to be a citizen.” Friedman 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.

269 Paletta, supra note 145.

270 See supra note 239 and accompanying text.