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LAW, POLICY, AND MORALITY DURING THE RECESSION

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WHY I WILL NEVER BE A KEYNESIAN

RICHARD A. EPSTEIN*

Necessity is both the mother of invention and the source of self-reflection. Nowhere is the latter more true than in social and economic affairs, where massive social and economic dislocations rightly prompt leading theorists to reexamine their fundamental beliefs in trying to figure out, as Paul Krugman framed the question: "Just what went wrong?" Unfortunately, these bouts of self-doubt have led many prominent thinkers to turn their attention back to the leading economic thinker during a past depression, John Maynard Keynes, and his most famous tome—book does not quite do—*The General Theory of Employment, Interest and Money.* The tome appeared in 1936, during the depths of the Great Depression that had been running for seven years and counting. Clearly the book did not cause the Depression, but it did not do anything to abate it either. That only happened with the onset of a far greater tragedy, the Second World War.

I confess that in my youth I purchased a copy of Keynes's masterpiece. Dutifully, I sought to read it several times, only to give up in frustration while trying to wade through its turgid prose. Fortunately, it is not necessary to plow through Keynes in order to get some sense of his basic position. Today's skillful

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expositors, including my colleague Judge Richard A. Posner, have provided lucid explanations of the Keynesian position.\(^3\) Judge Posner’s fascination with Keynes has led to a belated confession of past sins, chief of which is an excessive devotion to Chicago-type economics on both the macro and the micro levels. Thus, he tellingly writes: “Economists may have forgotten *The General Theory* and moved on, but economics has not outgrown it, or the informal mode of argument that it exemplifies, which can illuminate nooks and crannies that are closed to mathematics.”\(^4\) I yield to no one in the insistence that critical institutional detail often reveals far more than mathematical equations about the operation of the economic system. But that one point alone is consistent with the work of such theorists as Ronald Coase and such institutionalists as Douglass North, neither of whom is steeped in the occult mathematical arts.

Try as I may, however, I cannot yield to the same level of open-mindedness on this subject that Posner expresses. I come away from reading the new Keynesians more convinced than ever that they lack a coherent diagnosis of the origins and depths of the Depression. By implication, they lack a sensible program to shake the current economic malaise. President Barack Obama may be in the thrall of Keynesian economics, or perhaps just captured by the labor unions. But either way, any move to a larger governmental role in planning or stimulating the economy is likely to make the current recession deeper and the recovery slower than they ought to be.

To develop this thesis, I shall proceed in two parts. Part I deals with those issues that the Keynesians either forgot or swept under the table. In this context, I address not only the distinctive features in the current economic situation, but also those structural from the 1930s, many of which have still not run their course today. My point here is not that Keynes or modern Keynesians necessarily support these dangerous precedents. It is that they have nothing distinctive to contribute to their resolution that is not already understood within the standard neoclassical framework.

\(^4\) Id. at 38–39.
Part II takes a closer look at the inner workings of the theory to explain why any centralized effort to rejigger aggregate levels of consumption or savings will only make the task of economic recovery more perilous. There is no reason to try to establish some collective priority of one type of behavior over the other. The key move is to eliminate waste so as to allow both savings and consumption to expand, without trying at the center to find what Robert Nozick rightly called "patterned principles"—an effort that always turns out to misfire. The only way to move forward on both dimensions at once is to avoid the major mistakes of industrial policy identified in the first portion of this paper.

I. THE MANY SOURCES OF ECONOMIC DECAY

At first glance, we should all be impressed by the apparent breadth of Keynes's title, which seeks to link employment, interest, and money into a single theory. Success in unifying these three large classes of events has to count as a signal achievement in economic thought. But, by the same token, that synthesis should not be regarded as a comprehensive explanation of how the economy works in practice. Its scope is incomplete, and hence it gives only weak information about how to correct perceived economic imbalances, whether during the Great Depression or today. So it is useful to mention some of the issues that are missing from the Keynesian theory, each of which plays a real role in the operation of the economy.

Free trade is the first topic not covered by Keynes's title, nor mentioned in Posner's recent salute to his new master. Keynes's writing on this point seems to indicate some sympathy with the laissez-faire position, for he surely understood the risks of mercantilist policies. By the same token, however, Keynes also thinks that a bit of governmental oversight would not be all that bad. Indeed, it would be hard for Keynes to

6. See KEYNES, supra note 2, at 335 ("[Mercantilist] advantages claimed are avowedly national advantages and are unlikely to benefit the world as a whole.").
7. See id. at 337-38 ("[I]f we contemplate a society with a somewhat stable wage-unit, with national characteristics which determine the propensity to consume and the preference for liquidity, and with a monetary system which rigidly links the quantity of money to the stock of the precious metals, it will be essential for the maintenance of prosperity that the authorities should pay close attention to the state of the balance of trade.").
maintain a strong free trade perspective given his own view that we cannot trust laissez-faire capitalism to determine "the current volume of investment." The connection between the foreign and domestic markets is too intimate to let international trade run its course. Yet notwithstanding Keynes's doubts on the subject, vibrant international trade is clearly important to the overall health of the economy today, and it was also important (albeit at a smaller level) when transportation and communications costs were higher during the Depression. This observation is hardly new; the debate over free trade came to a head just before the passage of the Smoot-Hawley Tariff Act of 1930, which put a serious kibosh on international exchange. The basic mechanics of comparative advantage as they apply to free trade have been well discussed in the work of Adam Smith in the late eighteenth and early nineteenth centuries. Their insights were widely disregarded by the Republican Party, whose 1928 platform revealed protectionist preferences that later became law.

The danger of this protectionist position was not completely lost in the pre-Keynes years. In 1930, a large group of economists, 1028 in all, led by Paul Douglas of the University of Chicago, drafted an impassioned plea to Congress not to pass the legislation. That denunciation of Smoot-Hawley noted that any tariff increase would force distortions in domestic and foreign

8. Id. at 320 ("In conditions of laissez-faire the avoidance of wide fluctuations in employment may... prove impossible without a far-reaching change in the psychology of investment markets such as there is no reason to expect. I conclude that the duty of ordering the current volume of investment cannot safely be left in private hands.").


12. See Anthony O'Brien, Smoot-Hawley Tariff, http://eh.net/encyclopedia/article/o'brien.hawley-smoot.tariff (last visited Feb. 24, 2010) (quoting the 1928 Republican Party platform to say that "we realize that there are certain industries which cannot now successfully compete with foreign producers because of lower foreign wages and a lower cost of living abroad, and we pledge the next Republican Congress to an examination and where necessary a revision of these schedules to the end that American labor in the industries may again command the home market, may maintain its standard of living, and may count upon steady employment in its accustomed field").

13. An account of the relevant events, including the decisive letter, is found in Economists Against Smoot-Hawley, 4 ECON. J. WATCH 345, 345-58 (2007).
markets that would reduce overall levels of production to the
detriment of consumers, encourage retaliation that would only
make matters worse, hamper those in local service industries
who had nothing to fear from foreign competition, and harm
farmers by forcing them to pay more as consumers and shutting
down their access to foreign markets. The letter even quoted
President Herbert Hoover’s cautionary words that “[i]t is obvi-
ously unwise protection which sacrifices a greater amount of
employment in exports to gain a less amount of employment
from imports.”14 There may be some doubt as to the exact extent
of the damage caused by Smoot-Hawley given that total exports
and imports were less than six percent of Gross Domestic Prod-
uct at the time.15 But there can be no doubt that it had a negative
effect. President Hoover may have known all this, but the busi-
ness pressure for protectionism was tough to resist. World trade
shriveled, and, in part because of poor economic circumstances,
a climate of unrest led to the rise of fascism and Nazism.

It is not, of course, proper to charge Keynes with fostering these
counterproductive maneuvers. It is sufficient to say that his gen-
eral theory neglected to warn against such misguided government
interventions, which are easily condemned within the standard
neoclassical framework. So even if we were to classify Keynes and
Posner as ardent champions of free trade, nothing about that posi-
tion stems from the unique insights of a Keynesian theory.

Nor should we regard these insights as unimportant today. We
are blessed insofar as there is no powerful coalition in support of a
return to Smoot-Hawley. The defenders of protectionism tend to
rely instead on more modest claims, such as the inability to con-
duct “free and fair” trade—fear the “fair” in this formulation—
with nations that do not maintain appropriate labor or environ-
mental standards. Concern for fair trade has, for example, stalled
various bilateral free trade agreements with Colombia.16 But this
effort to use trade policy to meddle in the internal business of for-

14. Id. at 349.
16. The AFL-CIO position on the Colombia Free Trade Agreement reads:
“Workers across both countries oppose passage of the FTA until workers can fully
exercise international core labor rights without fear, the country makes deep and
sustained progress on ending impunity, and the agreement is amended to address
persistent criticisms of the trade model.” AFL-CIO, Colombia Free Trade Agree-
(last visited Feb. 24, 2010).
eign nations is a dead loser. We should trade with them whenever it works to our mutual advantage. The lure of foreign trade should help to discipline and rationalize internal productive capacities in both nations (thus bleeding out the monopoly power of unions), and with the increase in domestic wealth, we can confidently predict an expansion in efforts at environmental protection. No one wants to live in a mansion if he cannot breathe the outside air when he steps into his backyard. And so prosperity from free trade, and not protectionism, will increase pressure for sustainable environmental improvements.

Tax policy also deserves more attention. It represented one of the key mistakes of the Hoover Administration, which in its own way was as misguided on tax matters as President Franklin Delano Roosevelt’s New Deal was on social politics. In particular, President Hoover’s Revenue Act of 1932 raised the top marginal tax rate from twenty-five to sixty-three percent in order to staunch the deficit at the federal level. We hear similar calls for higher taxes today for much the same reason: We do not want to live in a society where a huge fraction of the population has to scrimp by on the government dole or toil at low-paying jobs while the rich live in the lap of luxury. But it is a mistake to think of taxation policy solely, or even largely, in terms of income distribution. Taxation has allocative as well as distributive consequences. In many cases, the imposition of progressive taxes contributes to the decline of investment and the withdrawal of human capital from the labor markets. It becomes almost self-defeating to find moral support for the very tax regime that has helped to contribute to a societal slowdown and to the current economic distress. In general, the opposite approach is better. If the flat tax is preferred in good times, as I think is the case, it should be preferred in bad times as well.

The advantages in good times include the simplification of the overall tax structure, the removal of incentives for people to split or assign income in counterproductive ways, and the elimination of the political risk of allowing, as now is the case in California, for a very large portion of the population to enact tax increases that only a small

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17. Pub. L. No. 72-154, § 47 Stat. 169, 177 (imposing a top marginal tax rate of fifty-five percent on net income); id. § 11, 47 Stat. at 174 (imposing an additional eight percent tax on net income, minus certain deductions).
slice of its richest citizens pay. The long term political dynamic of any steeply progressive system of taxation is to level off government expenditure, which in turn will reduce the overall level of production. In an ideal world, then, we do not constantly have to figure out how to switch tax structures as good times become bad and bad times become good. We follow instead the advice of David Hume, who thought that the stability of possession (by which he meant the institution of property generally) was the key to long-term success.

We do not, however, reside in perfect times. So one question that arises is what to do if current tax levels are high and there is no practical means to reduce them in the short run, precisely because of the strong populist impulse toward progressive taxes. At this point, we have to bite the bullet and recognize that something must be done in a second-best world to offset the loss of wealth (for both consumption and investment) in the private sector. One way to do so is to prime the pump to spend the revenue quickly. But, make no mistake about it, this spending binge by government is a distinct second-best solution. There is no reason to think that the government knows what projects to invest in, or why. To be sure, there is always room for government investment in infrastructure under any sensible theory of laissez-faire, but in general the effort should be to invest only to the point where the last dollar on public expenditure has the same rate of return as the last dollar on the private side. That ratio need not change as times get bad, especially if infrastructure were properly cared for in good times.

Yet that is not how matters sit with the new Keynesians. Posner seeks to find a larger space for public investment in a downturn by declaring that “[a]mbitious public-works program can be a confidence builder,” seeking to tap into Keynes’s explanation of how the government can promote the “return of confidence.” But the argument ignores the obvious indignant response that a poorly run government program can destroy confidence and further demoralize businesses who think that higher taxes will snatch away the fruits of their efforts. Only by assuming the eternal and unalterable benevolence of government can one posit that all soft externalities will move in the same direction. Think of the public cynicism about the Alaskan

"bridge to nowhere," or foolish public expenditures that led to the construction of the Murtha-Johnstown-Cambria Airport. These projects shatter public confidence.

What is missing from this entire paean to public works and expenditures is any sense of the public-choice dynamics that make pork barrel politics the order of the day. I am no social historian, but I suspect that public expenditures were also hijacked for partisan advantage in the Great Depression. But by the same token, I think that the size of the heists are far greater in a $787 billion pork barrel package, most of which is directed toward delayed capital expenditures that do not have (if any expenditure has) their supposed stimulus effect. In the end, it seems clear that the best solution is to lower taxes and not to leverage high taxes as an excuse for expanded public spending.

A third area that attracts little or no attention from Keynes is the extensive New Deal drive toward cartelization of industries, which may well have had a parallel impulse in Great Britain. American industrial cartelization was no modest endeavor. In the eighteen months between August 1933 and February 1935, FDR’s administrative agencies churned out some 546 Codes and 185 Supplemental Codes, pursuant to which they issued over eleven thousand administrative orders in the relentless pursuit of “fair” competition. The National Industrial Recovery Act (NIRA) was of course opposed to using these industrial codes to promote monopoly. But that spurt of generosity arose only because the Roosevelt political agenda organized cartels instead, which did not “oppress small enterprises [or] operate to discriminate against them.” These codes set minimum prices or, alternatively, requirements that goods be sold only above cost, generously defined, which is an indirect way to impose price floors. The social losses resulting from cartels are well established in economic theory and flow to the bottom line no matter what fiscal or monetary policies are in place. Their removal should have been a top priority of the very Roosevelt Administration that established them. The same

22. Id.
can be said about the continued use of the various agricultural marketing orders that have similar effects today.23

The New Deal efforts on this score were not limited to product markets. Before the first round of codes was struck down on grounds of improper delegation in *A.L.A. Schechter Poultry Corp. v. United States*,24 the New Dealers included a minimum wage and maximum hours standard, intended to cartelize labor markets. This was no accidental adjunct to the Roosevelt program. It was yet another manifestation of the relentless progressive agenda to substitute cartels for competition whenever possible. Indeed, the NIRA interventions did not die with the invalidation of the statute that created them. Because *Schechter Poultry* was decided on broad nondelegation grounds, the entire issue resurfaced in a statute with greater particularity, the Fair Labor Standards Act of 1938 (FLSA),25 which was sustained with great fanfare in *United States v. Darby*.26 The FLSA provided a solid statutory foundation for regulations of the minimum wage, maximum hours, and overtime that have expanded in scope relentlessly from the time of its initial passage.27

Nor were NIRA and FLSA the only misguided efforts to cartelize labor markets. Many of the low points of the Great Depression involved misguided labor statutes that had an adverse impact on unemployment. The year 1931 saw the adoption of the Davis-Bacon Act,28 which required wages on government contracts to be set at the “prevailing” level within the local community.29 There is some dispute as to whether the legislation was passed with an explicit intent to keep African-American workers from the South from competing with white laborers from the North.30 But even if

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23. For the origins of this agricultural policy, see the Agricultural Adjustment Act of 1938, Pub. L. No. 75-430, 52 Stat. 31, which replaced the Agricultural Adjustment Act of 1933, Pub. L. No. 73-10, 48 Stat. 31 (introducing quotas and crop supports).
26. 312 U.S. 100 (1941).
29. Id. §1, 46 Stat. at 1494.
the statute had no racist element, its protectionist origins against interstate competition cannot be disputed. Nor is it possible to deny the consequences of shielding incumbent workers from external competition: small local gains at the expense of larger national losses. Davis-Bacon is hardly a winning strategy to beef up national labor markets in times of high unemployment. Its repeal is seventy-nine years overdue.

Next on the list is the Norris-LaGuardia Act of 1932,\textsuperscript{31} which sharply limited the use of labor injunctions in trade disputes. Most importantly, it followed the pattern of the English Trade Disputes Act of 1906\textsuperscript{32} by refusing to issue injunctions when labor unions tried to induce workers to unionize secretly in violation of their terms of employment. Previously the employer had been able to stop the offending union in its tracks by obtaining injunctive relief, a right of action that the Supreme Court upheld in \textit{Hitchman Coal & Coke Co. v. Lewis}.\textsuperscript{33} The statute thus strengthened the hands of unions in ways that once again pushed wages for labor further from the competitive equilibrium, with a consequent loss in social welfare.

That statute was followed by an elaborate effort to organize collective bargaining arrangements under the NIRA. That act was struck down in \textit{Schechter Poultry},\textsuperscript{34} only to reappear in much more institutionalized form in the National Labor Relations Act of 1935,\textsuperscript{35} which created a new enforcement mechanism in the National Labor Relations Board. So a statute intended to usher in an era of labor peace brought in its wake labor instability that certainly failed to draw capital into labor intensive industries.

It is easy to understand the sense of desperation that led to the passage of these acts, but it is impossible to ignore the role that they played in keeping levels of unemployment high. Here, again, it hardly matters whether Keynes, Krugman, or Posner (especially the last two) supports these statutes or not. If they support or ignore these statutes, they have allowed macroeconomic concerns to blind them. If they oppose these statutes, they do so for microeconomic reasons that have nothing to do with the grand Keynesian synthesis. But either way, it is hard to defend the position that

\begin{itemize}
\item \textsuperscript{31} Pub. L. No. 72-65, 47 Stat. 70 (1932).
\item \textsuperscript{32} Trade Disputes Act, 1906, 6 Edw. 7, c. 47 (Eng.).
\item \textsuperscript{33} 245 U.S. 229 (1917).
\item \textsuperscript{34} 295 U.S. 495 (1935).
\item \textsuperscript{35} Pub. L. No. 74-198, 49 Stat. 449 (1935).
\end{itemize}
these midlevel changes do not matter, and harder still today to think that the situation would not get worse with the passage of the Employee Free Choice Act, against which I have argued at every possible opportunity. Posner himself is opposed to passage of the statute but thinks that its effect will be moderated by the global nature of labor markets. That perception is at odds with the perception of the American business community, which recoils at the prospect of a card-check device for selecting unions followed by a mandatory arbitration of the substantive term of the labor contract. This latter requirement is a real job killer if anything is. Put otherwise, the favor that the Obama Administration shows to organized labor is a real disincentive to economic recovery in employment markets. One does not have to be a Keynesian to explain why unemployment rates now stubbornly persist at around ten percent, with no decline in sight. The threat of more labor and environmental legislation acts as a real deterrent to new jobs. And the recent passage of ObamaCare will roil labor markets for years to come.

Last, there is the question about the stability and operation of financial markets, and here too the case for some Keynesian explanation for the failure of these markets looks to be vanishingly thin. As before, there are some conventional explanations that Keynesians may embrace, but these are hardly distinguishable from the more traditional Chicago-style explanations. Thus, the obvious culprits are the easy money policies of the Federal Reserve and the unwise guarantee policies of both Fannie Mae and Freddie Mac. Proving we have not learned our
lesson, the Federal Housing Administration (FHA) is now replicating these policies and has begun to specialize in making risky loans on a 3.5% down payment. In addition, it looks as though it will commit yet another $50 billion to salvage homeowners who are in default or whose properties are worth less than the mortgages on them. Once again, it does not take a Keynesian to note that the low rates of interest will generate a bubble, which will surely burst once there are no greater fools to step into the gap. Nor does it take a Keynesian to examine the role, if any, that mark-to-market accounting had in spurring the downward cycle in asset values as private banking houses had to sell off asset after asset to make back their margins.

There is some debate about the extent to which these policies are attributable to securities regulation or to private covenants. The right answer is some mixture of both, which suggests that both public and private parties did not perform ideally in the financial meltdown. But that observation hardly makes the case for more extensive governmental control over lending markets. Rather, the key question is who learns more quickly from their mistakes. There are only two choices: government bureaucrats who are systematically immunized from the consequences of their decisions or private lenders who (even with imperfect employment contracts) are not. No private bank will lend on the terms that the FHA is prepared to supply. The reasons are too evident to require extended discussion.

The situation only gets worse when we look at the rules in place once mortgages go into default. From the outset I have taken the uncompromising position that the only person who

39. See David Streitfeld, Housing Agency, Cash Dwindling, Tightens Rules, N.Y. TIMES, Nov. 13, 2009, at A1. The FHA Down Payment Guidelines note that “FHA loans do not have a zero down payment mortgage but the down payment can be as little as 3.5%. Here is the exciting part, … those funds (3.5%) can be a Gift and come from a family member, charity, or your employer.” FHA, FHA Down Payment Guidelines, http://www.fha-mortgageunderwriters.com/fha_down_payment_guidelines.htm (last visited Feb. 24, 2010). Why not do without the excitement? Note that “excitement” is an open invitation to bad underwriting. If the borrower cannot come up with the down payment on his own, chances of default probably rise.

40. See David Streitfeld, A Bold U.S. Plan to Help Struggling Homeowners, N.Y. TIMES, Mar. 26, 2010, at B1. Streitfeld questions whether the plan will work. The answer is no.

should be entitled to renegotiate loans or waive foreclosure is the bank or syndicate that holds the paper. The current policy reintroduces the worst features of the Depression strategy that sought delayed foreclosures in ways that only prolonged the agony for the individual parties and prevented the restabilization of the market. Everyone should have some sympathy for the plight of borrowers in the 1930s, given that the major deflation forced them to pay back loans with more expensive dollars than those they borrowed. But that problem can only be cured by keeping currencies stable—which is harder to do with one, or more, large stimulus programs waiting in the wings.

Today, we do not have deflation to justify government intervention, and the various programs of forced delay have done exactly what one would have predicted. Very few of the borrowers who were in arrears brought their payments current during the foreclosure moratorium. The common result was eventual foreclosure at additional expense, at which time the underlying properties were worth less than before. The systematic effect of debtor relief is to keep these units out of the resale market, to keep prices artificially high, and to put obstacles in the path of new home buyers who were guilty of no indiscretions of their own. It does not take a Keynesian to realize that the insecurity of all forward transactions saps the confidence that governments should build in markets. Even people who have excellent “animal spirits” will be loathe to invest in a market in which neither politicians nor courts give credence to “stable expectations.” Animal spirits lurk in all individuals who take joy in their work. The question is whether that private satisfaction from productive labor is enough to offset the additional burdens and uncertainty of oppressive regulation.

43. EDWARD VINCENT MURPHY, CONG. RESEARCH SERV., ECONOMIC ANALYSIS OF A MORTGAGE FORECLOSURE MORATORIUM (2008).
44. See GEORGE A. AKERLOF & ROBERT J. SHILLER, ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM (2009). No one denies that psychology matters, but it matters far more for personal interactions than large global phenomena.
45. See, e.g., Usery v. Turner Elkorn Mining Co., 428 U.S. 1, 16 (1976) (“[O]ur cases are clear that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations.”). The “solely” overturns thousands of years of sound thinking on property rights. As to what should be added, Justice Marshall never offered a coherent answer.
The motivations of individuals are, of course, not amenable to public intervention, but the rules that either shackle or encourage innovation are. Figuring out what these are, and how they relate to the current malaise is difficult because some of the policies to which I refer have been in effect for a long time, and others are of much more recent vintage. But even older policies may have greater salience as time marches on. One need only look to the ever greater threats to solvency in Medicare, Medicaid, and Social Security to realize that incremental changes and adjustments can produce long-term effects. The same can be said about the accumulated public pension liabilities that are now the norm in states like New York and California, owing to the enormous strength of their public unions. My own sense, therefore, is that we must start dismantling these programs if we as a nation are to get out of the long-term stagflation (or inflation?) that is our due. The Keynesians have little distinct to say about this dilemma. Nor, in the end, do they have much useful to say about the issues of employment, consumption, investment, and savings that lie at the core of their theory.

II. KEYNESIAN THOUGHT ON ITS OWN TURF

In this Part, I shall examine the power of Keynesian theory in those areas where it purports to differ from the standard Chicago-type economics of thinkers such as Milton Friedman and Robert Lucas. I start with the proposition, urged by Richard Posner, that the linchpin of the Keynesian synthesis is the push toward consumption, which is said to justify the adoption of stimulus programs to spur additional immediate economic activity. Posner stresses the point that, under the Keynesian model, "consumption is the 'sole end and object of all economic activity,'" 46 which, as Posner insists, is true "because all productive activity is designed to satisfy consumer demand either in the present or in the future." 47 But the last qualification about future consumption reduces the grand proposition to a truism that deprives the Keynesian approach of all utility. Keynes's General Theory sets income less consumption equal to savings, which in turn equals investment. But note that "consumption" covers only present consump-

46. Posner, supra note 3, at 36.
47. Id.
tion, not all consumption. And it also refers only to private consumption, not the indirect consumption that comes from public infrastructure investment. The statement, therefore, that the sole function of all human activity is consumption does not tell us when to prefer each form of consumption. It is only a bland observation that investments fall into a class of intermediate goods that are desired solely because of the consumption that they eventually facilitate. The grand Keynesian statement looks to be no more and no less informative than a general statement that people act to maximize their utility, or that the purpose of a social welfare function is to maximize human satisfaction, which we now know equates with consumption.

The key question, therefore, is how to make the various allocations. Let us start with the temporal dimension and, to keep matters simple for the moment, focus on a single isolated individual whose only choices are to consume now or to defer consumption of some existing stock of goods. This question involves the decision whether to forgo leisure today to create something of value tomorrow. The individual's range of choices is highly complex because the choices are not just consumption now or consumption later. It is possible to create depreciable assets, for example, that are consumed through use and over time.

In dealing with this particular problem, we start with the brutal truth that production and consumption do not move in lockstep progression over time. In the agricultural realm, the common insight is that the individual must decide what portion of the crop to consume today, what to save and to consume in winter, and what to keep as seed corn to plant for the next year's crop. "Do not eat your seed corn" has a descriptive as well as metaphorical meaning. Essentially the individual makes the choice in terms of discounted present value, which inclines one weakly toward present consumption. But the desire to equalize consumption in all states of the world pushes strongly toward savings and investment. At this point the individual problem looks like the one that Milton Friedman addressed in dealing with his permanent income hypothesis in the absence of trade.48

In periods of slack production, the individual will consume some of his store of savings; in periods of abundant production, he will replenish the stores. The objective is to even out con-

sumption in the face of variable production. I see nothing in the Keynesian concern with consumption that alters this analysis. It only says what has been known since Aristotle: Consumption, not investment, is the final cause of all human activity.

The next stage in the model asks what happens when we introduce the possibility of trade. At this point speaking about money as a means of exchange makes sense, and the question is how any group of individuals exploits the prospects for gains from trade. The answer, straight from Adam Smith, is through specialization. The decision to put money into a savings account or a debt instrument represents the choice to take a low but secure rate of return. Not all individuals will prefer that option, which in turn creates the opportunity for additional gains from trade by having those banks that receive their deposits lend money out to others for a higher rate of interest that compensates for the additional risk. The bank then seeks to minimize this risk by a range of good practices that include due diligence at the one end and the receipt of appropriate real security or personal guarantees at the other.

This division of labor seems desirable. Yet Posner has his doubts. Consider this striking sentence: "If you buy common stocks, you are investing, but the contribution of your investment to the productive capital employed in building a factory is attenuated." Attenuated? What an odd choice of words. It makes it appear as though the individual holder of capital has somehow defaulted on his obligation to be a trader whose "animal spirits" lead him into the fray. But a far better way to describe the situation is that the passive individual investor is willing to risk his capital with those whom he trusts under a regime of corporate law that offers sufficient protection against the expropriation of his investment by either public or private parties. Indeed, in many cases, savers do not make their own decisions about which stock to buy, but hire financial advisors, invest in mutual funds, or do both. There is no mysterious downward cycle in this process. And the distinction between people who make "passive investments" and those who make "active investments" does not represent some hidden pathology. It is a sign that all is well with the economy, not that there will be some hitherto unidentified market failure.

49. Posner, supra note 3, at 36.
Nor is there any reason to worry that this investment will reduce aggregate consumption below the appropriate level any more than there is reason to fear that it will raise it above the appropriate level. In the case of the individual who has to deploy his assets over time, there is no one formula that indicates how much he should consume in the first period or save for each future period. A lot depends on present and future labor skills, levels of accumulated capital, and estimation of future personal needs and social conditions. Similarly, on the trade front, there is no reason to fret if some individuals decide to save more and consume less, and others do the opposite. In an article in the New York Times, Roger Lowenstein hits the nail on the head when he notes this nation’s long-standing ambivalence toward saving.50 On Mondays, Wednesdays, and Fridays, we lament collectively that a consumerist society takes in too much today and thus promises to short change the next generation by leaving it with a mountain of debt. Yet on Tuesdays, Thursdays, and Saturdays, we take the opposite view and deplore the “hoarding” that Keynes and Posner fear will deprive the nation of the productive juices it needs. In the end this equivocation reflects a sensible uncertainty about trade-offs between present and future consumption. But I think that Lowenstein misdiagnoses the problem when he asserts that setting the trade-off between current and future consumption is a task “that the private sector [has] thoroughly botched.”51 At the very least it had a lot of help from the cheap money policies on the public side.

The urgent question, however, is not where to point fingers for past sins. It is to chart the correct future policy. Here is one simple suggestion. For heuristic purposes, put savings (investment) on the y-axis and current consumption on the x-axis. Then draw the usual hyperbolic indifference curve. Underlying today’s debates over consumption versus savings is an attempt to figure out where on this curve the optimal ratio of savings to current consumption is. Obviously it is somewhere in the middle. But no one knows precisely where. In the face of that limited knowledge, the vital mission is to move the entire curve northeast by developing sound institutional practices that re-

50. Roger Lowenstein, U.S. Savings Bind: Save money to rescue the economy! Spend money to rescue the economy!, N.Y. TIMES, Oct. 18, 2009 (Magazine), at 15.
51. Id. at 16.
verse the foolish practices set out above and encourage both savings and consumption in greater quantities.

In dealing with this question, the wrong approach is to buy into the Keynesian emphasis on "aggregates," whether for consumption, savings, investment, or anything else. This collective obsession is sure to take us down the road to national industrial policy in which we think that we can name some form of collective decision about which sectors and which firms should receive government largesse. It is once again critical to remind ourselves of Nozick's powerful critique of patterned principles. It was just such a political maneuver to set targets for the appropriate level of home ownership in the United States—aggregately and for individual groups—that induced the public lending policies that left us with a subprime crisis with reverberations beyond the collapse of the housing markets. The same is true here. What is there to fear if governments do not seek to tweak these aggregates, but just let each individual decide for himself how much to save and how much to spend? As people will all be at different stages of their own life cycles, we should expect these decisions to be all over the lot. And the disparity will only increase when we take into account the real possibility of wealth transfers within families, including transfers across generations.

But who cares about the supposed social implications of these private acts? If I decide to save everything I have above subsistence level, it does not mean that overall savings levels will go up. The amount that I invest may lower the overall rate of return on investment, which could easily encourage others to shift toward consumptive activity. In addition, my dollars when invested get paid out to other individuals, for example, workmen in construction, who then make their own decisions as to how much to consume or to save. We cannot, therefore, draw any inference as to the total level of savings by just watching the herky-jerky movements of any one individual. We have to look at them all.

Should we be concerned with these choices because of the supposed multiplier effect gained from present consumption? Not really. The decision to save counts as deferred consumption, which has its own multiplier effect. Here it is best to drop

\[52. \text{See supra text accompanying note 5.}\]
the term and just substitute for multiplier effect the traditional concern with gains from trade through voluntary transactions, which typically have positive external effects by creating additional opportunities for others. As one person saves the other invests in long term projects with borrowed capital. The key point is that stable expectations require enforceable contracts and steady and predictable price levels. So long as each person makes informed trades, each of these contracts over time should be a positive sum. Reduce the transaction costs in good Coasean style by supporting stable property relationships and the temporal consumption issue will take care of itself in the same way that all such allocations take care of themselves. People make choices and are bound by their consequences. The conclusion is hardly novel, for the same thing happens when we remove the intertemporal element from the equation. The choice of one consumer good over another is only possible for persons who can articulate and act on a set of stable preferences.

The puzzle is still not complete, however, because we have to worry about the creation of bona fide public goods that markets cannot generate. For that task we need to have a set of taxes that, ideally, create the fewest possible distortions in private behavior. We could think of general revenue taxes, special assessments, tolls, or other user fees as a way to support public projects. But the correct mix of public and private should not be determined by deciding to honor or override our animal spirits. What is really needed is a good estimation as to whether the next dollar on some public improvement is worth as much as or more than the next dollar in private hands. That question does not prejudge the further issue of whether the public funds should be spent on immediate consumption, such as rescue operations in a flood, or on long-term benefits, such as building the right superhighways. These trade-offs are governed by the same rules applicable to the private side.

But the one point that is clear is that there is no gain from stimulus programs that waste money and squander resources. In any sensible evaluative scheme we do not praise current expenditures that produce goods of no long-term value. It is for that reason that Keynes seemed loopy when he approved Roosevelt's decision to destroy excess crops, which were stored at government expense solely because of the agricultural adjustment acts that kept output down to keep prices up. We might as well burn down buildings to create new jobs in construction,
dig for oil with teaspoons in order to stimulate labor, or provide large subsidies to buy clunkers in August 2009, only to see new car sales plummet in September.\textsuperscript{53} The simple objection to Keynesian pump priming in a first-best world is that we are priming the wrong pump when public control over general investment (sound infrastructure aside) yields less usable output than the private investment itself.

CONCLUSION

In the end, I can see nothing distinctive in Keynesian theory that advances our understanding of economics. Consumption becomes a nice substitute for utility that conceals the trade-offs between current consumption and investment and between public and private investment and consumption. The real task is to figure out the right set of property rights that will give individuals incentives to make the right personal choices. Sound institutions will boost confidence across the board and encourage investment so long as no one has to factor into the equation the huge levels of gratuitous uncertainty that stem from useless government intervention. We have to accept that external circumstances will create good and bad times. No economic theory can ward off hurricanes, disease, or war, even if sound social institutions can contain some of their adverse effects. But the purpose of government is not to eliminate all the uncertainties of nature and politics. It is to not add to the confusion by creating baroque structures of taxation, regulation, and government spending that add fresh layers of uncertainty through mechanisms that expend real resources in order to reduce social output. One does not have to be a Keynesian to know that the sum of three negatives (administrative cost, allocative distortions, and unneeded uncertainty) is always negative, no matter what their relative proportions. Getting out of the gimmick business will do more good than all the bogus short-term stimulus packages that muddle-headed or devious politicians can generate. We do not want government to do nothing, but we do not want it to do something stupid either. The presumption remains: Government intervention is bad until shown to be good. For that reason I am not, nor will I ever be, a Keynesian.

The economic earthquake that shook the world financial markets and bankrupted seemingly invulnerable multinational corporations exposed perilous fault lines of the federal government's own creation. Under mounting pressure, at a critical moment, the fault lines cracked and took down everything from auto manufacturers to insurance providers.

Now that the Obama Administration's comprehensive regulatory reform proposals are making their way through Congress, the time has come to identify the root causes of the most recent economic downturn. Many leading economists agree: The economic crisis we are experiencing is directly tied to an over-inflated housing bubble wherein mortgage lenders made reckless, high-risk loans. These loans were given in record number to over-extended, under-qualified borrowers to satisfy an increasingly aggressive government drive for home ownership. Why the lenders adopted such counterintuitive and irresponsible business practices is the critical question. The answer reveals the disastrous folly of government intervention in the housing market spanning more than three quarters of a century.

To secure affordable housing, Congress created a new Government Sponsored Enterprise (GSE) known as the Federal National Mortgage Association (Fannie Mae) during the Great Depression to purchase and securitize home mortgages and promote greater liquidity in the mortgage market. At a time of unprecedented economic strain, the nation welcomed this fundamental component of President Franklin Delano Roosevelt's New Deal.

For thirty years, Fannie Mae had a near-monopoly on the secondary mortgage market and, with the backing of the fed-

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* United States Representative (R-CA); Ranking Member, House Committee on Oversight and Government Reform.
eral budget, an ostensibly endless supply of capital. In 1965, President Lyndon Johnson established the Department of Housing and Urban Development (HUD) as a part of his Great Society plan to eradicate poverty and promote homeownership through a government-run housing program and government subsidized mortgage lending. Facing mounting debt, however, Johnson later contrived a scheme to privatize Fannie Mae, removing the corporation’s liabilities from the federal balance sheets without limiting the potential for a taxpayer bailout.\(^2\)

By 1970, Congress was pushing Fannie Mae to purchase conventional mortgages, though the effort was complicated by federal restrictions on numerous primary lenders that were unable to work with Fannie Mae. The solution? Congress created the Federal Home Loan Mortgage Corporation (Freddie Mac) as a wholly-owned government-run mortgage lender,\(^3\) and then re-chartered it in 1989 as a publicly traded enterprise.\(^4\)

As the market for secondary mortgages grew, Fannie Mae and Freddie Mac nearly achieved monopoly results thanks to numerous competitive advantages guaranteed through their unique relationship with the federal government.\(^5\) Among these advantages were government-backed lines of credit equal to a whopping $2.25 billion and a corollary market reputation that led investors to believe the GSEs were too big to fail.\(^6\) This inflated investor confidence and exclusive government protection resulted in an unnatural expansion of Fannie Mae and Freddie Mac’s market dominance, and by the time the 1990s rolled around, the corporations together held more than three quarters of the secondary market for prime mortgages.\(^7\)

The GSEs were aided immensely by the federal government because Congress charged Fannie Mae and Freddie Mac with

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keeping the secondary mortgage market liquid and increasing the availability of affordable housing. No other private companies could borrow money at such an affordable rate. Private debt markets were willing to lend the GSEs money at an interest rate not much higher than the relatively risk-free rate they charged the U.S. government itself.\(^8\)

As a matter of regular business, Fannie Mae and Freddie Mac sold their bonds in the debt markets at relatively low price points and used the borrowed money to purchase mortgages from primary lenders like Countrywide Financial that dealt directly with customers seeking home loans. They then bundled many of these mortgages into securities and sold them to investors who paid Fannie Mae and Freddie Mac a fee to guarantee payment in the event of a mortgage default.\(^9\) The GSEs could also hold the securities in their own portfolios,\(^10\) making profits from the difference between their low cost of debt and the higher rates borrowers paid on their mortgages.

Along the way, Congress continued to impose requirements on Fannie Mae and Freddie Mac to guarantee affordable housing opportunities to more and more Americans, including those whose credit ratings and annual income could not sustain a traditional mortgage. Under increased pressure to lower underwriting standards and to meet congressional mandates for loans to low-income families, the GSEs fell victim to successive administrations' campaign promises to increase home ownership regardless of the individual or systemic risk.\(^11\)

Meanwhile, Congress exempted Fannie Mae and Freddie Mac from key regulations and responsible market oversight. For example, their congressional charters exempted them from Securities and Exchange Commission (SEC) oversight, making the GSEs the only exempt publicly traded corporations. It was not until scandals in 2003 and 2004 revealed the use of unapproved accounting practices to manipulate earnings that Fannie Mae and Freddie Mac

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8. Koppell, supra note 5, at 469; Frame & White, supra note 6, at 164.
9. Frame & White, supra note 6, at 160.
10. Id.
agreed to "voluntary" SEC filings.\textsuperscript{12} The GSEs were also protected from market oversight regarding the quality of their mortgage-backed security issuances, resulting in the packaging of $5 trillion in mortgages into mortgage-backed securities.\textsuperscript{13} These securities were then sold to investors who received the interest and principal payments. Bit by bit the bubble began to expand.

The politicization of mortgage lending reached its zenith during the Clinton Administration through major alterations of the Community Reinvestment Act of 1977,\textsuperscript{14} a piece of legislation originally passed to prevent banks from discriminating against otherwise credit-worthy borrowers in lower-income neighborhoods. The Clinton-era policies emphasized, on the other hand, performance-based standards of evaluation that tied bank ratings to the volume rather than the fairness of the banks' mortgage lending.\textsuperscript{15} As subprime lending increased to meet the Clinton Administration's standards, so did the pressure on Fannie Mae and Freddie Mac to purchase those loans on the secondary market to promote liquidity, regardless of the loans' quality and sustainability.\textsuperscript{16}

This "affordable housing" scheme inevitably started a mortgage bonanza, just as it was designed to do. Unexpectedly, however, borrowers from every income bracket, sensing a near-inevitable investment return facilitated by federal guarantees, seized the opportunities originally created for the poor. As requirements for down payments plummeted, so too did the home equity stake of the average American family.\textsuperscript{17} And as home prices continued their dizzying rise, many people decided to cash

\textsuperscript{16}Collapse of Fannie Mae and Freddie Mac: Hearing Before the H. Comm. on Oversight & Gov't Reform, 110th Cong. 11 (2008) (statement of Dr. Arnold Kling); see also Steven A. Holmes, \textit{Fannie Mae Eases Credit To Aid Mortgage Lending}, \textsc{N.Y. TIMES}, Sept. 30, 1999, at C2.
in by buying a house with an adjustable-rate mortgage featuring a low introductory teaser rate set to increase after a few years.\textsuperscript{18}

These borrowers, confident in the oft-cited assertion that U.S. home values had never before fallen in the aggregate, planned to sell or refinance their investment before the mortgage rate adjusted upward, pocketing the difference between the initial purchase price and the subsequent appreciation in value. But buyers failed to grasp the effect of a government policy that had quietly eroded the prudential limits on mortgage leverage. Indeed, the government had helped create a dangerous speculative bubble across the entire financial system.

Once government-sponsored efforts to decrease down payments spread to the wider housing market, home prices became increasingly untethered from borrowers' ability to pay. Instead, borrowers could make increasingly smaller down payments and take on higher debt, allowing home prices to continue their unrestrained rise.\textsuperscript{19} Some statistics help illustrate how this price increase occurred. Between 2001 and 2006, median home prices increased by an inflation-adjusted fifty percent, yet at the same time Americans' income failed to keep up.\textsuperscript{20} For the thirty years prior to 2000, the ratio of U.S. home prices to income averaged only about 4-to-1.\textsuperscript{21} In other words, the average American lived in a home costing four times his annual income. In just five years, from 2000 to 2005, that ratio doubled to 8-to-1.\textsuperscript{22} As a result of homes becoming more expensive, the only way for many Americans to buy a home during the housing bubble was to dramatically increase their leverage. It is not surprising, then, that between 2000 and 2006, mortgage debt in the United States increased by eighty percent.\textsuperscript{23} According to one early warning in 2006, such an increase in the price-to-income ratio had a less than one in three hundred chance of occurring and is essentially inexplicable by economic fundamentals.\textsuperscript{24}

\begin{thebibliography}{9}
\bibitem{18} Andrew Laperriere, \textit{Housing Bubble Trouble: Have We Been Living Beyond Our Means?}, \textit{WKLY. STAND.}, Apr. 10, 2006, at 25, 27.
\bibitem{19} \textit{Liebowitz}, supra note 17, at 4, 17--18.
\bibitem{20} \textit{Id.} at 25--26.
\bibitem{21} \textit{Id.} at 17--18.
\bibitem{22} \textit{Id.}
\bibitem{23} \textit{Id.}
\bibitem{24} \textit{Id.}
\end{thebibliography}
Thus more and more Americans had less and less skin in the game, which increased the ease with which borrowers could walk away from their mortgages with no significant loss. And walk away they did. By the time the myth of these “affordable” housing policies is fully realized, GSE mortgages could result in nearly 8.8 million foreclosures. So far, the fallout has led to the injection of billions of taxpayer dollars and a government takeover of Fannie Mae and Freddie Mac in September 2008 to prevent their total collapse and dissolution.

Fannie Mae and Freddie Mac had gambled on zero down payment mortgages to subprime borrowers with assurances that the unprecedented risk would be absorbed by the U.S. taxpayers in the end. A trifecta of irresponsible congressional mandates, ill-advised executive policies, and illusory market confidence provided both the rationale and the capital for dangerous leveraging and overexposure. But why did Congress doom the GSEs to fail? Why did successive administrations push them to the brink and thus jeopardize the entire U.S. economy? The answers to these questions are disconcerting.

Quite simply, a nexus of “affordable” housing mortgage lenders, the homebuilding industry, and major investment firms created a powerful “affordable” housing coalition led by Fannie Mae, Freddie Mac, and their political allies in Washington, D.C. This group used its money and power to buy influence on Capitol Hill. Between 1998 and 2008, Freddie Mac and Fannie Mae spent as much as $176 million on lobbying efforts to block legislative reform that would have stripped them of their preferential advantages.

Perhaps the most prominent partner for Fannie Mae and Freddie Mac was Countrywide Financial, a now defunct corporate behemoth. Former CEO Angelo Mozilo initiated a VIP loan program to purchase political favors and reduced oversight from high-powered elected and appointed government offi-

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25. See LIEBOWITZ, supra note 17, at 4–5, 13.
cials. After the Savings and Loan crisis of the 1980s, lenders like Countrywide rose to fill the void in subprime mortgage lending. They even expanded some of the risky lending practices that brought the earlier crisis to a head. A symbiotic relationship thus developed between these non-bank lenders and the GSEs. For example, under former CEO Jim Johnson, Fannie Mae reached a "strategic agreement" with Countrywide CEO Angelo Mozilo in which "Countrywide agreed to deliver a large portion of Fannie's annual loan volume in exchange for special financing terms." In fact, Countrywide regularly accounted for ten to thirty percent of all the loans Fannie Mae purchased in a given year.

Freddie Mac likewise joined in the subprime action, partnering with non-bank mortgage lender Ameriquest to install its automated underwriting software onsite. Fannie Mae and Freddie Mac both used Ameriquest's software to divert subprime loans from private label securitizers on Wall Street, driving up demand for risky junk mortgages.

Eventually, observant analysts and scrupulous political leaders smelled something rotten in the growing "affordable housing" scandal. Yet those who attempted to expose it and push for substantive reforms of housing policies met incredible resistance and often faced well-financed political retribution. Congressman Jim Leach (R-IA), for instance, proposed assessing a fee on the GSEs to offset federal subsidies. Fannie Mae and Freddie Mac killed the idea in only twelve hours. Fannie Mae also coerced then-Treasury Secretary Larry Summers—now Director of the White House Council of Economic Advisors—to "tone down" a report

30. See Liebowitz, supra note 17, at 10.
33. Id. at 114.
34. Letter from James Wiener, Managing Dir. of Freddie Mac, and Michael Poulos, Dir. of Freddie Mac, to Margaret Colon, Chief Admin. Officer of Freddie Mac, and Michael C. May, Senior Vice President of Freddie Mac (Apr. 1, 2004) (on file with the Harvard Journal of Law & Public Policy).
that originally criticized the cozy relationship between the federal government and the GSEs.\textsuperscript{36} When Congressman Paul Ryan (R-WI) sought to increase regulation of the GSEs, Fannie Mae sent lobbyists to stalk him and to call every mortgage holder in his district to claim falsely that he was trying to increase their mortgage rates, generating six thousand responses to Congressman Ryan's office.\textsuperscript{37} When Ryan transferred to a committee without direct oversight of the GSEs, Fannie CEO Franklin Raines sent him a congratulatory note, as if to say "good riddance."\textsuperscript{38} When Congressman Christopher Shays (R-CT) introduced legislation to end the GSEs' unique exemption from SEC registration, he "had lobbyists literally barging into [his] room," while Raines reportedly called the lawmaker to ask "What the hell have [you] done?"\textsuperscript{39} The GSEs also retaliated by ending their home-buying forums in Shays' congressional district.\textsuperscript{40}

Meanwhile, GSE employees contributed nearly $15 million between 1998 and 2008 to the campaigns of dozens of members of Congress serving on key committees responsible for oversight of Fannie Mae and Freddie Mac.\textsuperscript{41} By the time federal regulators seized the insolvent companies, sitting members of Congress had received over $4.8 million in political contributions since 1989, including over $3 million from the GSEs' political action committees.\textsuperscript{42} Of that total, fifty-seven percent went to Democrats, and forty-three percent to Republicans.\textsuperscript{43} Some of these contributions did not pass muster with the Federal Elections Commission (FEC), and in 2006 Freddie Mac paid the largest fine in FEC history: $3.8 million.\textsuperscript{44} Yet as the money flowed into campaign coffers, the favors flowed out.

\textsuperscript{36} Id.
\textsuperscript{38} Id.
\textsuperscript{40} Id.
\textsuperscript{41} Wallison & Calomiris, \textit{supra} note 2, at 3.
\textsuperscript{43} Id.
Additionally, Fannie Mae and Freddie Mac regional partnership offices provided millions in additional contributions to politicians who supported them by funding affordable housing projects in congressional districts. For example, one press release from the office of Senator Charles Schumer (D-NY) read: "Schumer Announces Up to $100 Million Freddie Mac Commitment to Address Fort Drum and Watertown Housing Crunch." The release touted that "Schumer has frequently partnered with Freddie Mac on creative, affordable housing initiatives around the state," and stated that Freddie Mac had committed to purchase $100 million of loans originated by HSBC bank, including loans with very low down payments. These politicians then claimed credit with their constituents for bringing home these earmark-like subsidies that did not have to go through the scrutiny of the usual appropriations process.

Fannie Mae and Freddie Mac also served as a revolving door for powerful former politicians, their aides, and even their family members. Former Freddie Mac CEO James Johnson managed Walter Mondale's 1984 presidential campaign, chaired the vice presidential selection committee for presidential candidate John Kerry, and was involved in President Barack Obama's vice presidential selection process. Former Fannie Mae CEO Franklin Raines previously served as President Clinton's Director of the Office of Management and Budget. Former Clinton Deputy Attorney General Jamie Gorelick served as vice chairman of Fannie Mae and earned over $26 million in compensation. Former Fannie Mae senior vice president John Buckley had served as a Republican congressional staffer and senior advisor to the presidential campaigns of Ronald Reagan in 1984 and Bob Dole in 1996. Another former Fannie senior vice president,

46. Id.
49. Id. at 8.
Arne Christenson, had been a senior advisor to Republican House Speaker Newt Gingrich. The son of Republican Senator Bob Bennett worked for Fannie Mae’s Utah regional office. Democratic Representative Barney Frank’s partner, Herb Moses, worked at Fannie Mae from 1991 to 1998 as Assistant Director for Product Initiatives while Congressman Frank sat on the House Committee with responsibility for oversight of the GSEs. Today, Congressman Frank is the powerful chairman of the House Financial Services Committee with primary responsibility for moving the Obama Administration’s comprehensive regulatory reform through the House. On December 11, 2009, the House voted by a narrow 223-202 margin to approve Congressman Frank’s 1,279 page bill, a piece of legislation that has been called “the most sweeping overhaul of the nation’s financial regulatory system since the Great Depression.”

Governance of Fannie Mae and Freddie Mac has long been subjected to political cronyism. Until President George W. Bush ended the practice, the President of the United States appointed five members to the GSEs’ boards. This arrangement was unique among publicly traded companies and solely a function of their hybrid public-private nature. These board positions were highly lucrative sinecures that presidents had used for decades to reward loyal political allies. Typically, those appointed to the board by the President served for very short periods of time and contributed very little to the day-to-day operations of the company, yet they were paid handsomely. For example, current White House Chief of Staff Rahm Emanuel was appointed to the board of Freddie Mac by President Clinton in February 2000, where he served for only fourteen months but received $320,000 in compensation. Emanuel also sold Freddie Mac stock valued between $100,000 and $250,000. Emanuel did not serve on any of the board’s work-
ing committees, and the board itself met no more than six times a year. Clinton also appointed lobbyist and golfing partner James Free and former aide Harold Ickes to the Freddie Mac board. Lead investigators working for the House Committee on Oversight and Government Reform are amassing volumes of paper that trace the practice of political favoritism and preferential treatment that stemmed from government interference in the mortgage lending industry.

For the first ten months of the 111th Congress, it appeared that House Speaker Nancy Pelosi and Democrats in Congress were circling their wagons to block a full-scale investigation into how Countrywide Financial, Fannie Mae, Freddie Mac, and a nexus of government officials created the economic storm that now rains hell on American taxpayers. After months of mounting pressure, Republicans on the House Oversight Committee finally were able to prevail upon Chairman Edolphus Towns (D-NY) to issue a wide-ranging subpoena to secure a majority of the records required to conduct a thorough investigation.

Getting to the root causes of the global financial crisis has been the stated goal of both Congress and the White House. Already, however, the Obama Administration is attempting to enact sweeping regulatory reforms and create a host of new regulatory agencies with only nominal reference to the systemic problems in the “affordable” housing policies that triggered our economic crisis and defrauded American taxpayers.

All told, the government's experiment in unsustainable affordable mortgage lending based on low down payments and “flexible” credit criteria has sucked the equity out of the U.S. housing market, trapped millions of Americans under crushing debt, and seriously damaged global financial markets. In 2006, the value of U.S. housing was estimated at $22.9 trillion. By late 2009, this number had collapsed to $16.6 trillion. Outstanding mortgage debt in late 2009 was still $10.3 trillion,

59. Id.
60. Id.
63. Id.
however, higher than it was at the height of the housing bubble in 2006—$9.8 trillion. Thus, the total loan-to-value ratio of the U.S. residential housing market in late 2009 was 62%, up from just 42.9% in 2006. This trend demonstrates that what was once unthinkable—a U.S. housing market in negative equity—is now an alarming possibility. Rather than pursuing policies that would restore the U.S. housing market to firm footing, the Obama Administration has pumped over $1.5 trillion into the housing market to artificially prop up prices. This stealthy stimulus, which is completely separate from the $787 billion boondoggle passed by Democrats last year, has been used to buy up Fannie and Freddie mortgage-backed securities, Fannie and Freddie corporate debt, and Fannie and Freddie preferred equity. When this government housing stimulus is inevitably withdrawn, we may yet have a double-dip in housing prices, bringing the market dangerously close to negative equity.

These statistics are alarming enough on their own, but the real tragedy of the government’s affordable housing policy is its impact on average Americans, particularly those of modest means. Millions of these borrowers, who were supposedly helped by federal affordable housing policies, have now been forced into delinquency and foreclosure, destroying their asset base, their credit, and in some cases, their families. For example, Latino homeowners, who once appeared to be among the most frequent beneficiaries of affordable housing policies, are now the victims of the policies that their political representatives in Washington once championed. According to the Pew Hispanic Center, nearly one in ten Latino homeowners said they had missed a mortgage payment or were unable to make a full payment, and three percent said they have received a foreclosure notice in the past year. At the same time, sixty-two percent of Latino homeowners said there have been foreclo-

64. Id.
sures in their neighborhoods, and thirty-six percent say they are worried about their own homes going into foreclosure.67

The consequences of these policies brought the entire global financial system to the brink of collapse, destroying trillions in equity and disrupting untold numbers of lives. It is essential to reexamine the borrow and spend, high-leverage policies that became prevalent in the mortgage market as a result of well-intentioned but reckless decisions made by elected officials. Without a return to fiscal discipline and prudent, responsible housing policies, we will continue to make the same mistakes that led to the current financial crisis.

67. Id.
By the early fall of 2009, the business contraction that began in December 2007 appeared to be ending, but the outlook remained hazy. Despite a number of “green shoots,” as Federal Reserve Chairman Ben Bernanke liked to put it, the data were not decisive enough to declare the end of the contraction. Employment was still falling through September 2009. Although in October 2009 it certainly seemed that the economy was near the bottom, it was not safe to say that the crisis was history. Nevertheless, much is already known about the causes of the financial crisis and government responses to it, permitting a much more than speculative review. David Wessel has provided a superb blow-by-blow account of events during the crisis; there is no point in repeating that account here. Nevertheless, a brief chronology of the phases of the financial crisis should help to organize the discussion.
I. CHRONOLOGY OF THE FINANCIAL CRISIS

The crisis broke in mid-August 2007, when the market suddenly cut off funding to several financial entities. The Federal Reserve’s initial response in August was to reduce the discount rate—the interest rate the Fed charges on loans to banks—in the hope that banks could provide funds to firms cut off by the market.

In mid-September 2007, the Fed began to cut its main policy interest rate, the federal funds rate. The rate had stood at 5.25% from June 2006 through August 2007. Although the Fed ordinarily changes its fed funds rate target in steps of twenty-five basis points, the first reduction in September was by fifty basis points. As financial strains grew and the economy gradually weakened, the Fed continued to reduce its fed funds target rate, reaching 3% in late January 2008.

In mid-March 2008, financial strains intensified as the market cut off funding to Bear Stearns, a large New York investment bank. To prevent Bear Stearns from failing, the Federal Reserve provided an emergency loan and assumed the credit risk on some Bear Stearns assets, which persuaded JP Morgan Chase to buy Bear Stearns. A few days later, the Federal Reserve cut its federal funds rate target by seventy-five basis points, down to 2.25. The Bear Stearns bailout marked the end of the first phase of the financial crisis.

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9. Id.
10. Id.
Causes and Consequences

In April, the Fed lowered its funds rate target another notch to 2%, which it held until September. During this second phase of the crisis, the economy was drifting downward, but not at an alarming pace. This phase ended with the Lehman crisis. The Fed did not bail out Lehman Brothers, an investment bank twice the size of Bear Stearns, and Lehman declared bankruptcy on September 15. Lehman's collapse marked the beginning of phase three of the crisis, when market strains went from serious to calamitous. The Fed bailed out American International Group (AIG), a huge insurance company, the day after Lehman failed. In October 2008, the Fed cut its target funds rate in two steps to 1% and further to near zero in December.

The flight to safety was so intense that in November and December 2008 the market bid the yield on Treasury bills literally to zero on some days. Credit strains were severe and economic activity declined sharply. There is no particular date or event to mark the end of phase three of the crisis; markets gradually improved and the economy transitioned to phase four, in which credit conditions became more settled and credit began to flow again.

The financial crisis was worldwide, with European banks and markets as severely affected as those in the United States. Asian banks were stronger than U.S. and European banks, but Asia could not escape the effects of the crisis. Output and employment fell around the world.

14. Id.
18. John Waggoner, Investors rush to earn nothing: 4-week T-bills sell like hotcakes at 0% interest, USA TODAY, Dec. 10, 2008, at 1B.
II. CONDITIONS LEADING TO THE CRISIS

After the stock market peak in 2000 and to resist the 2001 recession, the Fed reduced its target federal funds rate in steps, eventually reaching 1% in 2003. With interest rates low and memories of the dot-com stock crash fresh, investors searched for higher yielding investments. They thought that they had found the perfect vehicle in collateralized debt obligations (CDOs) backed by subprime mortgages. The CDOs were structured obligations, with several tranches of differing risk characteristics. The senior tranche had first claim on the mortgage interest and principal paid by the subprime mortgages in the mortgage pool backing each CDO issue. The senior tranches were rated triple-A by the rating agencies.

As the decade proceeded, underwriting standards for subprime mortgages deteriorated. Mortgage brokers, who originated the subprime mortgages, lent to households without adequate income or assets to service the mortgages. Income and asset documentation was weak or nonexistent. Some of the mortgage borrowers were investors anticipating quick resale of the properties they purchased—the “flippers.” Nevertheless, the market was so hungry for yield that investment banks found that they could easily package subprime mortgages into CDOs and peddle them to investors. Too many investors, unfortunately, took the triple-A ratings at face value and loaded their portfolios with the CDOs.

Citigroup is a good, but by no means unique, example. Citi had formed structured investment vehicles (SIVs) as off-balance-sheet entities to hold CDOs. Because mortgages return principal gradually over a period of years, these CDOs were inherently long-term assets for the SIVs. The SIVs financed their purchases

23. Roger Lowenstein, Triple-A Failure, N.Y. TIMES, Apr. 27, 2008 (Magazine), at 36.
25. Id. at 1281-82.
26. Id. at 1288-89.
mostly with borrowed funds, not equity.\textsuperscript{28} Moreover, the borrowed funds were often in the form of short-maturity, asset-backed commercial paper.\textsuperscript{29} Commercial paper is simply a corporate IOU, and the asset backing for each commercial paper issue was a package of CDOs. The commercial paper was short term, with maturities of thirty days, sixty days, or even overnight.

When the financial crisis broke in August 2007, commercial paper investors no longer rolled over their maturing paper.\textsuperscript{30} They demanded to be paid in cash instead. In the case of the Citigroup SIVs, Citi could have let the SIVs default, but instead brought the assets onto its own balance sheet and repaid the maturing commercial paper.\textsuperscript{31} Doing so put great strain on Citigroup itself.

The federal government encouraged growth of the subprime mortgage market in an attempt to increase the percentage of families owning their own homes.\textsuperscript{32} Congress and the Bush Administration pushed the giant mortgage intermediaries, Fannie Mae and Freddie Mac, to accumulate subprime mortgages.\textsuperscript{33} Previously, Fannie and Freddie had dealt only in prime mortgages with a maximum loan-to-value ratio of eighty percent.\textsuperscript{34} The main business of these government-sponsored enterprises (GSEs) was to securitize prime mortgages into mortgage-backed securities, some of which they sold into the market and some of which they held in their own portfolios. Other federal policies also encouraged home ownership and growth of the mortgage market.

House construction led the way to faster economic growth after the 2001 recession.\textsuperscript{35} Federal policies that encouraged

\textsuperscript{28} Id.  
\textsuperscript{29} Id.  
\textsuperscript{30} Id.  
\textsuperscript{31} Id.; see also \textsc{Int'l Monetary Fund, Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness} 72 (2008) (explaining how consolidation of SIVs impacts a company’s balance sheet).  
\textsuperscript{33} Id.  
\textsuperscript{34} \textsc{U.S. Gov't Accountability Office, Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-Term Structures} 2 n.7 (2009).  
\textsuperscript{35} Lawrence H. White, \textit{Federal Reserve Policy and the Housing Bubble}, 29 \textsc{Cato J.} 115, 119 (2009).
housing and an increase in house prices fed the boom.\textsuperscript{36} Mortgages, both prime and subprime, appeared to be reasonably safe investments because a borrower in distress could refinance or sell the property for enough to repay the mortgage. As house prices leveled off in 2006, and adjustable-rate mortgages taken out in the low interest rate environment of 2003–2004 began to adjust up, the music stopped.\textsuperscript{37} Defaults began to rise, and in mid-2007, some firms had trouble financing their positions.\textsuperscript{38}

Analysts continue to argue about how much responsibility for the financial crisis belongs to the federal government. My view is that the federal government was a supporting actor but the responsibility rests primarily with the private sector. The government did not make or even directly encourage Bear Stearns to sponsor hedge funds investing in subprime CDOs—hedge funds that collapsed in July 2007. Citigroup was not compelled to form its SIVs holding subprime assets. It did so in part to take assets off its balance sheet to escape bank capital requirements.

Nor do I fault lax regulation. The fundamental problem was a failure of economic analysis in both the private sector and among regulatory agencies. Neither market participants nor federal agencies thought that a significant decline in the national average of house prices could occur. The failure to understand fully the risks of subprime mortgages and to foresee the decline in house prices might be an honest mistake of portfolio managers and federal authorities alike. Building portfolios with risky long-maturity assets financed with little equity capital and short-maturity liabilities, however, is an inexcusable mistake. The federal government pursued policies to encourage homeownership, but that fact cannot justify the portfolio policies that crashed. The private-sector managers of firms that built such portfolios bear the responsibility for building houses of cards.

\textsuperscript{36} Roberts, \textit{supra} note 32.

\textsuperscript{37} See Press Release, S & P Indices, Home Prices Continue to Send Mixed Messages as 2009 Comes to a Close According to the S & P/Case-Shiller Home Price Indices (Feb. 23, 2010) (showing a graph depicting the fall in housing prices in 2006).

III. THE FEDERAL GOVERNMENT'S MANAGEMENT OF THE CRISIS

Although the National Bureau of Economic Research did not officially identify the cycle peak in December 2007 until a year later, after August 2007 the financial stress was obvious, as were signs of a weakening in the general economy. The Federal Reserve was the first responder to the crisis; fiscal policy responses came later.

To understand the Fed's management of the crisis, it is important to distinguish monetary policy from credit policy. Monetary policy involves central bank control over interest rates and the aggregate quantity of central bank funds in the system. The Fed's main monetary policy instrument is the federal funds interest rate, which is the rate on overnight loans between banks. Traditionally, the Fed controls this rate through purchases and sales of government securities in the open market.

Credit policy refers to the central bank's efforts to provide funds to particular borrowers or borrowing sectors. From the beginning, the Fed had a credit-oriented view as to how to respond to the crisis. Its first policy action in August 2007, as the crisis began, was not to reduce its fed funds target rate but instead to lower the discount rate, which is the rate the Fed charges on its loans to banks. The discount rate had for some years been one hundred basis points above the fed funds target rate, but the Fed cut the margin to fifty basis points on August 17, 2007. Predictably, that action had little effect because most banks were still able to borrow readily in the market at the fed funds rate, which was fifty basis points cheaper.

Many in the Fed thought that "stigma" explained why banks used the discount window so sparingly. Banks, they thought, were unwilling to borrow from the window because doing so would be a sign to the market of financial weakness, even though the Fed maintained the confidentiality of the borrow-

39. See NAT'L BUREAU OF ECON. RESEARCH, supra note 1.
The Fed searched for another mechanism to inject more funds into the banking system and in December 2007 launched the Term Auction Facility, or TAF. The TAF was a type of discount window borrowing in which the Fed auctioned off blocks of funds to the highest bidders.

The TAF did not, however, solve the basic problem that the banks and bank credit markets faced. As the crisis deepened, most banks were reporting large losses; discount window lending, including that through the TAF, was collateralized. Banks retained the credit risk on the collateral. At the time of the Lehman failure in mid-September 2008, TAF credit outstanding was $150 billion, but availability of TAF funds did nothing to make banks more willing to lend to Lehman or other risky borrowers. Thus, the TAF did little to improve bank credit availability.

Nor did the TAF do much to bring down bank lending rates to creditworthy borrowers. A bank borrowing from the Fed, even at the attractive TAF auction rate, could choose either to make new loans with the funds or to let its other liabilities, such as certificates of deposit (CDs), run off. Thus, the marginal cost of making a new commercial loan was still the CD rate and not the TAF auction rate. Essentially, TAF provided a modest increase in bank earnings because the TAF borrowing rate was below a bank’s cost of funds from other sources, such as from issuing CDs. The TAF did not solve the asset-liability duration mismatch problem banks faced. Banks held substantial longer-term loans financed with shorter-term funds. Even the ninety-day TAF funds did not address this problem. At best, the TAF was a stopgap measure that did not address the fundamentals of the financial crisis.

As TAF funds outstanding grew, and as the Fed invented other special facilities to ease credit strains in particular sectors of the market, the Fed did not increase the total funds it made available.

43. Id.
45. Id.
46. Id.
available to the market. Just before the Lehman failure, total reserve bank credit was only 3.6% above the figure a year earlier, which did not evidence an expansionary monetary policy. The Fed had reduced its fed funds target rate, but the reductions had barely kept pace with the decline in the demand for funds in the market. Although total reserve bank credit had grown by $30 billion over the fifty-two weeks prior to mid-September 2008, the Fed’s holdings of government securities had declined by $300 billion. During this phase of the crisis, the Fed in effect financed the Bear Stearns bailout, the TAF, and other special credit facilities by selling government securities from its portfolio. The easier credit policy was not reinforced by an increase in the aggregate supply of funds to the market.

Whether the Fed should have pursued a more expansionary monetary policy before Lehman’s collapse is not clear. In the summer of 2008, employment was not in a freefall and the enormous increase in energy prices to a peak in July raised valid inflation concerns. Fed monetary policy changed dramatically after the Lehman failure and the bailout of AIG. After Lehman, the Fed financed new credit extensions by printing new money. The Fed held its government securities portfolio roughly constant and allowed total reserve bank credit to explode from $888 billion just before Lehman to $2.25 trillion at the end of 2008. Term auction credit rose to $450 billion, and several other credit programs were expanded or newly invented.


49. Id.

50. See id.


52. This figure is based on the weekly average for the week ending December 31.


The initial fiscal policy response to the crisis was the Economic Stimulus Act of 2008, 55 enacted in February, which provided tax rebates and business tax deductions to counter the recession that many thought might have begun. 56 The Congressional Budget Office (CBO) estimated that the legislation would increase the federal deficit by $152 billion in 2008. 57 The deficit is an imperfect measure of the impact of fiscal policy, but for present purposes will serve as a useful measure of the size of the fiscal response. The CBO concluded that the legislation made a modest contribution, raising consumption in 2008, but that the impact on overall economic activity disappeared by the end of that year. 58 Thus, this stimulus bill made no lasting contribution to economic stability.

In February 2009, the new Obama Administration passed the American Recovery and Reinvestment Act of 2009. 59 This fiscal package was much larger than the one passed a year earlier. The CBO estimated the impact on the budget deficit to be an increase of $185 billion in fiscal 2009, of $399 billion in fiscal 2010, and a total of $787 billion over the ten-year budget horizon of 2009 to 2019. 60 Economists will argue about the effectiveness of this legislation for years to come.

Both the 2008 and 2009 stimulus bills were attempts to temper the general economic downturn. Other fiscal actions were more directly aimed at the financial crisis. In July 2008, at the urging of Treasury Secretary Henry Paulson, Congress granted the Treasury authority to provide financial assistance to Fannie Mae and Freddie Mac. 61 At the time, these two nominally private firms had more total obligations, on and off balance sheet, than the publicly held Treasury debt. They were brought into

56. Id. §§ 101–103.
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federal conservatorship uneventfully in early September, before a run on them could create a panic in the markets.62

The Troubled Asset Relief Program63 (TARP) was designed to deal directly with the so-called "toxic" subprime mortgage assets on banks' books. The turmoil following the Lehman bankruptcy was so great that the Treasury and the Federal Reserve agreed that it was necessary to attack the toxic asset problem directly.64 After considerable political wrangling, Congress passed the $700 billion TARP bill. The original Treasury objective with TARP was to buy toxic assets from banks. The idea was subject to a fatal flaw that should have been obvious to the Treasury from the start: What price would the Treasury pay for toxic assets? If the Treasury paid what the assets were truly worth, the program would not serve to assist the banks; if Treasury overpaid, the result would be a taxpayer gift to the banks. After batting around several ideas, the Treasury abandoned the idea of buying toxic assets.65

Instead, the Treasury used TARP funds to strengthen bank capital through purchases of senior preferred stock in the banks.66 In essence, the Treasury took a semi-ownership position in banks without diluting common shareholders. By bolstering bank capital, the Treasury enabled banks to resume lending to the private sector, or at least reduced pressure on banks to contract their lending. By June 2009, Treasury capital purchases totaled $199 billion, of which $70 billion had been repaid. A total of 591 institutions were involved. In addition, TARP funds were used for a variety of other loans, including $55 billion in assistance to automobile firms.67

67. Id.
IV. EVALUATION OF THE GOVERNMENT’S RESPONSE TO THE FINANCIAL CRISIS

The Treasury and the Federal Reserve were slow to recognize that the problem was much more than liquidity. Markets were cutting off funding to banks and other financial firms because investors feared that the firms might be insolvent. Those fears were justified. Two Bear Stearns hedge funds had collapsed in July 2007, and a number of other entities were obviously and visibly in shaky financial condition.68 There should have been an earlier recognition that house prices were going to decline, because prices were out of line with fundamentals. Thus, not only would subprime mortgages become increasingly troubled but so also would prime mortgages. Failure to recognize the implications of declining house prices was not a regulatory failure but a basic failure of economic analysis.69 Regulators could enforce capital standards on banks and could monitor bank risk management policies. As ordinarily conceived, the economic analysis of house prices went beyond what bank supervisors and examiners were expected to do.

The Treasury and the Federal Reserve can also be faulted for failing to engage in adequate contingency planning after the Bear Stearns bailout. It is hard to read Wessel’s account any other way.70 The Treasury and the Fed did not seek funding from Congress because they assumed that Congress would not be responsive.71 They did not try to make the public case, however. After Lehman failed, they had no choice, and Congress did respond with prompt passage of the TARP legislation. In contrast, the risks of failing to deal with Fannie Mae and Freddie Mac were well understood and the two firms were taken into conservatorship without incident.72

68. WESSEL, supra note 5, at 93.
69. See id. (noting that the Fed’s main policy concern as of July 2007 was the risk of rising inflation and not the housing bubble).
70. See id. at 178–80.
71. Id. at 179 (“Paulson and Bernanke concluded that there wasn’t any point in asking Congress—unless the crisis intensified to the point where there were no other options.”).
72. Id. at 186–87.
The Treasury and the Federal Reserve have not made a strong case for financial reform. Large banks have become larger; the problem of too big to fail (TBTF) is much more serious. Baker and McArthur estimate that the public subsidy to the big banks, because of the market's assumption that any large bank in trouble will be bailed out, runs somewhere between $6 billion and $34 billion per year. The issue is not primarily the subsidy arising from the fact that big banks can borrow more cheaply than small banks. Instead, the subsidy permits the big banks to grow even bigger, increasing the risk to the financial sector if (or when) they get into trouble again. Moreover, cheap financing encourages the big banks to take risks they might not otherwise take; with implied federal backing, banks need not fear that the market will cut off financing.

More than eighteen months after the Bear Stearns bailout, there seems to be no sense of urgency in addressing the TBTF problem and in instituting reforms to make the financial system more robust. This situation reflects a failure of political leadership in Washington. Although banks are currently more cautious than they were before the financial crisis, underlying conditions and incentives have not changed. As the economy improves and memories of the financial crisis fade, there is real danger that a new financial crisis will be taking shape.

V. LEGAL AND GOVERNANCE ISSUES

David Wessel is generally very complimentary of the policies pursued by the Federal Reserve. His introductory chapter to In Fed We Trust is titled "Whatever It Takes," and he repeats that phrase frequently in his commentary on Fed creativity in inventing new credit facilities to deal with the crisis. It will take

75. Id. (arguing that the mentioned subsidy arises precisely from the fact that banks enjoying protection under the "too big to fail" concept are able to borrow more cheaply).
76. WESSEL, supra note 5, at 1.
some years to accumulate research findings as to just how effective the Fed’s credit facilities were.\textsuperscript{77}

A legal issue, or governance issue, surrounds the Federal Reserve’s use of Section 13(3)\textsuperscript{78} of the Federal Reserve Act.\textsuperscript{79} This Section came into the Act as an amendment in 1932.\textsuperscript{80} Under the Federal Reserve Act, the basic power of the Fed is to make loans to banks and to conduct open market operations in obligations issued or guaranteed by the federal government. Section 13(3) provides emergency authority for the Federal Reserve to lend to nonbanks when such lending is deemed necessary in “unusual and exigent circumstances.”\textsuperscript{81}

The Federal Reserve invoked Section 13(3) as its legal justification for several different actions. The Fed appealed to Section 13(3) as the legal basis for the emergency funds to bail out Bear Stearns and AIG. The same justification was offered, however, for some other special credit facilities, including the commercial paper funding facility, illustrating the issues surrounding such justifications in general. The amendment was inserted late in the legislative process and was not subject to committee or floor debate. There is case law, however, indicating what “un-


\textsuperscript{78} David Fettig provides useful background information on Section 13(3). See David Fettig, The History of a Powerful Paragraph: Section 13(3) enacted Fed business loans 76 years ago, REGION, June 2008, at 33; see also David Fettig, Lender of More Than Last Resort: Recalling Section 13(b) and the years when the Federal Reserve opened its discount window to business, REGION, Dec. 2002, at 14.


\textsuperscript{81} 12 U.S.C. § 343 (2006) ("In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 357 of this title, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: \textit{Provided,} That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.").
usual and exigent circumstances” most likely meant in 1932. Contemporaneous courts interpreting similar language in other statutes focused on the suddenness and unexpectedness of calamitous events and whether immediate action was required to avoid disaster to a corporation. In the context of the Federal Reserve Act, therefore, the term “unusual and exigent circumstances” likely contemplates unforeseen financial circumstances that require immediate action or remedy, particularly when necessary to ensure the survival of a business entity.

Furthermore, although the third edition of Black's Law Dictionary, published in 1933, did not have a definition of “unusual and exigent circumstances,” it did have a definition of exigency that corroborates the case law's focus on imminence: “[d]emand, want, need, imperativeness; emergency, something arising suddenly out of the current of events; any event or occasional combination of circumstances, calling for immediate action or remedy; a pressing necessity; a sudden and unexpected happening or an unforeseen occurrence or condition.”

Finally, one relevant piece of legislative history concerns Section 11(r) of the Federal Reserve Act, which permits the Board to utilize its 13(3) powers in situations where there are fewer than five members present. This provision was part of a larger bill aimed at providing insurance in the event of terrorist attacks. One can thus assume the reason for it was so that the Board could take immediate action in response to a financial crisis as exigent as one brought on by a terrorist attack. Congress clearly had such an extreme exigency in mind because it provided that even a delay to contact other Board members by phone “or other electronic means” would be too long.

83. BLACK'S LAW DICTIONARY 721 (3rd ed. 1933).
86. 12 U.S.C. § 248(r)(2)(A)(ii)(III) (requiring before the Board exercises its 13(3) powers that it determine that exigent circumstances existed, that the borrower is unable to secure credit through other means, that action is necessary to prevent “serious harm to the economy or the stability” of the U.S. financial system, that they have been unable to contact the other board members by any means available, and that waiting any further to do so would be impossible).
The Fed's reliance on Section 13(3) is fully justified in the context of decisions to bail out Bear Stearns and AIG, whatever the merits of those bailouts, for those situations were clearly emergencies. The case for relying on Section 13(3) to justify the program to buy commercial paper, however, is much less clear. The Fed announced its Commercial Paper Funding Facility (CPFF) on October 7, 2008. The first loans were made about three weeks later, on October 27. By year end, this program had an outstanding balance of $332 billion. The program reached a peak of $350 billion in mid-January 2009.

The launch of CPFF did not reflect a weekend emergency. The financial crisis called for quick and decisive action, but not immediate action decided in a matter of hours. If there was an emergency at all, it was because of congressional unwillingness to act, not because Congress did not have time to act. If Congress was unwilling to act because of its concern about the politics of a program to provide credit to large corporations, a federal agency should not make its own decision on what is necessary, committing hundreds of billions of dollars in taxpayer resources.

One possible view is that the Fed found itself in an unfortunate position, but that it did what it had to do given October's financial turmoil. That seems to be Wessel's view: "whatever it takes." The Fed should have made a strong public case that Congress had to act to provide the needed credit. There would have been a public debate about the wisdom of the proposed program. We know nothing of the internal debates in the Fed about the CPFF. Essentially, the Fed simply asserted that the program was necessary to reduce financial turmoil. The Federal Reserve has never explained, either in October 2008 or since, why assistance to the particular borrowers eligible for the CPFF was essential to dealing with the financial crisis, whereas assistance to other potential borrowers was not essential.

If Congress had acted, the CPFF would have been administered by the Treasury, instead of by the Fed, and financed by new Treasury debt, instead of by monetary expansion. As with other federal credit programs, eligibility, reporting require-

88. WESSEL, supra note 5, at 228–29.
89. Id. at 229.
ments, disclosure requirements, the interest rate, and other credit terms would have been determined by legislation, or delegated to the Treasury. Government program provisions are inherently political decisions. The Fed should not have been making these decisions, because doing so would inevitably draw it into political disputes, such as those over disclosure.

The Federal Reserve’s program to buy mortgage-backed securities (MBSs) raises similar governance issues. The Fed’s program is to buy a total of $1.25 trillion of MBSs by the end of the first quarter of 2010.\(^{90}\) Like the CPFF, this program was not a weekend emergency effort, but rather one that Congress could have authorized. The Fed initially announced this program in a press release on November 25, 2008.\(^{91}\) The first appearance of MBSs on the Fed’s balance sheet was not until the H.4.1 release for January 15, 2009.\(^{92}\)

The time between announcement and execution of the Fed’s MBS purchase program is comparable to the gap between passage of the TARP legislation in 2008 and the stimulus bill in February 2009. Congress could have debated an MBS purchase program and decided whether the benefits of the program outweighed the additional government debt required to finance it, rather than letting an unelected agency initiate the program.

One element of such a congressional debate might logically have been whether it would be a good idea to expand the amount of Treasury debt outstanding by $1.25 trillion to finance this program. Given the enormous scale of the budget deficit, that would have been a valid issue to debate. Instead, the Federal Reserve is financing the program by creating new money. Another item that might have been debated in Congress would have been whether a total outlay of $1.25 trillion should all go for purchasing MBSs. Some might have argued that some of the funds should instead have been used to expand loans to small businesses. Or, perhaps some should have

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90. Id. at 269.
been used to buy bonds from hard-pressed state governments, or to expand mortgage relief for borrowers near foreclosure.

The point is not to argue here the merits of alternative uses of $1.25 trillion but to emphasize that decisions on credit programs have historically been left to Congress. Once the financial crisis is fully resolved, Congress should take up this issue. What are the appropriate constraints on the Federal Reserve? The issue may well be on the congressional agenda at some point. Wessel flags the issue in his first chapter:

Barney Frank, the sharp-tongued sharp mind who chaired the House Financial Services Committee, captured the issue clearly. Labeling Bernanke “the loan arranger” with his sidekick, Paulson, Frank said, “I think highly of Mr. Bernanke and Mr. Paulson. I think they are doing well, although I think it’s been inappropriate in a democracy to have them in this position where they were sort of doing this stuff unilaterally. They had no choice. And it’s not to their discredit, but . . . this notion that you wait until there’s a terrible situation and you just hope that the chairman of the Federal Reserve would pop up with the secretary of the Treasury and rescue you. It’s not the way in a democracy . . . you should be doing this . . . .

“No one in a democracy, unelected, should have $800 billion to spend as he sees fit,” he said.93

Economists almost universally believe that there should not be political interference with the central bank’s monetary policy decisions. A legacy of the Federal Reserve’s expansive credit programs may be that Congress will enact constraints on the Federal Reserve that affect its monetary policy decisions as well as its credit policies. Many will find the position stated by Barney Frank persuasive; whether they will be able to separate monetary from credit policies is less clear.

VI. REFORMS TO ENHANCE FINANCIAL STABILITY

A distressing feature of the financial crisis is that such events have happened so often before. Charles Kindleberger’s classic book, Manias, Panics and Crashes: A History of Financial Crises, went through four editions and has been updated since his

93. WESSEL, supra note 5, at 7.
death to a fifth edition.\textsuperscript{94} A more recent book by Carmen M. Reinhart and Kenneth S. Rogoff, \textit{This Time Is Different: Eight Centuries of Financial Folly},\textsuperscript{95} adds a great deal of data to the Kindleberger history.

The cost of the financial crisis is immense. One number is sufficient to indicate the scale of the costs in the United States: The crisis is responsible for reducing employment by eight million jobs and perhaps more depending on exactly when the recovery begins.\textsuperscript{96} Large banks that get into financial trouble not only affect their own shareholders and employees, but also firms and employment across the country and around the world.

The most fundamental reform is to force banks large enough to create a systemic risk to the economy to hold more capital as a cushion to protect the deposit insurance fund and to create more market discipline in their management. Economists have studied this issue for years; the most promising approach is that banks should be required to issue a substantial block of long-term subordinated debt.\textsuperscript{97}

To illustrate the proposal, suppose every firm with a bank charter was required to maintain a block of ten-year subordinated notes equal to ten percent of its total liabilities. Every year, the bank would have to roll over the maturing notes; if the market were un receptive, the bank would have to shrink its total assets by ten percent to live within its remaining block of outstanding subordinated notes. Stability of the banking system and market discipline might be further enhanced by providing that a bank could conserve cash that would otherwise be used to redeem maturing sub debt by converting the sub debt to equity at a predetermined ratio.

Market discipline requires that some creditors be at risk. Financial stability, however, requires that creditors who fear a loss must not be able to run. A key function of a bank is to offer

\begin{itemize}
\item \textsuperscript{94} CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, \textit{MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES} (5th ed. 2005).
\item \textsuperscript{95} CARMEN M. REINHART & KENNETH S. ROGOFF, \textit{THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY} (2009).
\item \textsuperscript{96} Floyd Norris, \textit{The Jobs News Get Worse}, N.Y. TIMES, Oct. 4, 2009, at WK3.
\item \textsuperscript{97} See Bd. of Governors of the Fed. Reserve Sys. Study Group on Subordinated Notes & Debentures, Using Subordinated Debt as an Instrument of Market Discipline 172 (1999) (analyzing thoroughly the subordinated debt proposal).
\end{itemize}
demand deposits and other short-dated time deposits or deposit-like obligations. The only way to assure financial stability and to assure that some creditors be at risk is to require long-term debt in the capital structure. The proposal also has the advantage that, when a bank is forced to contract because it cannot roll over maturing sub debt, the bank itself manages the restructuring. It is best to avoid regulatory discretion because a bank in trouble may be able to appeal to Congress to override regulators' decisions.

Another useful reform would be to encourage a less leveraged economy. One way to do so would be to phase out the deductibility of interest on all income tax returns. At present, the deductibility of interest encourages debt over equity. A quick calculation indicates that phasing out the deductibility of interest on corporate returns and reducing the statutory corporate tax rate from its current thirty-five percent to fifteen percent would be roughly revenue neutral.

VII. REFLECTIONS ON FREE MARKETS

The financial crisis is a sobering experience for a Chicago-school advocate of the market. The federal government was not without blame for the crisis, but the basic problem was that far too many financial firms pursued shortsighted portfolio policies. Banking 101 says that it is dangerous to design a portfolio with long-duration risky assets financed with short-duration liabilities and thin capital. That is what one financial firm after another did, and the government is not to blame for those misguided private-sector policies.

Throughout history, financial crises occur when liquidity dries up, usually because solvency concerns arise when risky assets decline in value. Why is it that the market seems to make the same basic mistake repeatedly? It is terribly important that we figure out the answer to this question, because we also know that markets and not government-run economies generate economic growth. This financial crisis was costly; if we cannot figure out how to make market economies more stable, we risk growing government involvement, which we can be certain will make economies grow more slowly.

My tentative conclusion is that market participants systematically underestimate the probability of extreme events. They rely on instincts described by the normal distribution and by
formal models based on normality. Yet, there is an enormous amount of evidence that the probability of extreme events out in the tails of the probability distribution is much higher than indicated by the normal distribution—the fat tails problem.98

If this observation is correct, then an appropriate function of government is to create incentives that offset the market’s underestimate of tail probabilities. For large banks, the issue is one of externalities. A large bank failure has costly effects on many third parties. Eliminating the deductibility of interest on tax returns would help to control the externality as would a stiff subordinated debt requirement for banks.

In reflecting on the causes and consequences of this financial crisis, it is a mistake to think of the subprime mortgage fiasco as a unique cause that will not recur. It is indeed unlikely that the subprime mortgage market itself will again create a systemic risk, but some other new and creative market probably will. The essence of a dynamic capital market is that it searches for new opportunities and feeds capital to new ventures. Some of the new ventures turn out to be busts. What ought not happen is that the busts shake the entire economy because they are financed by banks in too risky a fashion. Federal policy should require that banks hold a larger capital cushion against the inevitable busts. It is most unfortunate that financial reform is not yet a consequence of this financial crisis.

SMITH VERSUS KEYNES: ECONOMICS AND POLITICAL ECONOMY IN THE POST-CRISIS ERA

SAMUEL GREGG*

INTRODUCTION

Alongside politicians, bankers, and CEOs, few groups have received as much opprobrium for the 2008 financial crisis as economists. "Economists are the forgotten guilty men" was the phrase employed in February 2009 by Anatole Kaletsky, editor-at-large for the London Times, when explaining why "a bank with just $1 billion of capital [would] borrow an extra $99 billion and then buy $100 billion of speculative investments."1 Self-indulgence and imprudence had a part, but so too, Kaletsky asserted, did those economists who insisted that their models "proved" that occurrences such as Long Term Capital Management's demise in 1998 or Lehman Brothers's collapse almost exactly ten years later were mathematically likely to happen only once every billion years.2 Kaletsky's wider claim was that mainstream economics had been so discredited by the financial crisis that economics itself required an "intellectual revolution" or risked being reduced to a somewhat suspect sub-branch of mathematical modeling and statistical analysis.

Kaletsky has not been alone in making such arguments. Economic historian Harold James made a similar point, albeit more temperately:

[A]n overwhelming majority of modern economists were misled by treating short-term trends as if they were permanent phenomena that could be used to derive reliable behavioral correlations and extrapolations. There were some exceptions... but such analysts were dismissed as alarmist or

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2. Id.
eccentric, not only by the commercially driven economists who worked for financial institutions as de facto salesmen, but also by the overwhelming majority of academic economists, who were also subject to commercial pressures in the forms of peer evaluation and patterns of career development. These economists instilled a false complacency in politicians and other policymakers.3

In March 2009, Willem Butler, a former external member of the Bank of England’s Monetary Policy Committee, likewise referred to “[t]he unfortunate uselessness of most ‘state of the art’ academic monetary economics.”4 Though unwilling to demand either a complete paradigm change or a defenestration of the economics profession, the Economist suggested that the financial meltdown raised profound questions of coherence about two specific fields of economics: financial economics and macroeconomics. “Few financial economists,” it suggested, “thought much about illiquidity or counterparty risk, for instance, because their standard models ignore it.” Likewise, “[m]acroeconomists also had a blind spot: their standard models assumed that capital markets work perfectly.”5

These claims evoked a strong riposte from the Nobel Prize economist Robert Lucas in defense of the Efficient Market Hypothesis (EMH), the claim that the price of a financial asset reflects all relevant, generally available information. “One thing,” Lucas wrote, “we are not going to have, now or ever, is a set of models that forecasts sudden falls in the value of financial assets, like the declines that followed the failure of Lehman Brothers in September [2008].”6 Since the late Paul Samuelson published his proof for one version of the EMH in 1965 and Eugene Fama detailed the theory and evidence for three forms of the EMH in 1970,7 the EMH had been subject to consistent criticism. But none of these critiques, Lucas maintained, had proved its falsity. Other economists, however, argued that the

stock market meltdown demonstrated the EMH's inability to account for the market overpricing assets such as mortgages. On this basis, they conjectured, "the EMH, as applied to the stock market in aggregate, must be discarded or modified." 8

While these discussions are important, much of the debate about economic theory following the 2008 crisis has focused upon the place of models in economics. Some contemporary economists seem hesitant to question the appropriateness of their heavy dependence on models and mathematical logic. This hesitance may arise because they want to avoid raising difficult questions about the very nature of postwar mainstream economic science.

Since John Maynard Keynes's time, mainstream economics has undergone a steady process of mathematization and immersion in abstraction. One need only glance through their nearest copy of the *American Economic Review* and observe the plethora of algebra that is now central to most mainstream economists' argumentation. Outside the Austrian school of economics, few economists have publicly questioned this dependence. One economist willing to do so, however, was Wilhelm Röpke (1899–1966). Röpke is well known as one of the intellectual architects of postwar West Germany's path from National Socialist economic collectivism to a market-driven economic miracle in the decade following West Germany's economic liberalization in 1948. Less attention, however, has been given to Röpke's passionate critiques of postwar developments in economics as a social science. On one level, these denunciations were driven by Röpke's belief that policies based upon Keynesian-influenced economics would gradually diminish economic and political liberty. But another source of Röpke's angst was his conviction that Keynes and, more par-

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particularly, his many disciples were slowly undermining the integrity of economics as a social science. Though Röpke died over forty years ago, his analysis of trends in economic science following Keynes's *General Theory* provides useful insights into some of the challenges confronting contemporary economics. It also contains some intimation of a possible direction for post-crisis economics, one closer to the vision of Adam Smith than the legacy imparted by Keynes and his successors.

I. ECONOMICS, POSITIVISM, AND SCIENTISM

Reflecting on the fortunes of economics in the 1950s, Röpke marveled at the enormously augmented scope for economic research. He contrasted it with the economics profession's situation in prewar Germany as a lowly handmaiden to faculties of law. Postwar economic science enjoyed a stature that had previously eluded the discipline, partly, Röpke thought, because a range of difficulties had emerged since the 1930s that caused many to turn to economics for responses. But, Röpke held, these new realities were actually grounds for considerable concern about postwar changes in economics as a social science.

"The economist, too," Röpke once wrote, "has his occupational disease: restricted vision." Emphasizing that he spoke from personal experience, Röpke suggested that some economists found it hard to look beyond their own discipline or concede that the economy was part of a larger order about which other sciences had things to say. This provincialism was magnified by the error of "economism," the habit of viewing "everything in relation to the economy and in terms of material productivity, making material and economic interests the center of things by deducing everything from them and subordinating eve-
rything to them as mere means to an end." Economic research, Röpke insisted, would not be productive if economists largely ignored the complexity of the world in which economic choices and policies operate. Economism invariably led economists into the trap of what Röpke called "social rationalism," the tendency to regard market mechanisms as value-neutral methods applicable to any economic or social order. One example was the attempt of socialist economists such as Oskar Lange to reconcile the price mechanism with collectivist economies. How, Röpke asked, could a mechanism that assumes human freedom operate in societies premised on the radical subordination of liberty?

It followed, according to Röpke, that economists should seek to avoid segmenting economic inquiry from the complex character of human nature. Though attentive to utility, Röpke rejected the neoclassical premise of humans as rational utility maximizers: "The ordinary man is not such a homo economicus . . . . The motives which drive people toward economic success are as varied as the human soul itself." Nor did Röpke consider it reasonable to premise economic theory on an understanding of humans as selfless creatures. Instead, Röpke invoked a rather Smithian understanding of human beings to explain his fondness for market economies over the alternatives:

There is a deep moral reason for the fact that an economy of free enterprise brings about social health and a plenitude of goods, while a socialist economy ends in social disorder and poverty. The "liberal" economic system delivers to useful ends the extraordinary force inherent in individual self-assertion, whereas the socialist economy suppresses this force and wears itself out in the struggle against it. Is the system unethical that permits the individual to strive to advance himself and his neighbor through his own productive achievement? Is the ethical system the one that is organized to suppress this striving? . . . It makes virtue appear irrational and places an extravagant demand upon human nature when men in serving virtue in a collectivist economy must act against their own

18. Id. at 121.
19. See Röpke, supra note 13, at 233–34.
proper interests in ways that, as even the simplest of them can see, do nothing to increase the total wealth.20

Röpke was also impatient with economic theories that diminished the study of individual human choice and action to relative insignificance.21 This diminishment, Röpke maintained, was the product of scientism’s effect upon economics. He defined “scientism” as the tendency to “understand by science [what] is merely fundamentally the narrow territory of the ‘positivist’ and ‘exact’ natural sciences and their technical application.”22 Scientism embodied the notion that there were no limits to the cognitive capacities of positivist methodology and technical analysis. It was usually associated with “an optimistic belief in progress by means of a mechanical leadership of society.”23 The result was “the scientific elimination of the Human element in political and economic practice.”24

Röpke also treated scientism as destructive of humanity’s centuries-old striving towards a unity of knowledge, epitomized by the medieval and early-modern scholastic tradition. Though he agreed that “the endless multitude of possible problems”25 necessitated specialized intellectual inquiry in both the humanities and sciences, both social and natural, Röpke underlined “the utter futility of a science which progressively heaps up matter, which is always measuring, analyzing, and documenting but which continually gets further and further away from a synthesis.”26 It created people whose head[s] . . . [are] filled exclusively with “useful” knowledge and who cannot grasp that abstract natural science and physics possess quite a different educational value from the moral sciences . . . that the science of mathematics is an admirable, nay an indispensible training for the intellect but that when it has done its work it can be put aside.27

20. Id. at 233.
21. See Wilhelm Röpke, Selbstbesinnung der Wissenschaft, 10 NEUE SCHWEIZER RUNDSCHAU 4 (1942).
23. Id. at 69.
24. Id. at 63.
25. Id. at 75.
26. Id. at 70.
27. Id. at 66.
Scientism "implies simultaneously disdain for synthesis. It means ever more specialization, the breeding of a learned type."  

Among economists, scientism had helped to facilitate "the disinclination of so many economists to make contact with sociology, ethics or politics."  

This isolation of economists from the rest of the academy added up to a cult "of endless documentation, of Empiricism and Historicism, of the quantitatively measurable, of research more geometrico to the detriment of the humane sciences (the moral sciences), and their orientation towards the natural sciences as the one ideal to be pursued in everything."  

Much of Röpke's appraisal of scientism's impact upon economics parallels and draws upon another twentieth-century advocate of free markets, Friedrich von Hayek.  

In Hayek's view, scientism undermined economics insofar as it encouraged the illegitimate importation of the techniques of the natural sciences into a social science.  

Röpke also shared Hayek's concern that scientism in economics encouraged collectivist economic thinking. The post-Enlightenment "faith in the mission of rationalism for the reconstruction of society, faith in the task of 'organiser scientifiquement l'humanité,'" had simply misled some to believe economic life could simply be reorganized along more "rational" lines than market economies.

II. ECONOMISTE-PHILOSOPHES OR ECONOMETRICIANS?

The influence of positivism and scientism on economics marked, according to Röpke, a departure from the understanding of economics Adam Smith articulated. In Röpke's view, Smith was "a representative of the humanist spirit of the eighteenth century," whose *Wealth of Nations* formed part of a larger intended work on "the cultural history of mankind" in which "economics was viewed as an organic part of the larger
whole of the intellectual, moral, and historical life of society." 35 As the author of The Theory of Moral Sentiments, 36 Smith understood that his Wealth of Nations did not and could not encapsulate human life in its entirety. 37 Röpke asserted that Smith viewed social and economic life as the product of an invisible hand and "a living order with an immanent logic of its own which the human mind could comprehend and even destroy but could not duplicate." 38

By way of contrast, Röpke viewed John Maynard Keynes as Smith's antithesis. Keynes was "a representative of the geometric spirit of the 20th century" and "an exponent of positivistic scientism," for whom "economics was part of a mathematical-mechanical universe." 39 When combined with the modern proclivity for statistics, this outlook actually limited economists' ability to comprehend economic phenomena. 40 Thus, although Röpke treated Smith as a promising start, he considered Keynes to embody a rationalistic deterioration in modern economics' explanatory power. 41 Although Röpke did not regard all Keynesian concepts as mistaken, he did view "Keynesianism" as a defective way of economic thinking. Röpke consigned more blame to Keynes's followers, 42 but he maintained that Keynes's approach to economics had created an "old economics" and a "new economics" in which the reason of one was the nonsense of the other. 43

36. ADAM SMITH, THE THEORY OF MORAL SENTIMENTS (1759).
37. See RÖPKE, supra note 17, at 92.
38. RÖPKE, supra note 35, at 224.
39. Id.
41. RÖPKE, supra note 35, at 224.
42. Id. at 225. In his analysis of Keynes's thought, Gilles Dostaler presents a strong case that Keynes was not the only inspiration behind the revolution that bears his name. GILLES DOSTALER, KEYNES AND HIS BATTLES 255 (Niall B. Mann trans., 2007). Other economists, such as those of the Stockholm school, were proposing Keynesian-like arguments about effective demand as early as the 1920s. Id. at 256. Furthermore, the mathematization of "Keynesianism" was largely pioneered by Sir John Hicks in 1937. See J.R. Hicks, Mr. Keynes and the "Classics": A Suggested Interpretation, 5 ECONOMETRICA 147 (1937).
Here Röpke was not referring to the difference between relatively free market and relatively interventionist economic policies. His concern was with what people thought constituted the essence of economics as a social science and the methods it employed. According to Röpke, most economists working in the post-Keynes era were inclined to reduce economics to mathematical and statistical analysis or macroeconomics. Economics consequently became a quantitative enterprise that "teems with equations in ever-increasing profusion" and that focused on the development of patterns of aggregate behavior by entire societies that bore little resemblance to reality.44 Opening a post-Keynes economics textbook, Röpke claimed, made readers wonder whether they had purchased a chemistry curriculum.45

Röpke's concerns about the post-Keynes macroeconomic focus of economics did not mean that he somehow "opposed" macroeconomics. Even non-Keynesians employed terms like "a country is living beyond its means" as a way of describing how the aggregate expenditure for investment and consumption in a given area created more purchasing power than could be provided at present prices for the economy's output in that area.46 Röpke's complaint was that Keynes had essentially "declared the method of thinking in aggregates to be the only valid one, now and in the long run."47 This development was undermining the doctrine of the movement of individual prices, the great achievement of 150 years of economics,48 and, thus, the real content of economics. With the appearance of a generation of economists exclusively trained to work with economic aggregates, Röpke maintained that the economist's skills were increasingly diminished to the capacity to articulate "hypothetical statements about functional relationships in mathematical formulas or curves."49

Here Röpke may have been thinking of Paul Samuelson's attempt to rearticulate economics in mathematical terms.50 For Röpke, such endeavors confused the object of economics with a

44. Röpke, supra note 11, at 121.
45. Id.
46. See RÖPKE, supra note 17, at 177.
47. RÖPKE, supra note 43, at 172.
48. See id. at 171.
49. RÖPKE, supra note 17, at 193.
50. See PAUL ANTHONY SAMUELSON, FOUNDATIONS OF ECONOMIC ANALYSIS (1947).
medium of economic analysis. As Jesús Huerta de Soto noted, mathematics is a form of language based upon symbols that partly emerged as a way of facilitating the study of the natural sciences. But the functional relationships that mathematics attempts to capture in the economic world are constantly undermined by factors such as entrepreneurship, which distorts the constancy of information that mathematics demands.\(^{51}\) In Röpke’s view, mathematics and empirical methods were also less adequate when it came to studying the economic effects and implications of things such as traditions, institutions, and values. Mathematical formalism, Röpke argued, chose to address these realities by generally ignoring them. It thus lost sight of economics’ essence, which is not macro-aggregates but the choices of individuals and institutions. On this basis, Röpke suggested that the “new economics” was destroying economics as “a ‘moral science’ in the sense that it deals with man as an intellectual and moral being.”\(^{52}\) Instead, in the new economics, the economist became a type of bureaucratic technocrat charged with preempting economic problems through the use of sophisticated mathematical quantitative methods. Consequently, the post-Keynes economist was invariably obsessed by one thing, i.e., “effective demand,” which he thinks must be kept up at whatever cost, while he forgets the working of the mechanism of prices, wages, interest and exchange rates. Whereas formerly a good economist was a man who knew how to assess the relation of the actual economic forces and whereas formerly judgment, experience, and a sense of proportion were rated higher than the formal skill in handling certain research techniques introduced illegitimately from the natural sciences into economics—today glory goes to him who knows how to express more or less hypothetical statements in mathematical symbols and curves.\(^{53}\)

Concerns about these changes, Röpke noted, were not limited to non-Keynesians. He cited one of Keynes’s disciples (and first biographer), Roy Harrod, saying that substituting a fascination

52. Röpke, supra note 11, at 122.
with mathematical aggregates for attention to basic economic principles had led him to conclude that “we should be better off with the old Political Economy.”

Drawing upon the Austrian economist Ludwig von Mises, Röpke maintained that sound economics allows mathematics to explicate certain relationships that have quantitative characteristics. But the more economics drifted in a mathematical-statistical direction, the more it ignored that which is un-mathematical and does not always behave predictably: human beings. Röpke was not persuaded that mathematics could encompass the instability and complexity of economic life. Despite the apparent information such methods could obtain, economic trends rarely seemed to conform to the new economics’ forecasts. The result was not only that “with all our cleverness, we have become decidedly less wise, while knowing more and more about less and less,” but also that economic science was dehumanized. “Keeping economics human,” Röpke held, did not necessitate completely rejecting mathematics or aggregate concepts. But he did ask economists to consider that behind factors such as supply and demand, amounts of savings, volumes of investment, rates of inflation, and levels of wages were “individual human beings with their feelings, their deliberations, their appraisals of value, their collective suggestions and decisions.”

Röpke’s warnings against the dominance of the language of aggregates and mathematics also reflected his worry that economics would gradually become unintelligible to non-economists and of decreased usefulness to policymakers. Moreover, Röpke argued that the new economics’ marginalization of individual human beings reflected general social trends “toward impersonalization, toward collectivization, toward mechanization, toward dehumanization.” Just as modern economic science received tremendous impetus in the late-eighteenth, nineteenth, and early-twentieth centuries from the desire to understand market economies, Röpke maintained that

54. Id. at 3 n.1.
55. Röpke, supra note 11, at 122.
56. RÖPKE, supra note 53, at 3.
57. Röpke, supra note 11, at 123.
58. Id.
59. Id. at 124.
60. Id.
mid-twentieth century economics was being influenced by the context of political and economic collectivization in which it was practiced. The postwar “new economics” helped to support the belief that the state could “manage” the economy and therefore facilitated expectations that governments should attempt to do so. Governmental institutions committed to interventionist policies wanted macroeconomic research that added empirical credibility to such proposals. As Keynes’s most important biographer, Robert Skidelsky, noted:

The needs of Keynesian macroeconomic policy spawned vast quantities of national-income statistics which were fed into huge computer-forecasting models set up to capture the significant short-term trends of the macroeconomy. The Keynesian age was the golden age of macroeconomics: the famous economists of the time were all macroeconomists; most of them worked for or advised government at least some of the time. The study of markets and how they worked, or even failed to, was distinctly unfashionable.

A form of collusion consequently developed between the postwar economic profession and states pursuing interventionist strategies. It meant, Röpke thought, that many economists had essentially compromised their integrity as scholars committed to the pursuit of truth above the temptations of expediency.

III. RELATIVIZING—NOT ABANDONING—MODELS

Röpke’s diagnosis of some of the problems characterizing mainstream postwar economics is several decades old. Hence, it does not address the emergence of New Classical economics in the late 1960s, monetarism in the 1970s, the New Keynesianism of the early 1980s, or what some call the “New Neoclassical Synthesis” of New Keynesian and New Classical economics of the late 1990s. Nevertheless, Röpke’s analysis plays directly into many contemporary debates about the failures, imagined or otherwise, of economics in the context of the 2008 financial crisis.

Today, as Philip Booth observes, “[t]here is a tendency in modern economics to ignore variables that do not fit neatly into econometric models. . . . [T]here may be many economic vari-

ables and processes that are not amenable to measurement or to modelling but that have important information content." The presence of these variables has immediate implications for understanding complex phenomena like the role of money in creating inflation.

It may be difficult for central banks (or financial market forecasters) to precisely model the impact of money supply on inflation as relationships have become less predictable over time. This does not mean, however, that monetary aggregates are not a very important (indeed, possibly the most important) variable in determining inflation. It simply means that to understand the processes we have to interpret the data and we may have to accept that any predictions we make are simply predictions of tendencies rather than of precise magnitudes.

Consequently, not only central banks but also politicians and governments in the post-crisis era ought to tone down their rhetoric about "managing" an economy, because economic science simply does not possess the predictive abilities to validate claims to control such a complex system.

The question, however, is where do we go from here? Does a post-crisis economics involve dispensing with most of the mathematical tools and modeling that assumed such a prominent place in economic science in the wake of Keynes's General Theory? Are we to conclude along with Paul Krugman and others that much of the economic research of the past thirty years has been a spectacular waste of time and energy?

In his famous review of Milton Friedman and Anna Schwartz's A Monetary History of the United States, Robert Clower stated that "[i]f successful prediction were the sole criterion of the merit of a science, economics should long since

63. Philip Booth, Learning from the Crash, and Teaching after it, in PROFIT, PRUDENCE AND VIRTUE: ESSAYS IN ETHICS, BUSINESS AND MANAGEMENT 225, 234 (Samuel Gregg & James Stoner eds., 2009) (citation omitted). Booth notes that this point was the central argument of Hayek's 1974 Nobel Prize lecture, The Pretence of Knowledge. Id. at 234 n.9.
64. Id. at 234.
65. See Paul Krugman, How Did Economists Get It So Wrong?, N.Y. TIMES, Sept. 6, 2009, (Magazine), at 36.
have ceased to exist as a serious intellectual pursuit.” In other words, economic science is not just concerned with making economic predictions or shaping economic policy. It is about understanding the truth about the economic dimension of human life. To this end, economists have a range of tools at their disposal, including logic, inference, historical analysis, statistics, and mathematics. Doubts about the predictive powers of economics should not mean that we engage in blanket disparagements of economists’ use of mathematical tools. As Booth comments, “[n]eo-classical economics can be helpful for understanding particular problems. The closed form solutions to many modern finance problems, such as the pricing of derivatives, derive their method from the neo-classical way of thinking.” As long as there is a quantitative dimension to economics, we will need tools that allow us to compare theories about how the economy works to quantifiable data. They provide us with useful—though not all-encompassing—information about factors that economists and those they advise should be considering, ranging from matters such as the effects of interest rate increases to the growth of wealth in given societies. Though predictability in the social sciences is only imperfectly possible, the philosopher Alasdair MacIntyre correctly stated that it is often achievable thanks to our knowledge of statistical regularities, the common realization that people need to coordinate their actions, and our awareness of the causal regularities of social life and nature.

A similar point applies to abstract models. Economic models are like maps. Although maps do not in themselves capture the whole truth, they do provide us with some insight into aspects of the truth. A map of London can tell us how to get from Heathrow to Westminster. It cannot, however, encapsulate London’s entire reality. Similarly, economic models cannot encapsulate a holistic vision of the economy. But, depending upon the subject matter and the model’s capacity to approximate aspects of reality, they can provide us with some information about what is happening in an economy and how to attain certain economic

68. Booth, supra note 63, at 232.
objectives. Some abstractness is often necessary in many social and natural sciences if we are to reach conclusions about any number of questions. As James Buchanan and Geoffrey Brennan noted, abstraction in economic science is a way “of allowing economists to impose intellectual order on the observed chaos of human interaction, without excessive distracting detail in dimensions of the analysis that are not centrally relevant.”

By the same token, economists should acknowledge that neoclassical economic models are only useful for certain purposes. A radically empirical, positive approach to economics is inadequate because it simply leaves out too much. A London street directory will not show us the distance between Buenos Aires and London. Nor does it tell us that we should travel from London to Paris. Likewise, economic models are not designed to provide us with all the information we need to resolve economic and political dilemmas. It follows that, as Buchanan and Brennan noted, even those economists who believe that applying the presumption of *homo economicus* to many problems is useful should recognize that *homo economicus* has its own limits as a useful abstraction. We can only load the construction with so much, and we stand in danger of having our whole “science” collapse in an absurd heap if we push beyond the useful limits. The fact that the whole set of “noneconomic” motivations are more difficult to model than the “economic” should not lead us to deny their existence.

On these grounds, we may state that one useful post-crisis lesson for many economists is the need to be more cognizant of the limits of abstract modeling and wary of attempts to reduce economic concepts to mathematical formulae. Economists need to be willing, as Booth commented, to “focus on variables that are important rather than just on variables that are precisely measurable.” For the same reason, economists should also be willing

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72. Id. at 55.
73. Booth, supra note 63, at 234.
to discourage those—including government officials, central bankers, and politicians—tempted to base entire schema ranging from particular investment strategies to government monetary policy upon one or more models, econometric or otherwise.

IV. ECONOMICS AND POLITICAL ECONOMY

If Röpke was correct in his claim that many economists’ reputations in the post-Keynes era have been primarily built upon their skills as econometricians and macroeconomists, and if—as Röpke also insisted—much postwar economic science fell into the traps of positivism and scientism, then there will be considerable resistance to the suggestions above. One explanation for such resistance might be simply career preservation. Another is that a commitment (conscious or otherwise) to positivism and scientism involves an assent (again, conscious or otherwise) to a range of intellectual positions that are not so easy to discard if they have long been central to a person’s habits of thinking. But if economists believe that economics is, like any other moral, social, or natural science, about the search for truth, then they have no reason to adhere to assumptions and methodologies that have, in many respects, actually limited economics’ ability to wrestle with its subject matter.

One way forward might be attempting to widen the horizons of economics by seeking to engage it—especially its technical-positive dimension—in truly synthetical analysis. Synthesis here does not mean a version of Hegelian dialectics or the application of the *homo economicus* model to a range of problems that were traditionally outside the realm of economics. As the Austrian-school economist Murray Rothbard wrote in 1989:

In recent years, economists have invaded other intellectual disciplines and, in the dubious name of “science,” have employed staggeringly oversimplified assumptions in order to make sweeping and provocative conclusions about fields they know little about. This is a modern form of “economic imperialism” in the realm of the intellect. Almost always, the bias of this economic imperialism has been quantitative and implicitly Benthamite, in which poetry and pushpin are reduced to a single-level, and which amply justifies the gibe of Oscar Wilde about cynics, that they [economists] know the price of everything and the value of nothing. The results of
this economic imperialism have been particularly ludicrous in the fields of sex, the family, and education.\(^7\)

Doubtless many economists would claim that Rothbard oversimplified the character of their endeavor insofar as their application of economic research methods to such questions is not concerned with reducing everything to an economic explanation, but rather with providing new insights that might otherwise remain dormant. The broader point, however, is that such endeavors are not in themselves synthetic. A more promising path for synthesis may lie in re-grounding economics' positive-technical dimension upon a renewed Smithian understanding of political economy.

Since Antoyne de Montchrétien first coined the term in 1615 to describe how monarchs could manage their kingdoms,\(^7\) \textit{œconomie politique} has been defined in many ways. It was Adam Smith, however, who gave political economy its commonly accepted \textit{positive} meaning by defining "what is properly called Political Oeconomy" as the scientific study of "the nature and causes of the wealth of nations."

\(^7\) As A.M.C. Waterman noted, Smith's political economy partly concerns the positing of scientific (in the positivist sense of the word) theories to understand economic phenomena. This scientific positing constitutes most of what is commonly understood to be economics today. In another sense, however, Waterman claimed that Smith's political economy also involves the study of the interrelationship between economic theory and the political ideas and movements of a given time.\(^7\) Lastly, there is the sense in which Smith understood political economy in terms of what we would call economic policy, insofar as Smith treated political economy as "a branch of the science of a statesman or legislator" whose goals were first "to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence


for themselves; and second, to supply the state or commonwealth with a revenue sufficient for the publick services.”

On one level, Smith’s *Wealth of Nations* was a work of abstract economic analysis and prescription. Smith scrutinized the prevailing mercantilist economic theories and those of the French physiocrats, presented a fresh argument about how wealth creation occurs, and then explained what might be done if society’s overall material enrichment was considered desirable. But we should not forget that, as E.G. West stated, *Wealth of Nations* began not as a book on economics but as an essay in conjectural history, “the systematic study of the effects of legal, institutional and general environmental conditions upon human progress.”

In doing so, Smith also attempted to articulate normative reasons for an economy based on private property, free competition, free trade, rule of law, and limited government. For Smith, the shift from mercantilist to market economies was not just a question of implementing insights from scientific economic reasoning focused on wealth creation. It was also a matter of civilizational growth. Although certain elements of commercial order disturbed Smith, he also preferred market-oriented economies to previous economic arrangements on the basis not only of their greater efficiency, but also of the greater liberty provided by market economies to ever-widening numbers of people. Emma Rothschild reminded us that Smith saw economic liberty as something to be supported partly because of its ability to free people from many forms of subjugation.

With a few exceptions, this Smithian conception of economics and political economy faded after Smith’s death in 1790. Instead, economics in the Anglo-Saxon world increasingly focused upon studying the choices and actions of *homo economicus*, a being whose nature is rather different than the more sophisticated, sometimes irrational creatures in Smith’s writings. By 1844, John Stuart Mill was stating:

What is now commonly understood by the term “Political Economy” . . . makes entire abstraction of every other hu-

78. 1 SMITH, supra note 76, at 428.
Smith Versus Keynes

man passion or motive; except those which may be regarded as perpetually antagonizing principles to the desire of wealth, namely, aversion to labour, and desire of the present enjoyment of costly indulgences. . . Political Economy considers mankind as occupied solely in acquiring and consuming wealth; and aims at showing what is the course of action into which mankind, living in a state of society, would be impelled, if that motive, except in the degree in which it is checked by the two perpetual counter-motives above averted to, were absolute ruler of all their actions.82

Mill did qualify these remarks. No economist, he claimed, truly believed that this description captured humanity’s essence.83 Nevertheless, Mill did reflect a narrowing of the parameters of modern economics established by Adam Smith.

Since Mill’s forays into economics, there have been many successful efforts to widen the scope of economic science, some of which have impacted mainstream economic research as well as economic policy. Examples of this impact include the Freiburg “ordo-liberal” school associated with the German economists Walter Eucken and Franz Böhm, the “new institutional economics” of Ronald Coase, Harold Demsetz, and Douglass North, as well as the “law and economics” movement promoted by figures such as Richard Posner. What distinguishes ordo-liberalism from the other schools is that the ordo-liberals were committed to integrating the “liberal” concern for liberty with the “conservative” belief in order into their economic research program and policy recommendations. In short, they treated a concern for the promotion of certain values as integral to economic inquiry and recommendations. Eucken and Böhm were especially concerned with the issue of how to preserve freedom in complex social orders based primarily upon voluntary cooperation. Like many other Germans, Eucken was worried about the accumulation of power and less convinced that the spontaneous interaction of people usually sufficed to produce a stable and flourishing social order.84 Writing in 1933, Böhm noted that: “The experience of the last dec-

82. JOHN STUART MILL, Of the Definition of Political Economy; and on the Method of Investigation Proper to It, in ESSAYS ON SOME UNSETTLED QUESTIONS OF POLITICAL ECONOMY 120, 137–38 (1844).
83. Id. at 139.
84. See WALTER EUCKEN, GRUNDSÄTZE DER WIRTSCHAFTSPOLITIK (1952).
ades has shown that business associations and interest groups have mastered the art of turning every politically influential ideology to their own purpose in a most effective manner." Cartels, to Böhm's mind, exemplified how private contracts, often with the support of the legal system and government, were used to shelter sections of the economy from competition. This collusion of private and public power undermined essential market mechanisms such as free prices and paved the way for extensive economic intervention and, eventually, centrally planned economies. Seeking to find ways to limit the ability of interest groups to capture state power in order to diminish free competition, Eucken and Böhm drew upon Scottish Enlightenment insights but also what might be regarded as natural law reasoning to try to establish precise parameters that recognized positive law's legitimate authority on questions of economic regulation while simultaneously limiting (often via constitutional law) that authority to very specific tasks.

This attention to values brings us face-to-face with the challenge presented by Smith's political economy to mainstream economics. It reflects the Scottish Enlightenment approach to intellectual inquiry in which there was no rigid separation of social science and moral normativity. For Scottish Enlightenment figures such as Adam Ferguson, it was not simply that identifying certain normative concerns was considered central to explaining social phenomena; rather, Scottish social science sought to comprehend and evaluate man so that "we endeavour to understand what he ought to be." Smith's understanding of political economy certainly contained a strong positive dimension insofar as Smith wanted to outline theories that explain economic phenomena. His Wealth of Nations, however, is full of historical commentary and reflected a strongly normative-sociological purpose: the identification of the social, historical, and ethical conditions that permitted the establishment and maintenance of the civilization of natural liberty that Smith believed was good for all people. This project necessitated directing attention to how and why certain institu-

85. FRANZ BÖHM, WETTBEWERB UND MONOPOLKAMPF, at xi (1933).
tions and habits had developed to protect and support these liberties. The descriptive and normative dimensions of Smith’s political economy are consequently deeply intertwined. There is no doubt that Smith considered utility to be something that intellectual inquiry could not ignore. But liberty and virtue were similarly indispensable if people were to engage in human flourishing. As Ryan Patrick Hanley observed, “it is largely recognized today that the model citizen of Smith’s commercial society resembles less an interest-maximizing caricature of homo economicus . . . than the more moderate, sober prudent man described in [The Theory of Moral Sentiments].” In short, Smith and other Scots sought a judicious integration of positive analysis with the promotion of particular normative goals.

Economists wishing to re-engage economics in a wider discussion about the truth of human reality could thus do worse than return to the writings of Adam Smith. Here one finds a truly synthetic approach to comprehending not just the economic dimension of human reality, but also how that economic component fits into a fuller picture of human reality—one that is committed to treating moral virtues as real to the same extent as the forces of entrepreneurship and peaceful free exchange, not to mention institutions such as the rule of law that are the very stuff of modern flourishing economies. Returning to Smith does not imply wholesale abandonment of all the tools and methods developed in a range of different schools of economic thought since 1776. It does, however, suggest that efforts to quarantine economic science from normative considerations or even knowledge of the basic moral goods knowable by human reason ought to be themselves viewed as unreasonable and unscientific.

CONCLUSION

Obviously, rethinking the scope and emphasis of economics along the lines suggested here would involve rather significant changes in the teaching of economics and in our expectations about what the discipline can yield in terms of human knowledge. This task is difficult because neither economics nor

88. See HANLEY, supra note 80, at 34–35.
89. Id. at 112.
economists have proved immune to the effects of the hyper-specialization that characterizes so much of contemporary university education. The ability to engage in this type of economic research—to integrate positive technical analysis with knowledge acquired from other disciplines—requires a sophisticated knowledge of fields outside positive technical economics. Yet integration may be only half the challenge for contemporary economics. If the 2008 financial crisis has taught us anything, it is that economists, business executives, politicians, and bankers—indeed, all of us—need to cultivate a range of moral and intellectual habits (especially humility) that inform the use of technical skills. Although Keynes was much criticized by Röpke for his impact on the character of postwar economics, one suspects Röpke would have agreed with Keynes's famous description of the talents required to be a good economist—one that is just as relevant today in a post-crisis world:

The master-economist must possess a rare combination of gifts. He must reach a high standard in several different directions and must combine talents not often found together. He must be mathematician, historian, statesman, philosopher—in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present in light of the past for the purposes of the future. No part of man's nature or his institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician.90

The Banks Versus the Constitution

Ron Paul* 

Some people say we are heading for socialism. I can see why they might think that: Since October 2008, the U.S. Treasury Department and the Federal Reserve have taken majority stakes in the country’s largest commercial insurer (AIG), largest auto manufacturer (General Motors), and largest mortgage lenders (Fannie Mae and Freddie Mac, which were already government-sponsored). The bailouts that began under President Bush and Treasury Secretary Henry Paulson, and which have continued under President Obama and Treasury Secretary Timothy Geithner, have also seen the federal government take shares in banks like Citigroup and Bank of America. This is not capitalism, and it is not the kind of economy the Framers of the Constitution envisioned.

The truth is that we have been drifting away from the Framers’ vision for a very long time. Even before the economic crash of 2008, we did not have anything resembling a truly free economy. One of the most important sectors of the economy, the banking sector, was already quasi-socialist or corporatist. The Federal Reserve, with its monopoly powers and its chairman and governors appointed by the President, has been an extra-constitutional branch of government since its creation in 1913. The bailouts, and the government ownership that has come with them, are a direct result of the Federal Reserve’s policies. At the same time, this government body has been eroding Americans’ capacity for self-government by forcing them to

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adjust their lives to an overall inflationary economy. This is a vicious cycle: The central bank creates a series of booms and busts that makes business planning very difficult. As a result, more and more businesses fail and turn to government for bailouts. The public is told that capitalism is to blame and becomes accustomed to the idea that only government is capable of long-term planning. When the next bust hits, the cycle repeats.

The Constitution does not provide for the creation of a central bank. The Framers were well acquainted with the powers and practices of the Bank of England, and under the Articles of Confederation there had been a short-lived experiment in central banking.² Yet the Framers chose not to include a provision in the Constitution to create a central bank. Even if they had wanted to include such a provision, doing so might have jeopardized ratification. Americans were very suspicious of central banks, seeing them as a source of official corruption.

The British government relied on the Bank of England to finance its national debt, and the debt was used to finance bigger armies and more wars. The debt had to be repaid eventually, which meant higher taxes for British subjects, including, before the Revolution, the American colonists. Historian John Remington Graham explains:

The British people groaned under heavy taxes to pay the interest on the national debt without ever touching the principal due. Each war nudged the King and Parliament into an increasingly servile condition, ever more obliged to the huge financial network behind the East India Company and the Bank of England. So it was that these interests were able to demand and obtain the legislation which ignited the American Revolution.⁴

Despite the lack of constitutional authorization for a national bank, the idea of central banking still appeals to politicians because central banks make financing wars and government growth much easier. Thus, Alexander Hamilton proposed the

². See Jerry W. Markham, Banking Regulation: Its History and Future, 4 N.C. BANKING INST. 221, 223 (2000) (discussing the role played by the Bank of North America and suggesting that Hamilton used the Bank of England as a model for the creation of the first national bank).
³. For the historical roots of Americans' aversion to central banking, see GORDON S. WOOD, THE AMERICAN REVOLUTION: A HISTORY 57–60 (2002).
creation of such a bank to the first Congress, even though the Framers of the Constitution and the ratifying conventions would never have agreed to create one.\(^5\) He got his wish, and the first Bank of the United States was chartered in 1791. Like the Federal Reserve, Hamilton’s bank was in theory private, but the federal government provided its initial capital and from the outset owned one-fifth of the bank’s stock.

Thomas Jefferson recognized the danger that the Bank of the United States posed to the Constitution. He wrote to President Washington in 1791 to state the case that “[t]he incorporation of a bank, and other powers assumed by this bill, have not, in my opinion, been delegated to the United States by the constitution... They are not among the powers specially enumerated.”\(^6\) And although the bank’s defenders said it would be a convenience for helping government to collect taxes, Jefferson noted that “the constitution allows only the means which are ‘necessary,’ not those which are merely convenient for effecting the enumerated powers.”\(^7\) If the federal government could do anything it deemed convenient, the Constitution would be a dead letter.

Congress, controlled by Jefferson’s Democratic-Republican party at the time, let the bank’s charter expire in 1811. But just five years later, President Madison signed on to the creation of the Second Bank of the United States, in part to pay off debts from the War of 1812. Economic historian Murray Rothbard described the result:

> Prices rose greatly in real estate, land, farm improvement projects, and slaves, much of it fueled by the use of bank credit for speculation in urban and rural real estate. There was a boom in turnpike construction, furthered by vast federal expenditures on turnpikes. Freight rates rose on steamboats, and shipbuilding shared in the general prosperity.


\(^6\) Thomas Jefferson, *Opinion of Thomas Jefferson, Secretary of State, on the Same Subject*, reprinted in *LEGISLATIVE AND DOCUMENTARY HISTORY*, supra note 5, at 91–92.

\(^7\) Id. at 93 (emphasis added).
Also, general boom conditions expanded stock trading so rapidly that traders, who had been buying and selling stocks on the curbs on Wall Street for nearly a century, found it necessary to open the first indoor stock exchange in the country, the New York Stock Exchange, in March 1817. Also, investment banking began in the United States during this boom period.\(^8\)

This was America's first great bubble economy, created by bad loans and easy money. The bubble burst in the Panic of 1819, which saw a massive credit contraction and the failure of seventy-four banks, a shocking number considering that at the time the country only had 341 legally incorporated banks.\(^9\)

"The result of the contraction was a massive rash of defaults, bankruptcies of business and manufacturers, and liquidation of unsound investments during the boom," as well as "a vast drop in real estate values and rents."\(^10\)

President Andrew Jackson vetoed the bill to renew the Second Bank's charter in 1831, calling the bank "unauthorized by the Constitution, subversive of the rights of the States, and dangerous to the liberties of the people."\(^11\) The idea of centralized banking continued to appeal to politicians, however, and in 1913 Congress created the Federal Reserve System. It is not a coincidence that the Federal Reserve was planned and launched at the height of the Progressive Era and not long before Woodrow Wilson took the country into World War I. The Federal Reserve, which is essentially the Third Bank of the United States, was necessary to underwrite the Progressives' dreams of a more activist federal government.\(^12\) Central bank financing also enabled intervention in World War I, just as the Bank of England had been indispensable to Britain's wars and

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9. Id. at 89.
10. Id.
12. Plenty of big businesses also wanted to see the Progressives get their wish because more regulation would impose disproportionate costs on their smaller competitors. See generally Gabriel Kolko, The Triumph of Conservatism (1963) (discussing the role of big business in the Progressive Era).
the Second Bank of the United States helped pay off debts from the War of 1812.

Almost everyone in Washington has forgotten the lessons of the Panic of 1819 and Jackson’s fight with the Second Bank of the United States. Banks and governments can print money and expand credit, but they cannot create real wealth. Unsurprisingly, in the decade after the Federal Reserve was instituted, we saw another classic boom followed in the 1930s by the worst bust until the present day. Austrian School economists such as Ludwig von Mises and Friedrich Hayek have explained why central banking always leads to this cycle.\(^\text{13}\) When money and credit are available more readily from a central bank than they would be in a free market, other banks will make loans that otherwise would seem too risky. Why play it safe, if you can gamble with somebody else’s money borrowed at a low interest rate? More loans are made, more fiat currency circulates, and businesses, just like banks, have an incentive to take more risks than they otherwise would. They start building new factories or retail outlets, or maybe they start to speculate in financial derivatives. The apparent boom employs more people, which leads to more consumption.

For a little while this lending seems like a virtuous cycle, as low interest rates and easy money lead to apparent prosperity for businesses and consumers. In reality, however, a lot more risks are being taken, and eventually those risks lead to failures. When businesses fail they cannot pay back their bank loans. Then the banks fail because they are not getting repaid. People are thrown out of work, and consumer spending shrinks. Then even more businesses fail, and what looked like a virtuous cycle turns out to be vicious.

Banks and businesses make mistakes all the time, of course. A central bank, however, encourages everyone to make mistakes in the same direction—toward taking more risks—all at the same time. Instead of occasional bank and business failures, we get a string of them at once. This widespread failure is what happened in 1819 and 1929, and it is happening again today.

\(^{13}\) See, e.g., LUDWIG VON MISES, THE THEORY OF MONEY AND CREDIT (1953). For a good introduction to the Austrian School of economics, see generally THOMAS E. WOODS JR., MELTDOWN: A FREE MARKET LOOK AT WHY THE STOCK MARKET COLLAPSED, THE ECONOMY TANKED, & GOVERNMENT BAILOUTS WILL MAKE THINGS WORSE (2009).
Some specific bad policy decisions by Congress led to real estate becoming especially vulnerable to the boom-and-bust cycle. The Community Reinvestment Act,\textsuperscript{14} for example, forced banks to make even more bad loans than they otherwise would have made. The fundamental source of the boom-and-bust cycle, however, lies with the Federal Reserve System. As long as we have it, we will continue to ride the rollercoaster of the business cycle, until finally the dollar is destroyed.

The dollar is put at risk by everything that Washington likes to do to get out of recessions: stimulus packages, near-zero interest rates, increases in base money, and issuance of more debt. President Obama, Secretary Geithner, and Chairman Bernanke have pushed these policies into overdrive since January 2009.\textsuperscript{15} We have seen the results as our currency tumbles and foreign investors such as the BRIC\textsuperscript{16} nations rethink their dollar holdings. The dollar is already getting pummeled,\textsuperscript{17} but once banks and businesses begin to think the crisis is over—not because of real recovery, but because of the false sense of prosperity created by government spending—we will see a massive inflationary boom followed by an even bigger bust. This final chapter will be catastrophic for the dollar.

It is painful to see your business fail or to lose your job, but the damage to our economy was actually done during the boom times, when too many financially unsound projects were started. Propping up failing enterprises now will only do more harm by encouraging additional malinvestment. Unfortunately, the damage that central banking has done to our country is not limited to the economy. Not only are individuals being thrown out of work as jobs that were never sustainable now disappear, but central banking and Keynesian economics have even changed the way Americans think about society and government. They have encouraged us to think only about the short term and to look to Washington for long-term planning.

\textsuperscript{15} For an account of the economic policies of President Obama, his Treasury secretary, and the Federal Reserve chairman, see generally TIMOTHY P. CARNEY, \textit{Obamanomics: How Barack Obama is Bankrupting You and Enriching His Wall Street Friends, Corporate Lobbyists, and Union Bosses} (2009).
\textsuperscript{16} Brazil, Russia, India, and China, amongst other rapidly developing nations.
An explanation for this change can be found in the work of economist Hans-Hermann Hoppe, who has called attention to the importance of "time preference" in relation to civil society.\textsuperscript{18} Time preference is an economic concept: People with a high time preference prefer instant gratification; people with a low time preference are willing to defer satisfaction.\textsuperscript{19} The inflationary conditions created by central banking and Keynesian stimulus efforts encourage a high time preference. Money is better spent now rather than saved, we are told, because consumer spending props up the economy. And if you try to save, you will only find your savings eaten away by inflation over time. The message that Washington and the Federal Reserve send is, "Don't think too much about the future, just live for today."\textsuperscript{20}

The raising of Americans' time preference has encouraged the idea that only government can plan for the long term. If you try to save for your retirement, for your children's education, or for unexpected medical expenses, your savings might not have much purchasing power left by the time you need it. So why not let Washington take responsibility for your retirement, your children's education, and your family's health? In a long-term inflationary economy where saving is discouraged, people are virtually compelled to invest in stocks, bonds, and other financial instruments in the hope of earning returns that will beat inflation.\textsuperscript{21} Of course, these investments are subject to the boom-and-bust cycle just like other areas of the economy, and when the bust hits, people who might have been reluctant investors in the first place will naturally welcome a bailout rather than lose their savings. At the political level, the will to resist bigger government weakens, and at the personal level short-term decision making prevails. The British writer Theodore Dalrymple has described this situation well:

[A]sset inflation—ultimately, the debasement of the currency—as the principal source of wealth corrodes the character of people. It not only undermines the traditional bour-
geois virtues but makes them ridiculous and even reverses them. Prudence becomes imprudence, thrift becomes improvidence, sobriety becomes mean-spiritedness, modesty becomes lack of ambition, self-control becomes betrayal of the inner self, patience becomes lack of foresight, steadiness becomes inflexibility: all that was wisdom becomes foolishness. And circumstances force almost everyone to join in the dance.

Except in one circumstance, that is: the possession of a salary and a pension that the government promises, implicitly or explicitly, to index against inflation.22

We have a financial system that pretends to be capitalism but which actually encourages dependence on Washington. By undermining the long-term economic thinking that goes into building strong marriages, families, churches, and voluntary organizations, as well as businesses, the economy of easy money and bigger government uproots the institutions that have defined American life. Through this process it is not only the Constitution that is endangered, but also the social order that fosters self-responsible men and women who want to follow the Constitution in the first place. The corruption in our national economic structure goes very deep, right to the heart of the banking system. In one way, this corruption of capitalism is worse than socialism, because at least under socialism people understand that government is to blame for the miserable condition of their economy. Under the system we have, people are encouraged to blame bad economic conditions on too much freedom and demand more government as the solution.

Luckily, many Americans are waking up to the danger Washington and the Federal Reserve have created. When I speak on college campuses, students often greet me with chants of “End the Fed!” Books like Thomas Woods’s Meltdown that explain the Austrian theory of the business cycle and apply it to our current crisis are selling very well. And legislation I have proposed to audit the Federal Reserve has picked up overwhelming support in Congress because the public is demanding accountability. A December 2009 poll showed that 79% of Americans want the Federal Reserve to open its books to Congress.23

The Framers were very concerned about the monetary stability of the republic, which is why the Constitution prohibits the states from coining money or emitting bills of credit. Americans had suffered the consequences of runaway inflation during the Revolutionary War, when the Continental Congress printed fiat currency with abandon. What would they think of a Federal Reserve System that steadily inflates the currency and has caused the dollar to lose 96% of its value since 1913? The only thing that might have shocked them more is that politicians have been allowed to get away with creating such a system. Over the course of the twentieth century, the welfare state, Keynesian economics, and the effects of inflation have worn away many citizens' vigilance for their liberties.

It is not too late to reverse course, however, as Americans become increasingly discontent with the Federal Reserve System and discover what this unconstitutional fourth branch of government has done to their money. With this latest financial crisis, the damage to our economy has been so great that many people are looking for a better explanation than the idea that we just did not have enough regulation or that businessmen became uncontrollably greedy. In a free market, the check on greed is that you lose your own money, or that of willing investors, if you make bad decisions. By contrast, the bailouts and the Federal Reserve's efforts to increase lending again have created perverse incentives: They reward the banks and businesses that made bad decisions and punish their competitors who made sound decisions—while taxpayers get to foot the bill. This response is meant to distract us from the source of the trouble, which is that our banking and monetary system is not free. There are grave legal and constitutional questions involved in what Washington has done in response to this crisis. But the first and most serious question we have to address is how central banking guarantees that these crises will keep repeating and keep getting worse.

Soon after the $700 billion Troubled Asset Relief Program (TARP) became law in October of 2008, the Washington Post ran a widely acclaimed article entitled "The End Of American Capitalism?" The article called into question the supremacy of capitalism and the durability of free markets in the wake of the financial crisis. The same theme appeared in countless articles in the months that followed. By April 2009, a poll found that only fifty-three percent of American adults believed capitalism to be better than socialism. This lack of confidence in capitalism provided the setting in which President Obama pledged "to act boldly, to turn adversity into opportunity, and use this crisis as a chance to transform our economy for the 21st century." Public expenditures have gone toward bailouts of failing firms, economic stimulus plans, Cash for Clunkers, and other proactive government policies aimed at pulling the U.S. economy out of recession. President Obama's pledged transformation has been a multi-trillion dollar failure and offers new evidence of the bankruptcy of countercyclical government interventionism as a means of economic recovery. If the short-term effects of these programs have been disappointing, the long-term effects of the nearly three trillion dollars in additional debt will be even more debilitating.
I. THE TRANSLUCENT HAND

An elementary truth must be noted before any discussion of the financial crisis and its aftermath can take place: the economic system of the United States prior to the downturn did not represent free-market capitalism. This point is not novel. Economics textbooks, almost unanimously, describe the system as a "mixed economy" in which nearly every private sector is subjected to some degree of government regulation, and the 2008 Federal Register contains almost eighty-thousand pages.\(^4\) It is an error to consider "capitalism" and the American economic system to be roughly synonymous. This important distinction has been drowned out by the dissonant grumblings of unjustified acrimony towards markets. Free-market capitalism has become a straw man on which leftists blames every economic ill in an attempt to usher in policies that further increase the role of government in the marketplace.

Since the New Deal, fiscal conservatives have been on defense, not on offense. In 2009, there was no free market to defend. In the 1930s, government entities produced, on average, roughly fifteen percent of GDP.\(^5\) From 1970 through 2008, government on average accounted for about twenty-five percent of GDP (the effects of spending increases in 2009 will be considered subsequently).\(^6\) These figures do not even account for the unseen costs associated with the burden of government—the costs of complying with regulations—which were about another eight percent of GDP in 2008.\(^7\)

The supply-side revolution associated with President Ronald Reagan—the most hopeful attempt at securing prosperity through limited government in twentieth-century American politics—was about tearing down big-government policies by, for example, lowering tax rates and lessening regulatory burdens. It was not a defense of a free-market status quo. Al-

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5. See BUREAU OF ECON. ANALYSIS, NAT'L INCOME PROD. ACCT. TABLES, TABLE 1.1.5 (2009), available at http://www.bea.gov/National/ripaweb/SelectTable.asp?Selected=N.
6. Id.
7. Crews, supra note 4, at 2.
though the revolution made some progress, it by no means created the Randian state assumed by its detractors.\(^8\)

II. CRY ME A CRISIS

The contemporary leftists have taken to using the term “free-market fundamentalism” to pejoratively characterize the economic philosophy of President George W. Bush’s Administration and to blaming “deregulation” for the financial crisis.\(^9\) President Bush, however—even before the trillions of dollars in bailouts and guarantees during his last year in office—was far from a fiscal conservative. Veronique de Rugy, an expert on fiscal policy at George Mason University’s Mercatus Center, has done research that shows President Bush to have been the biggest regulator since Richard Nixon and that the Bush team “spent more taxpayer money on issuing and enforcing regulations than any previous administration in U.S. history.”\(^10\)

President Obama seems to have overlooked this nontrivial fact. In a Democratic primary debate, Mr. Obama shared his thoughts on the government’s role in the financial crisis:

[T]he sub-prime lending mess, part of the reason it happened was because we had an administration that does not believe in any kind of oversight. . . . You’ve got to disclose if you’ve got a teaser rate and suddenly their mortgage payments are going to jack up and they can’t pay for them. And one of the things that I intend to do as president of the United States is restore a sense of accountability and regulatory oversight over the financial markets.\(^11\)

This reading of history is dead wrong. Worse yet, President Obama now works closely with many who were complicit in, or directly responsible for, the well-intentioned but pernicious policies that led to the subprime lending debacle that triggered the most severe recession in a generation.

When it came to increasing home ownership, Congress abdicated its due diligence role in part because of the awesome lob-


bying power of the housing industry, which provided massive campaign contributions to members of Congress in both parties in return for ever-generous housing subsidies and a blind eye to the massive debt and risks of Fannie Mae and Freddie Mac. In a House Financial Services Committee hearing in 2003, Representative Barney Frank made a declaration indicative of Congress’s attitude toward the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac: “I do not want the same kind of focus on safety and soundness that we have in OCC [Office of the Comptroller of the Currency] and OTS [Office of Thrift Supervision]. I want to roll the dice a little bit more in this situation towards subsidized housing.”12 Such blatant carelessness cannot be forgiven.

Yet Representative Frank and the many other congressmen who are on the record making similar statements are politicians, not experts on risk-based capital standards. Where were the experts? In 2002, Peter Orszag (President Obama’s current Director of the Office of Management and Budget) coauthored a paper with Nobel laureate Joseph Stiglitz (an Obama supporter and unyielding critic of free-market capitalism) that analyzed the state of the GSEs Fannie Mae and Freddie Mac:

The paper concludes that the probability of default by the GSEs is extremely small. Given this, the expected monetary costs of exposure to GSE insolvency are relatively small—even given very large levels of outstanding GSE debt and even assuming that the government would bear the cost of all GSE debt in the case of insolvency. For example, if the probability of the stress test conditions occurring is less than one in 500,000, and if the GSEs hold sufficient capital to withstand the stress test, the implication is that the expected cost to the government of providing an explicit government guarantee on $1 trillion in GSE debt is less than $2 million. To be sure, it is difficult to analyze extremely low-probability events, such as the one embodied in the stress test. Even if the analysis is off by an order of magnitude, however, the expected cost to the government is still very modest.13

In fact, the GSEs did not remain sound. Their failure put taxpayers on the line for $1.45 billion in mortgage-backed security and debt purchases.\textsuperscript{14} This was only the tip of the iceberg. Eighteen months after a bailout frenzy that began with Bear Stearns in March 2008, the Federal Reserve, Treasury, and Federal Deposit Insurance Corporation had “committed” $11 trillion, $3 trillion of which had already been “invested.”\textsuperscript{15}

III. NEW BOSS, SAME AS THE OLD BOSS

We will not dwell on the precise causes of the financial crisis, but we side with renowned Stanford economist John Taylor’s assertion that the failure is primarily due to government, not markets.\textsuperscript{16} To the extent there is a systemic culprit, it is not capitalism, but rather corporatism. Progressives wrongly conflate conservatives’ adoration of free enterprise with that of political profiteering and rent-seeking, whereby legislative loopholes and carve-outs are secured by lobbyists and politically favored special-interest groups. This process warps the playing field and creates perverse incentives. This point is one on which Michael Moore and Milton Friedman would agree.

Two professors of finance at the University of Chicago, Raghuram Rajan and Luigi Zingales, have written a book on this subject titled Saving Capitalism from the Capitalists.\textsuperscript{17} They argue that the dangerous combination of capitalism and politics poses a serious threat to economic growth and opportunity.\textsuperscript{18} Crony capitalism, or corporatism—whichever you prefer—has existed in Washington to some degree for as long as the federal government has been spending money. The current financial crisis was caused in significant part by a large amount of such interest-driven market manipulation. If you doubt the existence of such manipulation, take a look at the campaign contributions from

\begin{footnotesize}
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\item \textsuperscript{14} FED. RESERVE BANK OF ST. LOUIS, THE FINANCIAL CRISIS: A TIMELINE OF EVENTS AND POLICY ACTIONS (2009).
\item \textsuperscript{16} JOHN B. TAYLOR, GETTING OFF TRACK, at xi (2009).
\item \textsuperscript{17} RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS (2003).
\item \textsuperscript{18} Id. at 2.
\end{enumerate}
\end{footnotesize}
Fannie Mae and Freddie Mac. This manipulation, and the problems associated with it, stem largely from the forced entanglement of business and politics. Remember, Fannie and Freddie are Government Sponsored Enterprises. Now, thanks to the bailouts, many more firms are inextricably linked to the federal government for the foreseeable future.

IV. EXIT, STAGE FAR LEFT

Bad monetary policy also played a pivotal role in the financial crisis. From late 2002 through 2004 the Federal Reserve Bank held interest rates on loans to banks at about one percent, which made the real federal funds rate negative. Uncle Sam thus subsidized banks to make increasingly risky loans, and the result was the subprime mortgage madness that caused massive foreclosures. This was not a market dysfunction, but a government one, notwithstanding the blind euphoria of lenders and borrowers in the housing market that contributed to the multi-trillion dollar real estate bubble.

Loose fiscal policy accompanied loose monetary policy in the years running up to the financial crash in September 2008. As mentioned above, George W. Bush was not a small-government, free-market conservative—though he talked as if he were. President Bush presided over one of the most big-government administrations since Lyndon Johnson.

It is widely assumed that most of President Bush's spending and debt increases were a result of the defense and homeland security buildup after September 11, but those increases only accounted for about forty percent of all new spending. From 2001 to 2008, after adjusting for inflation, education spending was up fifty-eight percent, income-security programs up twenty-seven percent, Medicare up fifty-one percent, and community and regional development spending up ninety-four percent. It was in many of these areas that President Obama, then candidate, claimed we had an investment deficit. President Bush, hoping to keep his "ownership society" bona fides,

Straw Man Capitalism

never denied President Barack Obama’s assertion that he had contributed to those investment deficits. President Obama has thus been able to continue arguing that government spending programs urgently need more funding.

Nevertheless, the traditional spending increases for which President Bush was responsible are distinct from the spending that occurred during the financial crisis. In December 2008, after the government responded to a year of market turmoil with massive bailout packages, President Bush explained his dogmatic drift by saying, “I’ve abandoned free-market principles to save the free-market system.” Of course, lurching toward governmental solutions during times of crisis has been commonplace throughout American history, especially in the last century. But such solutions have seldom worked. Amity Shlaes points out in her book on the Great Depression, The Forgotten Man, that almost all of the New Deal programs failed to bring the economy anywhere near full employment and failed to drive the economy out of a decade-long depression. Even by 1940, more than seven years after the New Deal was launched, the U.S. economy was still flat on its back.

V. ENTER LEVI A. THAN

President Obama ignored all of the historical evidence of the failure of Keynesian interventions, and he abandoned any suggestion that the free-market system could revive the economy. Instead he doubled down on the Bush Administration’s government buildup. Data from the White House Office of Management and Budget show that between 2007 and 2010 the federal government’s share of the economy is expected to have grown by thirty-one percent to the highest levels since World War II. One reason the spending boom did not create an economic recovery or a return to hiring is that all of the new


24. Shlaes notes that unemployment in 1940 was at 14.6 percent, and chronicles the popularity of Republican presidential candidate Wendell Willkie, who ran in that year largely on opposition to New Deal policies. Id. at 366–83.

spending and debt translates into higher future tax increases, which stunt business expansion. A study in 2009 by the non-partisan Tax Foundation found that to return to a balanced budget with the new levels of debt under President Obama, tax rates would have to nearly triple. According to the study, the highest tax rate would rise to more than ninety percent. Who wants to invest during that tax tsunami?

It is also a serious mistake to assume that government spending and debt will fade as the recession ends. Research from economic historian Robert Higgs shows that in times of economic crisis government grows and recedes, but it never shrinks back to its growth trajectory before the crisis. In other words, crises that bring about large-scale market intervention result in a permanent increase in the size of government. We are in the midst of a cascade of market interventions.

The original purpose of TARP was solely to buy up toxic assets. However, TARP turned into a slush fund for the Treasury Department to assist auto companies, insurance companies, and the already-subsidized housing industry. The money, which some banks were forced to take, also came with strings attached: Firms were subject to (sometimes ad hoc) regulations including caps on executive pay compensation. We also saw TARP money used for the preposterous Cash for Clunkers program, which merely paid Americans to take good cars off the road so that the government could demolish them. This program fell for the broken windows fallacy: You do not break windows so you can put people to work trying to fix them.

The growth of government certainly does not stop with banks and financial firms. President Obama says that the environment is also in crisis, and we must “act quickly and ... act boldly to transform our entire economy—from our cars and

our fuels to our factories and our buildings." The Brookings Institute predicts the cap and trade component of such an endeavor alone to cause a loss in personal consumption of $1 to $2 trillion in present-value terms. Even if the prospects of climate change legislation now seem dim, the Administration is making threats that it will be able to accomplish the same goals through the Environmental Protection Agency. As Senators John Kerry and Lindsey Graham explain:

Failure to act comes with another cost. If Congress does not pass legislation dealing with climate change, the administration will use the Environmental Protection Agency to impose new regulations. Imposed regulations are likely to be tougher and they certainly will not include the job protections and investment incentives we are proposing.

The message to those who have stalled for years is clear: killing a Senate bill is not success; indeed, given the threat of agency regulation, those who have been content to make the legislative process grind to a halt would later come running to Congress in a panic to secure the kinds of incentives and investments we can pass today. Industry needs the certainty that comes with Congressional action.

In other words, businesses must pay protection money to the government through cap and trade or they will be hit upside the head with EPA rules that will be much more severe. This is what some might call extortion.

The disastrous $787 billion American Recovery and Reinvestment Act of 2009 (the "stimulus") was President Obama's crowning achievement in his first year in office, but it failed to stimulate jobs or growth. In a report put out before the legislation was passed, Council of Economic Advisors Chairwoman Christina Romer and Vice President Joe Biden's economic advisor Jared Bernstein argued that without the stimulus unemployment could approach nine percent by the end of the third

quarter of 2009, but that with the stimulus, it would stay below eight percent.\textsuperscript{35} In the end of the third quarter of 2009, unemployment was at 9.8\%.\textsuperscript{36} The Vice President claimed that they had "misread the economy" and did not realize how bad the situation was. That, however, is the point.\textsuperscript{37}

Econometrically-modeled guesses about jobs that the stimulus could create (or "save") are a microcosm of other attempts at planning. Failures in the marketplace are far more preferable to failures of government, as economist and Nobel laureate Milton Friedman explained:

I believe that what really distinguishes economists is not whether they recognize market failure, but how much importance they attach to government failure, especially when government seeks to remedy what are said to be market failures. That difference in turn is related to the time perspective that economists bring to various issues. Speaking for myself, I do not believe that I have more faith in the equilibrating tendencies of market forces than most Keynesians, but I have far less faith than most economists, whether Keynesians or monetarists, in the ability of government to offset market failure without making matters worse.\textsuperscript{38}

The self-correcting capacity of markets is infinitely dynamic, but only if protected from the facade of omniscience that government planners too often hope and pretend to possess.

\textbf{VI. FACING A BOLD NEW ECONOMY}

For decades, there will be squabbles among scholars about whether this recession was the "worst" downturn since the Great Depression. Not in dispute, though, is that its impact upon the conscience of the country is one of epic proportions. The eighteen months following the collapse and bailout of Bear Stearns in March of 2008 have, at least temporarily, fundamen-
tally remade American capitalism. We have moved from a model of survival of the fittest in business to survival of the unfittest. The new dogma of “too big to fail” creates huge moral hazard problems as taxpayers underwrite bad business bets by banks and investment houses. In other words, the vast and sweeping government interventions that began in early 2008 did not save capitalism, as President Bush had hoped. Instead, they have given way to more political corporatism—or crony capitalism—where market decisions and capital allocation are increasingly steered by politicians in Washington, D.C. Wall Street is no longer the financial capital of the world—Capitol Hill is.

Each year, the Fraser Institute puts out a report showing the correlation between economic freedom and prosperity. The authors prefaced their assessment of “the impact of financial & economic crises on economic freedom” with some optimism this year, despite setbacks to market-oriented policies:

> Those who predict capitalism’s demise have to contend with one important historical fact: capitalism has an almost unlimited capacity to reinvent itself. It cannot be a mere coincidence that all prosperous countries are capitalistic in the sense that they are organized around private property and let markets play a major role in allocating resources. 

Those who have lost faith in the merits of capitalism have done so on the basis of a false pretext. Though the outlook for the next few years seems bleak, free-market capitalism will find its way back to the hearts and minds of Americans.

Markets are the greatest engine of prosperity ever known. Harvard economist Andrei Shleifer recently published an article in the *Journal of Economic Literature* titled “The Age of Milton Friedman.” The article documents the progress of mankind over the quarter century from 1980 to 2005. “[A]s the world embraced free market policies, living standards rose sharply while life expectancy, educational attainment, and democracy improved and absolute poverty declined.” Numerous other such accounts exist and support the notion that freedom and

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39. 2009 FRASTER INST. ANNUAL REPORT, ECONOMIC FREEDOM OF THE WORLD 25 (citation omitted).
capitalism have been the greatest anti-poverty program in the history of humankind.

If any good is to come out of the governmental expansions during the great financial crisis of 2008 and 2009, it will be the added evidence that government interference often makes crises in the financial markets worse. We will never know what might have happened had Washington stepped aside and let the strong survive and the weak perish, but our hunch is that unemployment would be much lower, the recession would have been much shorter, and the nation would be $3 trillion less in debt.
Sound economic policy, morally upright economic judgment and action, and a stable web of economic institutions and agents are all essential for human well-being. The absence of any of these things creates crucial obstacles to the flourishing of persons, both individually and socially. A natural law theory is, in essence, a critical and reflective account of the constitutive aspects of the well-being and fulfillment of human persons and their communities, and of the requirements that human well-being place on human actions. So the project of bringing natural law theory to bear on questions of economics is entirely to the good. The natural law tradition, manifested in thinkers such as Plato, Aristotle, and St. Thomas Aquinas and his successors, has typically attended to some of the crucial concerns at the intersection of economic activity and human well-being. Natural law thinkers have addressed the nature of property and of charitable obligations, the role of money and money lending, and the context of moral principles governing relations between states in ways that continue to influence the West’s common thinking. Yet insights of the natural law tradition on such matters have also become occluded as new theories, new situations, and new technologies have shaped the context in which economic choice and action take place.

The purpose of this Essay is to identify both the natural law justification for a free market—hence the Essay’s concern for freedom—and the broad natural law understanding of the primary moral norm governing that market—hence the Essay’s concern for equality. Both freedom and equality, properly understood, are essential to the natural law account of the market as presented by its greatest proponent, St. Thomas Aquinas.1

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Separate either from the other and the account will cease to be recognizable as genuinely belonging to the natural law tradition.

Aquinas famously provided a rather pessimistic account of the justification for private property. The goods of the earth are in one sense to be held in common: They exist for the benefit of all persons and have no particular person's name attached to them by nature. Yet, if men hold and dispose of property in common, various problems will arise. Aquinas noted in particular that people will care less adequately for what they do not think of as their own. Communal ownership can also lead to confusion over what should be done with the property. This uncertainty can lead to quarrels. Private property is thus justified for the purpose of procuring and dispensing of goods, but property is still common in regards to the use to which it is put.

John Finnis has offered an important addendum to this pessimistic justification. Private property contributes to the freedom and autonomy of individuals, which benefits them in the task of becoming self-constituting, flourishing human beings. In the natural law tradition, freedom is not treated as good in itself; it becomes good, however, because it allows human beings to participate actively in shaping their own lives. As Aquinas wrote, practical reason is our very participation in the eternal law: God chooses to guide us towards our perfection not by instilling in us principles of direction that determine our actions, but by allowing us, through our own knowledge of those principles, to direct ourselves towards our fulfillment and to decide for ourselves whether or not to act. In this "participated theonomy," we are active cooperators with God in shaping our lives in accordance with His plan. We can thus identify God's call to each individual to share in that self-shaping project as that person's "vocation."

3. Id.
4. Id.
5. Finnis, supra note 1, at 169.
6. See id. at 90.
7. See Aquinas, supra note 2, at I-II, Q. 91, arts. 2-3.
Such self-shaping is greatly enhanced by the institution of private property. Private ownership allows agents to decide how they will procure and dispose of property in accordance with, and in service of, their vocation in a way that would not otherwise be possible. So, to Aquinas's reasons for private ownership we can add another perhaps more fundamental one: private property is instrumentally necessary for our active self-constitution because it enables certain crucial forms of vocation-enabling freedom.

By its very nature, property ownership creates the potential to engage in commercial activity. With private property comes authority to procure and dispose of it. In any realistic appraisal of the world, it will be clear that it is simply impossible for most, perhaps all, persons to appropriate for themselves all and only those goods they need to meet basic needs and the needs of their vocation. Exchange of goods—mutuality of procurement and disposal—is a social inevitability if persons are to flourish, a necessity giving rise to the custom of promissory, and eventually contractual, obligation and a common currency. These customs are a necessary prerequisite to a formal marketplace, for a social practice must exist before its conventions may be formalized by legal rules. Nonetheless, these social practices are responsive to human needs and are already shaped by normative considerations, especially fairness. It is only fair that, having been done a good by another by obtaining a good or service, I should reciprocate and provide the other with the good I have agreed to provide. Moreover, such mutual provisions should accord with some reasonably commensurating framework of value, such that what I receive is roughly equal to what I have given.

These principles can serve as the basis for an account of "the market" and its moral justifications. The market essentially consists of a practice of exchange, the creation of capital, and the existence of credit. The most fundamental justification of the market is fairness. Fairness justifies a moderately free market, but it also justifies—morally, socially, and, again, legally—the regulation of that freedom. The structure of the natural law approach here mirrors that of the approach to private property: There is no unregulated freedom, no freedom for its own sake anywhere in a natural law account of anything. Freedom should exist only in service of genuine human goods. Freedom is instrumentally good not simply, and not even primarily, because it enables a group of people to pursue the good more efficiently than they could as individuals. The efficiency of a free market is important, and invisible
Hand mechanisms are likewise necessary for an accurate assessment of a reasonable allocation of goods. But freedoms, including market freedoms, are essential primarily because they enable the fulfillment of obligations and the self-constituting activity of reasonable agents. In short, market freedom is an instrument that enables the pursuit of one's personal vocation. It is this vocational obligation, rather than freedom, that should ultimately be protected by, or in spite of, a free market.

Assuming that agents are not self-sufficient, an exchange of goods and labor is a rational necessity. What principle should govern such exchange so that the exchange may be said to be just? What motives should, normatively, be operative for agents engaged in such exchange? The principle is fairness, and the motive is need. Each consideration looks to the other in a way that justifies reliance on market mechanisms, as the following argument makes clear. An exchange is fair when it leaves neither the buyer nor the seller worse off than before. The exchange must therefore be one in which each agent parts with something of value equal to what the other agent receives. Equal value, however, is determined by need. The buyer has need for some good or service and the seller has need for money relative to what he has to offer. The needs of the seller for money include compensation for time, expense, skill, and labor expended on what is sold. Thus, need is not an entirely simple and univocal notion. Instead, it requires further interpretation before it will assist us in determining whether an exchange is fair. Finnis notes:

The normal manifestation of need [indigentia] is preference [praeligere]: so ‘need’ amounts in these contexts to ‘demand’. The conventional institution of money [numisma] enables us to measure demand, i.e. the demand of the buyer who has money and of the seller who needs (indiget) money and has what meets the buyer’s demand [indigentia]. The normal measure of something’s value, therefore, will be the price it would currently fetch ‘in the market [secundum communem forum]’, i.e. in deals between any willing sellers and buyers in the same locality and time-frame, each party being aware of the thing’s merits and defects.

10. See Finnis, supra note 1, at 81–90.
11. The exchange of money will be addressed subsequently.
Suppose, however, that Smith possesses such urgent private need of some good or service from Jones that he would willingly pay more than the market price for it. Such a need, Aquinas holds, cannot change the just price, even though Smith will, in a sense, gain more than Jones gets, because the difference in the exchange—the surplus value received by Smith—derives not from anything about Jones the seller—the labor he has put into it, the price he can get in the free market, or his other needs or losses—but from a condition of Smith himself. For Jones to sell at more than market price is therefore for him to sell what is not his; it is for him to receive something for nothing.  

Wariness of receiving something for nothing drives Aquinas’s market ethic. Receiving something for nothing clearly violates the idea of equality in exchange and is thus unfair. The same principle of equality in exchange also militates against an untrammeled desire for profit. Again, it is worth noting that even if a market driven only by “base” desires were to work to the advantage of everyone, this market would not be just for the natural law lawyer; the just market is structured from the outset by general justice, a virtuous orientation towards a common good that includes fair treatment of all by all within its scope.

Three realities together form the essential stratum of exchange: goods, labor, and money. A common structure of argument justifies a free market across each of these strata. The natural law account adds limits to this freedom. It creates obligations to dispose of superflua (wealth in excess of that necessary to pursue one’s vocation), to provide aid to those in desperate need, and to provide for a governmental role in case voluntary giving ever runs out, removing to that extent the provision of some goods and services from the market. At the end of this Essay, I will suggest some further limiting considerations. For now, it is sufficient to provide the justificatory structure for a natural law account of reasonable reliance on the market.

Before addressing briefly the question of the regulation of markets, I turn first to the third of the realities that may be exchanged: money. The natural law tradition is well known for its suspicion of usury. Many understand usury as loaning money at interest.

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13. See AQUINAS, supra note 2, at II-II, Q. 77, art. 1.
14. See id.
This characterization, however, reflects a simplistic understanding of what precisely Aquinas was objecting to, and it does an injustice to his thought. Aquinas distinguishes between a thing and its use. In many cases, the use of a thing can be exchanged—bought and sold—without the thing itself being bought and sold. In such cases, the owner of the thing can ask both for the thing to be returned and for a price for its use. In other cases, however, the existence of a thing and its use cannot be separated. For example, one cannot usually rent bread: its use involves its consumption. In these cases, a price can be put on the thing, but one cannot both ask for the thing back and charge for its use. In selling its use, one sells the thing and vice versa. The use belongs entirely to the one who has obtained the loan unless, for example, the creditor enters into a cooperative for-profit arrangement, sharing risks as well as possible rewards with the debtor.

One must, therefore, charge what the money is worth in "loaning" it to another. Because money is worth what it is worth, it seems that Aquinas’s account would preclude any charging of interest. But it does not. One may charge for what has been lost in giving over the money—the opportunity, for example, to invest the money for gain. One may also charge a fee for failure to repay the debt on time. To charge interest beyond the possible investment income, plus a possible fee for failure to repay, however, is to charge for what is no longer within the creditor’s rights: the use of the money itself. It is this further charge to which Aquinas objects.

How, then, can one determine what constitutes a reasonable interest rate? If such interest, apart from late fees, is intended to compensate for loss—what could have been gained had the money remained in the owner’s possession—and if one keeps in mind that such a loss is in a sense speculative, then one charges reasonably “if one takes as the measure of loss of profit...the general or average return on morally acceptable investments in a genuine capital market available to the lender.” Moreover, these morally acceptable investments include, in a way that the contem-

16. See AQUINAS, supra note 2, at II-II, Q. 78, art. 1.
17. Note that not all investments are “loans” to someone else. If I buy stock in a company, the dividends they pay me are not “interest” but are nonetheless a return on my investment.
18. FINNIS, supra note 12, at 209.
porary market economy makes more fully available than in Aqui-
nas’s day, “shares in commercial and productive associations.” 19

It is surely possible to see how such principles can be vio-
lated, however, in an unrestricted market. The needs of some
for money, for example, can be exploited through interest rates
far in excess of the “general or average” rate of market return.
Or consider the following two-fold misadventure in money de-
scribed recently by Amartya Sen:

The moral and legal obligations and responsibilities associ-
ated with transactions have in recent years become much
harder to trace, thanks to the rapid development of secondary
markets involving derivatives and other financial instru-
ments. A subprime lender who misleads a borrower into tak-
ing unwise risks can now pass off the financial assets to third
parties—who are remote from the original transaction. 20

It seems highly implausible that this secondary market in deriva-
tives is always problematic. Yet it seems clear that the system that
gave rise to the problems Professor Sen referenced went afoul of a
Thomistic understanding of the market in at least two ways.

The first was the moral failing of investors actively seeking
something for nothing. When the practical impossibility of this
scheme made itself clear, the scheme collapsed under its own
weight. One of the widely noted and significant moral defects of
the institutional structures surrounding the economic crisis of
2008 relates to employment practices. If any of the chief executives
of the various Wall Street financial firms had refused to pursue
profit from the credit bubble, they would almost certainly have
been fired. In addition to its susceptibility to criticism from the
standpoint of long-term prudence, this imposed behavior violated
the Thomistic standpoint’s emphasis on equality in exchange.

Professor Sen also focused on a separate consideration equally
essential to the Thomistic account. In his brief discussion of the
regulation of buying and selling by the law, Aquinas notes that
human law is unable to prohibit everything that is contrary to vir-
tue. 21 He implies, however, that the law should be concerned in the
market context with deceit. 22 This emphasis is sound; it is clear that

19. Id. at 210.
21. AQUINAS, supra note 2, at II-II, Q. 77, art. 1.
22. See id.
deceit constitutes the largest barrier to both freedom and equality in exchange because both values are encouraged by a mutual understanding of the worth of what is being traded. But again, structural features leading up to the economic crisis militated against the transparency for which Aquinas called. These features included the complexity and modularity of the transactions, the collusion of ratings agencies with financial firms, and the ability of agents across the board to carry out transactions while casting a blind eye to the economic health of their transaction partners.

Such failures, and others within the free market, suggest the need for both moral underpinnings and transparency. The moral underpinnings include the virtue of general justice, a general willingness to play fair, to forego the pursuit of profit for its own sake, to accept the principle of equality of exchange, and to see the market as an institution within which all can benefit. Transparency and openness in the market require appropriate levels of state regulation, adequately protected from insider interests and charged with the protection of fairness amongst participants.

In a natural law account, private property, the market, and the state itself ultimately exist for the sake of individuals and families. They, rather than money, must be the life of the market. Thus, in the domain that was central to the developing economic crisis beginning in 2007, no scheme of regulation or its absence can be adequate that does not recognize both of the following desiderata: first, that individuals and families should be benefited by schemes for the provision of credit that make possible ownership of property highly conducive to prosperous family life, such as a house, and second, that such schemes must not encourage irresponsible borrowing. At a more basic level, no doubt, families must return to an understanding of moral formation in which virtues such as thrift and hard work are encouraged and children are taught the importance of being trustworthy. As we have seen, the erosion of these values has been devastating for society’s financial institutions. Just as large-scale economic institutions and practices must look to families and individuals as ultimate beneficiaries, so too must those families and individuals remain the moral bedrock for cultivation of the virtues necessary for a fair and free market.
The recent meltdown in our financial institutions, to say nothing of our portfolios and 401(k)s, seemed to confirm the view of Thomas Reid, Justice James Wilson, and others that we are not skeptics by nature. David Hume might have raised metaphysical doubts that we could speak with surety about “causation,” but when the financial crisis set in, the common sense assumption of ordinary folk was that someone had caused these things to happen. President Obama has been convinced, of course, that the gravest problems in our national life are always caused by someone else. He affects to be blissfully unaware that he and his party contributed to the recent crisis as they sought to ward off any attempt on the part of the Bush Administration to rein in Fannie Mae, with its policy of spreading subprime mortgages throughout the land. There is no want of theories about whom or what to blame, and yet it is striking that the Constitution has emerged from this crisis unscathed, in the sense that no one blames the Constitution. Whatever the Federal Reserve did in keeping interest rates low and sustaining the bubble in housing, whatever the Democrats did in giving a free rein to Fannie Mae to encourage people to take on mort-

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1. As Justice Wilson argued in his lectures on jurisprudence, the “propensity to speak the truth”—in giving directions, offering testimony, and guiding children—is “more universally predominant, than is generally imagined. . . . Even the most consummate liar declares truths much more frequently than falsehoods.” JAMES WILSON, LECTURES ON LAW (1804), reprinted in 1 THE WORKS OF JAMES WILSON 385 (Robert McCloskey ed., 1967). Justice Wilson was guided by the great Scottish philosopher, Thomas Reid, whom he cited in his very first opinion for the Supreme Court in Chisholm v. Georgia, 2 U.S. (2 Dall.) 419 (1793). Here, at the beginning of American jurisprudence, Justice Wilson set the stage with the general principles of jurisprudence, but before even that, he invoked the teachings of Thomas Reid “in his excellent enquiry into the human mind, on the principles of common sense, speaking of the sceptical and illiberal philosophy, which under bold, but false, pretentions is liberality, prevailed in many parts of Europe before he wrote.” Id. at 453–54.
gages they could not afford, whatever mistakes Secretary Hank Paulson and Chairman Ben Bernanke made in arranging the bailouts and enlarging the powers of the federal government in the crisis, none of this was evidently enjoined or determined by the Constitution. And yet this crisis arguably has been amplified in its dimensions and its tragic effects precisely because men and women in high public office were no longer attentive to the moral cautions that members of the political class used to see vividly. These cautions had been seen more sharply when the political class took the provisions of the Constitution more seriously.

There seemed to be a keener sense, in an earlier time, of the deep moral principles that lie behind certain provisions of the Constitution. Justice Holmes thought that the modern legal project could be advanced "if every word of moral significance could be banished from the law altogether." \(^2\) The measure of his triumph is that several generations of lawyers have come to make a facile distinction between the things that are moral and those that are "legal." When they managed to screen from their own sight the moral meanings contained in the Constitution, it is arguable that they were schooled over the years not to notice the moral cautions that the Constitution persistently cast up for people exercising the powers of law.

Richard Epstein has argued that we cannot diminish the extended effects of the crisis by dismissing the simple and venerable idea of the "Obligation of Contracts" as something instantly to be flicked aside in a moment of trouble.\(^3\) Pension funds and ordinary folk bought bonds in Chrysler, and yet found their claims thrust aside in the political management of the crisis, rather than taking their place in line under the laws of bankruptcy administered by a federal judge.\(^4\)

The first generation of jurists in the Framing era had a clearer sense of the connection between law and moral judgment, for they seemed to understand the moral groundwork that stood beneath the provisions of the Constitution and the statutes that


were consistent with the Constitution. Nowhere has the discrepancy between that earlier generation and our own been as striking, and as portentous, to our political life as in the understanding of the Contracts Clause.\(^5\) Hobbes famously remarked that contracts are “but words and breath, have no force to oblige, contain, constrain, or protect any man, but what [they have] from the public sword”\(^6\)—from the coercive power that is necessary to enforce a contract. In this reckoning, an unenforceable contract is no contract at all. Hobbes, of course, preceded the American Framers, and yet his understanding is closer to the changes produced in our own time since the New Deal. For once Hobbes’s understanding is in place, it is a short step to the conclusion that the power of law is a necessary component in anything that would be taken seriously as a contract. And so, if the people exercising political power think that an injury to the common good could be averted by altering the terms of a private contract, the authority to make those changes is simply built into the responsibilities they bear in the exercise of that public power. That was essentially the understanding that Chief Justice Hughes drew upon when he sought to explain, in *Home Building & Loan Ass’n v. Blaisdell*,\(^7\) why the legislature of Minnesota might have been justified, in the exigencies of the Depression, in averting the foreclosure of farms by declaring a moratorium on foreclosures. Cicero, much earlier, caught the moral sense of the problem when he commented on schemes to solve the enduring tension between debtors and creditors in this way: What is the meaning, he asked, of an “abolition of debts, except that you buy a farm with my money; that you have the farm, and I have not my money?”\(^8\)

That understanding can be countered only by an understanding of what there is in the idea of a contract that is not dependent on the conventions of the law. In the early jurisprudence of the republic, that understanding was expressed with uncommon clarity by Chief Justice John Marshall in *Ogden v. Saunders*.\(^9\) Daniel Webster, in his brief on the case, set forth the

\(^5\) U.S. CONST. art. I, § 10.
\(^7\) 290 U.S. 398, 444–45 (1934).
problem as clearly as Chief Justice Marshall would later explain the matter. Webster framed the problem with stringent clarity upon which it is hard to improve:

If the contract be lawful, the party is bound to perform it. But bound by what? What is it that binds him? And this leads to what we regard as a principal fallacy in the argument on the other side. That argument supposes, and insists, that the whole obligation of a contract has its origin in the municipal law. This position we controvert. We do not say that it is that obligation which springs from conscience merely; but we deny that it is only such as springs from the particular law of the place where the contract is made. It must be a lawful contract, doubtless; that is, permitted and allowed; because society has a right to prohibit all such contracts, as well as all such actions, as it deems to be mischievous or injurious. But, if the contract be such as the law of society tolerates—in other words, if it be lawful—then, we say, the duty of performing it springs from universal law. Webster imagines that a man promises to pay money in New York. Does the obligation to respect that contract emanate only from the laws of New York, “or does it subsist independent of those laws?”

We contend that the obligation of a contract, that is, the duty of performing it, is not created by the law of the particular place where it is made, and dependent on that law for its existence; but that it may subsist, and does subsist, without that law, and independent of it. The obligation is in the contract itself, in the assent of the parties, and in the sanction of universal law.

Let us sort this out. Contracts must be made, in the first place, for legitimate purposes only. As Justice Rufus Peckham would later make explicit, the courts will not uphold “immoral” contracts: They will not uphold contracts for hit murders or for prostitution. The laws in particular places may vary in their stringency. Pornography might be a perfectly legitimate calling in San Francisco, but not in Boston, and if the

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11. Id.
12. Id.
13. Id. (emphasis added).
laws in Massachusetts bar pornography, the courts will not enforce contracts to engage in pornography. Those are the parts that are bound to particular places. What, then, is the part of contract that is “universal,” as Webster said?\(^{16}\) As he suggests in a stroke of imagination, it is the part that would exist even when there is no government on the scene.\(^{17}\) Let us recall those two people making a contract in New York. If one of them moves to Pennsylvania, we assume that the obligation to honor the contract has not been altered by the shift in locale. But let us suppose that the contract has been made between two persons cast ashore on an uninhabited territory, or in a place over which no law of society extends. There are such places, and contracts have been made by individuals casually there, and these contracts have been enforced in courts of law in civilized communities. Whence do such contracts derive their obligation, if not from universal law?\(^{18}\) Suppose instead that the two people are stranded on a deserted island. They promise each other that they will each explore a different part of the island, and if either one finds help or rescue, he will notify the other. On the strength of that promise, each person stakes his interest in his safety. If the promise is not kept, the other person could lose his life. It is the awareness of that potential injury at stake in making the promise, and trust that the promise will be kept, that forms the obligation of the contract. In a domestic example, carpenters and workmen think they have the commitment of a builder to do the work he has engaged them to do. On the strength of that promise, they forego other work that would be necessary to sustain themselves and their families. They put themselves at risk, then, of a serious injury when they depend on the promise in the contract. And it is that serious injury that justifies the move of the community to make that promise enforceable in the law. That is why we have a law of contracts.

When Chief Justice Hughes in the Blaisdell case held that the contracts contained in mortgages may be suspended or revised by the authorities because of the hardship of the Depression, he made a nullity of the contracts. And in the sweep of his grand

\(^{16}\) Webster, supra note 10, at 71.
\(^{17}\) Id. at 71–72.
\(^{18}\) Id.
gesture it apparently escaped his notice—as it had not escaped
the notice of Cicero—that the benefits conferred in this way on
the farmers holding mortgages would be paid for by the costs
imposed on depositors in the banks. Those depositors would
no longer stand to receive the returns of interest they had been
promised for leaving their money with the bank, and indeed,
they could lose the savings they had deposited. As Justice
George Sutherland remarked in dissent, the Contracts Clause
in the Constitution was not to be suspended because of the exi-
gencies of an emergency; it was made precisely as something
that had to be honored in the presence of a real emergency.19

In the same way, there was a remarkable flippancy when the
latter-day followers of Chief Justice Hughes and the jurispru-
dence of the New Deal decided that the best way to prop up
the Chrysler corporation and the union of auto workers was to
treat as expendable those pensioners and investors who had
bet a good portion of their savings on bonds in Chrysler.20 They
depended on the obligations that traditionally flowed to the
holders of bonds. It may require interviews by an anthropolo-
gist to tell us more accurately how the decision makers in the
Obama Administration understood these matters. But on the
surface of things, it would be hard to account for the way they
acted without imputing to them remarkable obtuseness, which
somehow blocked from their notice the injuries that would take
place, the deep moral faults that would be marked, by this will-
ingness simply to flick away the obligations of contract. But that
is precisely what the Constitution in an earlier day helped people
in authority to see. When the legal imagination was cultivated by
this understanding, the bells and alarms sounded a warning that
these people in authority were doing something truly portentous.

In the famous Legal Tender Cases in 1870, Chief Justice Salmon
Chase managed to pierce to the moral reasoning that lay be-
hind the provisions in the Constitution in the same way.21
Strictly speaking, the Contracts Clause bore only on state gov-

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19. Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 448–49 (1934) (Suther-
land, J., dissenting) ("A provision of the Constitution, it is hardly necessary to say,
does not admit of two distinctly opposite interpretations. It does not mean one
thing at one time and an entirely different thing at another time.").
20. See McCullagh, supra note 4.
ernments. But Chief Justice Chase understood a deep principle behind that clause, one that would also apply to the federal government if it sought to alter contracts by political fiat. The government did precisely that in a series of cases, for it required debts contracted in gold to be satisfied by payments rendered in paper money, which had lost about two-thirds of its value. But the Chief Justice gave us another example that seems to have disappeared from the sensibilities of many lawyers and judges in our own time. Chase focused for a moment on the Takings Clause of the Fifth Amendment: that "private property [shall not] be taken for public use, without just compensation." There was, of course, no "taking" of property in cases that involved the requirement of paper money in payment of debts. Literally speaking there was no transfer of ownership from a private owner to the public authorities. The Chief Justice suggested, however, that with a modest engagement of the moral imagination, the principle behind this provision would plausibly extend beyond the narrow terms of the text:

[The provision on the taking of property] does not, in terms, prohibit legislation which appropriates the private property of one class of citizens to the use of another class; but if such property cannot be taken for the benefit of all, without compensation, it is difficult to understand how it can be so taken for the benefit of a part without violating the spirit of the prohibition.

Imagine that the government seizes an apartment building from an owner, without compensation, and transfers that property to the ownership of the government. Would it be a different case, in principle, if the government seized the same building, without compensation, and transferred ownership to the tenants? Would the government then be able to evade the discipline of the Constitution and the need to pay compensation? And would it evade, with the same move, the need to justify to the voters and taxpayers the taxes that would be necessary to fund these expenditures?

22. U.S. CONST. art. 1, § 10.
24. Id. at 606-08.
25. U.S. CONST. amend. V.
Sometime in the late 1970s, the recognition was settling in among the political class that voters were reaching the limits of their willingness to be taxed. The movement for Proposition 13 in California sounded the telling note here in forcing a limit on taxes, and perhaps prefiguring the Age of Reagan.  

But then a countering stratagem began to recommend itself to the political class: The government could simply mandate that private owners provide public goods. For example, the government could require owners of oceanfront property to provide access to the shore for the public if they wished to receive special permission to build on their properties.

But some have tried to take this tactic to a new level by requiring private employers to provide health insurance for their employees, as though this were a measure within the police powers of government to act for the safety and health of workers. Michael Dukakis in 1988 raised this argument to the level of a presidential campaign, and now President Obama has made it, of course, a part of his sweeping health care scheme.

An employer might be taxed at eight percent of the average wages he pays to provide that health care if he does not. The government will then exempt, with the usual gestures of liberality, those businesses too small to bear these public obligations. If these measures had been advocated at the end of the nineteenth century or early in the twentieth, the alarm would have gone off at once. Our predecessors would have called the proposed health care bill "class legislation," government action that confiscates the property of A in order to transfer it to B, as though B had done something wrong and A, somehow mistreated or injured, deserved compensation. There would have been no doubt that we were at the threshold of policies that raised the gravest constitutional questions. But now we glide easily across these distinctions that once marked real moral and

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27. See Nordlinger v. Hahn, 505 U.S. 1 (1992) (upholding the constitutionality of Proposition 13, which amended the California constitution to cap property taxes).


31. Id. § 413(a).

32. Id. § 413(b) (providing a complete exemption for employers with a payroll of less than $500,000).
constitutional barriers, and we do it without the least sense that anything of constitutional import may be taking place. We may argue, at most, about the utility or effectiveness of the proposed policy. But it is a telling measure of our political life today that the question of constitutionality is virtually never heard. It has disappeared from the public sensibility, in the way that the text of the Constitution seems to have receded into a fog of memory of things distant.

Harry Truman once remarked that “the only thing new in the world is the history you don’t know.” If there is one constitutional issue that marks the most dramatic passage from the Constitution as it was to the Constitution as remade and unmade by the Progressives and the New Deal, it is the issue of the “delegation of authority.” It is the issue that Justice Scalia had in mind when he warned that the Constitution confers on the legislative branch “the power to make laws, not the power to make legislators.” That issue was momentous as it lingered in the New Deal, even after the grave breaches coinciding with the rise of the administrative state under Woodrow Wilson. The country gained a plethora of new independent agencies that were neither of the executive, nor of the legislature, nor of the judiciary. And they were charged with using their discretion to achieve the public good. They set the grooves of precedent in which Secretary Paulson could freely act during the financial meltdown in the fall of 2008, when he was given the authority to expend money under the new TARP program with no more guidance than the assignment of acting for the public good. Let us try to recapture the sense of the moral and constitutional problem by recalling one of the more vivid cases from New Deal days.

Jacob Maged, forty-nine years old, a tailor in Jersey City, was sentenced to three months in jail in 1934 and fined $100, his wife and four daughters compelled then to run his shop in his absence. What had he done? Knowingly, deliberately, he had pressed a suit for one of his customers for thirty-five cents instead of the forty cents mandated under the National Recovery Act. And Abe Traube, the head of the Cleaners and Dyers Board, said, “We think that this is the only way to enforce the

NRA. If we did the same thing in New York City we would soon get the whole industry in line.\textsuperscript{35} With the delegation of authority, an unelected board composed of businessmen and union members in the same business could wield the powers of law to set prices and hours and punish anyone, like Jacob Maged, who might try to earn a living during the Depression by working for a little less, or working a little longer, than other people.

We assume that such things were put away by the courts during the New Deal. But we do not notice when they come back, and so apparently no moral signals are sounded for President Obama as he and his team contemplate a grand administration of health care that delegates the authority to decide just how much is worth spending on the medical care of any patient, especially older patients.\textsuperscript{36} If the question had been put before a legislative committee—if Congressmen had to vote about which procedures were worth covering and which were not—the measure would have a hard time surviving congressional scrutiny and gaining enough votes to pass.

In the days of the New Deal, Huey Long complained that the New Deal had "[e]very fault of socialism . . . without one of its virtues."\textsuperscript{37} He pointed out that regulations were issued, with the force of law, from administrative agencies, regulations that could not have passed the Congress if they had been put forth as measures to be enacted into law. And now we fast-forward, as they say, and we may ask the question, in the spirit of Huey Long: On what basis, in what statute, did President Obama find the authority to cashier the President of General Motors?\textsuperscript{38} Granted, the taking of massive public funds creates some sense of obligation to the public. And yet, a statute providing funding in an emergency to financial institutions would not itself convert a private entity into a public entity, nor clearly transfer

\textsuperscript{35} ARKES, supra note 15, at 160–61.
\textsuperscript{36} See 3962, §§ 221–224 (establishing a “Health Benefits Advisory Committee” to recommend minimum health insurance coverage standards to the Secretary of Health and Human Services for adoption by notice-and-comment rulemaking).
\textsuperscript{37} ROBERT MANN, LEGACY TO POWER: SENATOR RUSSELL LONG OF LOUISIANA 26 (1992).
to the hands of the government the authority to name the management of the company.

On that kind of question, it is never out of season to recall John Marshall's classic argument in the Dartmouth College case.\textsuperscript{39} The Chief Justice made interesting concessions to the political leadership in New Hampshire, which had sought to take over this private college and turn it into a public entity with members of the board appointed by the legislature.\textsuperscript{40} Education was of inestimable significance for the life of a republic—as the health of the auto industry is for the country in our own day—but that did not convert a private entity into a public entity.\textsuperscript{41} No more did a corporate charter conferred by the State.\textsuperscript{42} It was of inestimable value that Dartmouth was an entity that could endure over time even as the president and the board—and the students—changed. But as the Chief Justice argued, it no more made Dartmouth a public entity than the conferring of immortal life on any person would convert that person into a public entity.\textsuperscript{43} What the legislature had done was “to convert a literary institution, moulded according to the will of its founders, and placed under the control of private literary men,” into an instrument directed by the government of New Hampshire.\textsuperscript{44} But then came Chief Justice Marshall's concession: “This may be for the advantage of this college in particular, and may be for the advantage of literature in general; but it is not according to the will of the donors, and is subversive of that contract, on the faith of which their property was given.”\textsuperscript{45}

We might imagine the legislature of an earlier day in Massachusetts taking charge of the board at Harvard and appointing Henry James and Mark Twain. Or in our own day, appointing to the board of Amherst College John Updike and Philip Roth. It would no doubt be a board of more literary excellence. But it would not be the board arranged by the founders of the institution, their legal successors, and their alumni. It could be, quite arguably, a better literary institution. But it would not be theirs.

\textsuperscript{39} Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).
\textsuperscript{40} Id. at 626.
\textsuperscript{41} Id. at 634–35.
\textsuperscript{42} Id. at 638.
\textsuperscript{43} Id. at 641–42.
\textsuperscript{44} Id. at 653.
\textsuperscript{45} Id.
It would no longer be that private college, shaped by judgments that had been formed to an uncommon, cultivated standard. And for all we know, General Motors and Chrysler might be better businesses if they were run by Larry Summers or Steve Rattner, but they would not be private firms organized by their own, private criteria.

It is one of the deceptive ironies of our time that we have heard more about "privacy" as the anchor of our claims to personal freedom and constitutional rights at a time when private rights have never been so deeply disrespected. At the time of the Civil Rights Cases in the 1880s, it seemed to be understood that a liberal constitutional order began with a respect for the domain of privacy in marking off a hard limit to the reach of public authority.\footnote{See Civil Rights Cases, 109 U.S. 3, 11 (1883).} That zone of privacy offered a certain insulation for people to do it their own way, even when their private discriminations conveyed the most undisguised contempt for the people and the styles of demeanor they meant to bar from their presence. And yet all of that could be accepted with a certain shrug as one of those inescapable marks of a regime of constitutional restraints, a regime that confirmed for people a freedom to arrange things according to their own, private criteria in private businesses, private clubs, and private families.

To recall these understandings is to tell the story of a people more and more convinced that they have become the bearer of constitutional rights ever broader, ever grander than what has been known before, even as they have detached themselves ever more from the moral grounds that stood beneath those constitutional rights. The political class has tutored the public to a cluster of constitutional rights, but can no longer give a moral account of those rights. And hence, when the financial crisis hit with its deepening effect, most of our people could no longer detect the alarms that alerted us in an earlier time that something was awry in the constitutional order—something of profound moral significance. The loss of that awareness threatens to make a lasting difference in the lives we have together as a people, living in a republic, and living with the benign illusion that we were living under the protections of the Constitution.
This may be our first epistemologically-driven depression. (Epistemology is the branch of philosophy that deals with the nature and limits of knowledge, with how we know what we think we know.) That is, a large role was played by the failure of the private and corporate actors to understand what they were doing. Most heads of ailing or deceased financial institutions did not comprehend the degree of risk and exposure entailed by the dealings of their underlings—and many investors, including municipalities and pension funds, bought financial instruments without understanding the risks involved.¹

There are two major competing narratives for the financial crisis. One narrative focuses on moral failure, in which the compensation structure for executives at financial institutions encouraged them to place their own and other firms at risk to reap short-term gains.² The other narrative focuses on cognitive failure, in which executives and regulators overestimated the risk-mitigating effects of quantitative modeling and financial engineering. It is important to sort out which of these narratives deserves more credence.

Those who emphasize moral failure have highlighted a number of distortions between private and social benefits, including: that executive pay at financial institutions is not tied to long term viability,³ the "originate to distribute" model of mortgage financing gives the originator an incentive to make bad loans that are passed down the line in the system of struc-

¹ Adjunct scholar, Cato Institute. Mr. Kling has worked as an economist at the Federal Reserve and at Freddie Mac.
³ Lucian Bebchuk has emphasized this disconnect. See id.
tured financing of mortgage securities, and rating agencies are overly generous in granting AAA and AA ratings because they were paid by the issuers of mortgage-related securities.

Under the moral failure theory, the essential problem is the misalignment between the incentives of executives to maximize their own salaries and the long-term best interest of the financial firms they led. In this narrative, regulators were either stymied by ideological faith in markets or hampered by organizational flaws—most notably, the alleged absence of anyone charged with monitoring systemic risk.

The other narrative is one of cognitive failure. Under this view, key individuals believed propositions that turned out to be untrue. Propositions that were falsely believed included: that a nationwide decline in housing prices, having not occurred since the Great Depression, was impossible; increased home ownership rates were a sign of economic health; the use of structured finance and credit derivatives had reduced risk to key financial institutions; monetary policy only needed to focus on overall economic performance, not on asset bubbles; banks were well capitalized; and quantitative risk models provided reliable information on the soundness of mortgage-backed securities and of the institutions holding such securities. In hindsight, these propositions were wrong. Policymakers were caught up in the same cognitive environment as financial executives. Market mistakes went unchecked not because regulators lacked the will or the institutional structure with which to regulate, but because they shared with the financial executives the same illusions and false assumptions.

Under the narrative of moral failure, the financial crisis was like a fire started by delinquent teenagers, with the adults in charge not sufficiently inclined or positioned to exercise ade-


6. Bebchuk & Spamann, supra note 2, at 249.

7. For what is, in my view, the best work on the crisis thus far, see GILLIAN TETT, FOOL’S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE (2009).
quate supervision. The solution is thus to reorganize and re-energize the regulatory apparatus.

Under the narrative of cognitive failure, it is as if the authorities supplied the lighter fluid, matches, and newspapers used to start the fire. In particular, housing policy encouraged too many households to obtain homes with too little equity. Bank capital regulations steered banks away from traditional lending toward securitization. Moreover, these regulations encouraged the banks' use of ratings agencies and off-balance-sheet entities to minimize the capital held to back risky investments. If this narrative holds, then financial regulation itself is inherently problematic. Regulators, sharing the same cognitive environment as financial industry executives, are unlikely to be able to distinguish evolutionary changes that are dangerous from those that are benign. It may not be possible to design a foolproof regulatory system.

I. FREDDIE MAC

Perhaps the best illustration of the tension between moral and cognitive failure narratives is the response to Freddie Mac's rapid decline. Freddie Mac, a company chartered by the government in 1970 but sold to private investors in 1989, was one of the institutions that suffered catastrophic losses, in part because it relaxed credit standards from 2002 through 2007. Was this relaxation a moral or cognitive failure?

In August 2008, the New York Times reported that in deciding to become more active in the subprime mortgage market, Freddie Mac's CEO, Richard Syron, had ignored the warnings of the company's Chief Risk Officer, David Andrukonis. Early in 2004, Andrukonis had sent Syron memoranda that argued against purchasing mortgages that were originated with reduced documentation. Shortly afterward, Andrukonis left, and Freddie Mac expanded its purchases of various high-risk mortgage products.

10. Id.
11. Id.
The narrative of moral failure would suggest that Syron was motivated by the desire for short-term profits and bonus payments to the detriment of his obligations to shareholders and other long-term constituencies. Certain reports, however, such as one that appeared in the *Boston Globe,*\(^\text{12}\) paint a different picture. According to this alternative account, Syron focused on his responsibility to keep Freddie Mac active in a mortgage market that was shifting away from traditional safe mortgages and toward riskier products.\(^\text{13}\) Moreover, he believed that Freddie Mac had a mission to serve the needs of minorities and low-income home buyers.\(^\text{14}\) One could therefore argue that his decisions were driven by moral considerations, not by personal greed.

The ultimate difference between David Andrukonis and Richard Syron, however, was not that one had a moral backbone that the other lacked. The difference was cognitive. Andrukonis, a twenty-year employee of the mortgage company, knew of the bad experience Freddie Mac once had with low-documentation loans in the late 1980s—an experience that resulted in agreement between Freddie Mac and Fannie Mae not to purchase reduced-documentation loans. He was also skeptical of the ability of Freddie Mac to safely expand its share of loans to so-called "under-served" borrowers. By contrast, Syron, who became CEO in 2003, thought that Freddie Mac had been too conservative in the past and needed to demonstrate greater commitment to the mission of making home ownership more affordable.\(^\text{15}\)

II. INSIDE THE CREDIT RATING AGENCIES

The history of credit rating agencies also highlights the moral and cognitive failure dichotomy. These agencies played a central role in the buildup to the crisis.\(^\text{16}\) Financial engineers structured mortgage-backed securities to try to maximize the pro-

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13. *Id.*
14. *Id.*
15. Andrukonis was a colleague of mine when I worked at Freddie Mac in the late 1980s and early 1990s, and we have remained friends since. My reconstruction of the controversy is based in part on conversations with Andrukonis after the story broke in the *New York Times.*
portion of securities that could obtain a rating of AA or AAA.\textsuperscript{17} In this endeavor, they received close cooperation from rating agency staff. The high ratings allowed these securities to be sold to a broad spectrum of institutional investors at relatively low interest rates. As it turned out, many of these securities subsequently suffered substantial losses.

Frank Raiter, Standard and Poor’s former Managing Director and Head of Residential Mortgage-Backed Securities (RMBS), suggested in congressional testimony that, with the best modeling techniques, his rating agency might have begun to take a more conservative approach to rating structured-mortgage securities in 2003 or 2004.\textsuperscript{18} He also pointed out that upgrading his agency’s modeling capability would have added costs without increasing market share.\textsuperscript{19} This position is consistent with the moral failure narrative. Raiter further pointed out, however, that “[t]he Managing Director of the surveillance area for RMBS did not believe loan level data was necessary and that had the effect of quashing all requests for funds to build in-house data bases.”\textsuperscript{20} This position is consistent with the cognitive narrative.

More generally, there seems to be evidence of both moral failure and cognitive failure at credit rating agencies. Morally, certain internal documents from various credit rating agencies indicate that at least some employees knew of problems with rating methodology.\textsuperscript{21} Cognitively, there were indications of a belief that a nationwide housing price decline would never occur.\textsuperscript{22}

Most notably, regulators appear to have supported the use of credit rating agencies. Capital regulations explicitly encouraged banks to hold securities rated AA or AAA. In a comment letter to regulators, Fannie Mae warned that the use of ratings on untraded securities solely for regulatory purposes would create an incentive to distort ratings because the ratings agencies would be accountable only to the creators of the securi-

\textsuperscript{17} See id. at 2.
\textsuperscript{18} Id. at 37–39 (statement of Frank L. Raiter, former Managing Director, Standard & Poor’s).
\textsuperscript{19} Id. at 38.
\textsuperscript{20} Id.
\textsuperscript{22} See id. at 68 (testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings).
ties—not to any buyers in the market. Along the same lines, a group of economists that regularly provided commentary on bank regulatory matters wrote:

"The use of private credit ratings to measure loan risk may adversely affect the quality of ratings. If regulators shift the burden of assessing the quality of bank loans to ratings agencies, those regulators risk undermining the quality of credit ratings to investors. Ratings agencies would have incentives to engage in the financial equivalent of "grade inflation" by supplying favorable ratings to banks seeking to lower their capital requirements. If the ratings agencies debase the level of ratings, while maintaining ordinal rankings of issuers' risks, the agencies may be able to avoid a loss in revenue because investors still find their ratings useful... In short, if the primary constituency for new ratings is banks for regulatory purposes rather than investors, standards are likely to deteriorate."

Notwithstanding this commentary, a white paper recently issued by the regulatory community states: "Market discipline broke down as investors relied excessively on credit rating agencies." This statement seems to imply that the use of rating agencies reflected a moral failure within the private sector. As the historical record demonstrates, however, cognitive failures may have played just as significant a role.

III. COGNITIVE FAILURES IN THE REGULATORY COMMUNITY

Today, we know that certain financial practices were unsafe and unsound. Mortgage securities were created without sufficient due diligence concerning the quality of the underlying loans. Banks were able to use structured finance and off-balance-sheet entities to reduce regulatory capital for risky investments. Credit default swaps created excess risk concentration. At the time, however, regulators viewed all of these developments positively. The regulatory community accepted, and even encouraged, mortgage securities, structured finance, off-balance sheet entities, and credit default swaps.

Regulators considered mortgage securities a safer, more efficient form of mortgage finance than traditional mortgage lending. They viewed the decline of the savings and loan industry in the 1970s and 1980s as a result of the mismatch between short-term deposits and long-term mortgages. Mortgage securities, in contrast, seemed to avoid this shortcoming because they could be placed with pension funds and other institutions with long-term investment horizons.

In reality, the growth of mortgage securitization was not so benign. Distortions in bank capital requirements fueled much of that growth. For high-quality mortgages issued and held by banks, capital requirements were too high.\textsuperscript{26} As a result, banks were inhibited from undertaking traditional mortgage lending. To compensate for the disincentive to invest in mortgages caused by high capital requirements, regulators permitted banks to reduce their capital requirements—but only for mortgages held as securities. This approach had a perverse effect. In addition to lowering the capital requirements for holding safe mortgages in the form of mortgage-backed securities, the reduced capital requirements for securities enabled banks to hold less capital for risky mortgages as well, including subprime loans.

A given pool of mortgages, for which a bank might otherwise be required to hold four percent capital (that is, $4 in capital for each $100 in mortgage principal), could be carved into tranches, each with a separate capital requirement, based on its rating by a credit rating agency. When added together, the sum of these capital requirements would be less than three percent.

Banks were also able to dodge capital requirements altogether by putting mortgage securities into off-balance sheet entities. Known as Structured Investment Vehicles, these entities issued short-term commercial paper to fund their holdings of mortgage securities. A line of credit from the bank backed the commercial paper, but because the line of credit was in force for less than a year, no capital was required for regulatory purposes.

Regulators clearly were aware of this regulatory capital arbitrage.\textsuperscript{27} Fannie Mae and Freddie Mac complained in January 2002 about the potential for regulatory capital arbitrage in


\textsuperscript{27} See id. at 48–49.
comments about rules that gave official sanction to the use of ratings to reduce capital requirements on mortgage securities.\footnote{Hegland, supra note 23, at 16.}

Regulators also were aware of the banks’ growing use of credit derivatives, such as credit default swaps, to transfer away risk. Today, the regulatory community refers to the investment banks and insurance companies that absorbed credit risk as the “shadow banking system,” suggesting a financial network that was stealthy, if not downright illicit. At the time, however, lending regulatory authorities acknowledged and even applauded the use of these techniques. In fact, regulators were proud of the role they played in stimulating and spreading these innovations.

For example, in June 2006, Federal Reserve Chairman Ben Bernanke said:

The evolution of risk management as a discipline has thus been driven by market forces on the one hand and developments in banking supervision on the other, each side operating with the other in complementary and mutually reinforcing ways. Banks and other market participants have made many of the key innovations in risk measurement and risk management, but supervisors have often helped to adapt and disseminate best practices to a broader array of financial institutions.

The interaction between the private and public sectors in the development of risk-management techniques has been particularly extensive in the field of bank capital regulation, especially for the banking organizations that are the largest, most complex, and most internationally active.

Moreover, the development of new technologies for buying and selling risks has allowed many banks to move away from the traditional book-and-hold lending practice in favor of a more active strategy that seeks the best mix of assets in light of the prevailing credit environment, market conditions, and business opportunities. Much more so than in the past, banks today are able to manage and control obligor and portfolio concentrations, maturities, and loan sizes, and to address and even eliminate problem assets before they create losses. Many banks also stress-test their portfolios on a business-line basis to help inform their overall risk management.

\footnote{Hegland, supra note 23, at 16.}
To an important degree, banks can be more active in their management of credit risks and other portfolio risks because of the increased availability of financial instruments and activities such as loan syndications, loan trading, credit derivatives, and securitization. For example, trading in credit derivatives has grown rapidly over the last decade, reaching $18 trillion (in notional terms) in 2005. The notional value of trading in credit default swaps on many well-known corporate names now exceeds the value of trading in the primary debt securities of the same obligors.29

At about the same time, the International Monetary Fund wrote that “[t]here is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient.”30

Regulators were aware of the ways that banks were using securitization, agency ratings, off-balance-sheet financing, and credit default swaps to expand mortgage lending while minimizing the capital necessary to back such risks. Like the bankers themselves, the regulators believed that these innovations were making financial intermediation safer and more efficient.

IV. CAPITAL REGULATION AS A FUNDAMENTAL CAUSE OF THE CRISIS

Capital regulations played a fundamental role in fostering the behavior that created the financial crisis. They discouraged traditional mortgage lending and instead encouraged securitization. They created a role for credit rating agencies to enable banks to take credit risk on mortgages, including subprime mortgages, without having to hold the requisite capital. And they allowed banks to further reduce capital by undertaking the transactions that we now think of as “shadow banking,” including structured investment vehicles and credit default swaps.

Bank capital regulation made traditional mortgage origination of low-risk loans uneconomical in comparison with securi-

tization. Banks were thus discouraged from simply originating and holding low-risk mortgages. Instead, they were rewarded for holding mortgage loans in the form of securities, without regard to how or by whom those loans were originated.

Capital regulations also shifted focus away from the risk on the underlying mortgages and instead put emphasis on grading by credit rating agencies of slices of mortgage-backed securities. The quality of the underlying loans grew progressively worse, and originators relaxed the requirements for down payments, extended eligibility to borrowers with more troubled credit histories, and abolished requirements for borrowers to provide documentary proof of their income, assets, and employment status. None of this deterioration in loan quality, however, kept financial engineers from carving AA-rated and AAA-rated mortgage security tranches out of loan pools. In turn, banks were eager to supply funds to fuel the housing boom.

Moreover, capital regulations created a situation in which the banking system became highly fragile. Because of regulatory capital arbitrage, banks were not required to hold sufficient capital relative to the risks that they were taking. When the crisis hit, there were consequently justifiable doubts about the solvency of many large banks, which in turn caused a freeze in inter-bank lending. If banks instead had been required to hold sufficient capital reserves, an adverse shock would have raised fewer questions about bank solvency.

Additionally, capital regulations stimulated the use of structured investment vehicles and credit default swaps, enabling banks to present a lower risk profile. At the time, regulators were pleased with the way these instruments were reconfiguring credit risk. When the crisis hit, however, regulators were just as tormented by risks embedded in the large position in credit default swaps at AIG or the off-balance-sheet entities of the leading international banks as they would have been had those risks been on the books of the banks. Officials at the Fed and at the Treasury found themselves confronted by the sorts of domino effects and bank runs that they thought had long since been made impossible by deposit insurance and other market developments.

Lastly, capital regulations encouraged cyclicality. Assets maintained high ratings during the boom, but were downgraded when the housing market turned. This reversal forced banks to sell assets to restore regulatory capital. Those asset sales, however, further depressed asset values, which meant that banks had to mark
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down their equity even further. In other words, during a boom, the value of bank capital may have seemed higher than it really was, and during the crash the value of bank capital may have appeared lower than it really was. In view of the way things worked out, several economists have proposed countercyclical capital requirements designed to mitigate these effects.31

V. HOUSING POLICY

Capital regulations were the primary locus of cognitive errors leading to the financial crisis, but it is worth commenting on the role that housing policy played. The irrational efforts to promote home ownership certainly contributed to the boom and crash in the housing market. The proportion of households in the United States owning their dwellings rose from sixty-four percent in 1994 to sixty-nine percent in 2006.32 Among politicians, there was bipartisan pride in this development. The policies that pushed up the home ownership rate, however, were rather questionable in retrospect. In particular, the Community Reinvestment Act33 and regulatory oversight of Fannie Mae and Freddie Mac were used to impose quotas on lenders in segments of the housing market where households had difficulty affording the homes that they were buying. Moreover, the policies did not distinguish owners from speculators, and the proportion of loans for non-owner-occupied housing rose from five percent in the 1990s to fifteen percent in 2005 and 2006.34

Increasing home ownership also encouraged costly mortgage indebtedness. Arguably, there are positive externalities associated with having people own rather than rent their dwellings. But a high ratio of mortgage debt to house price is, if anything, a negative externality, because it reduces the stability of the housing market. Public policy is nevertheless heavily committed to subsidizing mortgage indebtedness through the income tax deductibility of mortgage interest, direct federal subsidies in

the Federal Housing Administration and Veterans Affairs, and indirect federal subsidies through Fannie Mae and Freddie Mac, which enjoyed special status as Government-Sponsored Enterprises. Had there not been such political support for home ownership and mortgage subsidies, the housing cycle probably would have been much less severe, and this mitigation could have interrupted one of the key triggers of the financial crisis.

VI. THE ISSUE OF NARRATIVE

The ultimate outcome of the financial crisis will be visible in the high school history textbooks of the future. If those books convey the causes of the crisis only in terms of moral failure, then as a society we will have entrenched a historical narrative that is excessively skeptical of markets and excessively credulous of the effectiveness of regulation.

The narrative of moral failure is attractive for many reasons. First, for those who are inclined to distrust markets and support vigorous government intervention, the narrative provides reinforcement of those prejudices. Second, it is a narrative with clear villains, in the form of greedy financial executives. Such villains always make a story more emotionally compelling. Finally, the narrative provides a comforting resolution: Once we reorganize and reinvigorate the regulatory apparatus, we can rest assured that the crisis will not recur.

The narrative of cognitive failure is not so comforting. Rather than identifying villains, this narrative sees the crisis as the outcome of mistakes by well-intentioned people, including both financial executives and regulators. Moreover, this narrative carries with it the implication that human fallibility will persist, and so we cannot be confident that regulatory reform can make our financial system crisis-proof.

The narrative of cognitive failure suggests a need for greater humility on the part of policymakers. They should perhaps rethink the push for greater home ownership, particularly to the extent that the push encourages people to borrow nearly all of the money necessary to finance the purchase of a home. They might even want to reconsider the corporate income tax, which penalizes equity relative to debt, creating an incentive for banks and other firms to look for ways to maximize their use of debt relative to equity. Above all, the public should not be deceived into believing that regulatory foresight can be as keen as regulatory hindsight.
THE CASE AGAINST THE FISCAL STIMULUS

JEFFREY MIRON*

INTRODUCTION

When President Barack Obama took office on January 20, 2009, the U.S. economy had been in recession for over a year, and the prospects for a quick recovery appeared bleak. The Federal Reserve had already lowered interest rates to zero, which implied that monetary policy was unlikely to provide further stimulus. Thus, the Administration, along with many economists and pundits, turned to the other key pillar of stabilization policy: fiscal stimulus.

The fiscal approach was immediately controversial, however, for two main reasons. First, academic economists have come to regard fiscal policy as less suitable than monetary policy for stabilization purposes, principally because monetary policy can act quickly, whereas fiscal policy can suffer significant delays in adoption, implementation, and impact. Second, the U.S. was already facing a dismal long-term fiscal outlook because of programs like Medicare, Medicaid, Social Security, the wars in Iraq and Afghanistan, and the TARP bailout. This outlook made some economists wary of new measures that would increase the deficit, even if only temporarily. Yet the Administration apparently concluded that it had no alternative given the state of the economy, so it plowed ahead with a fiscal stimulus.

Deciding to adopt a fiscal stimulus, however, did not resolve all of the issues. The other question was what combination of tax cuts and expenditure increases to include in the stimulus package. Strict Keynesian theory holds that any tax cut or spending in-

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crease can stimulate the economy, even if the tax cut is badly designed and even if the increased spending is for worthless junk. If this perspective is right, quibbling about the exact composition of the package is neither necessary nor fruitful.

I argue here, however, that the structure of a fiscal stimulus is crucially important and that the package Congress adopted was far from ideal, regardless of the merits of the Keynesian model. Whether countercyclical fiscal policy is beneficial is a more difficult question, but it is not the critical issue if a stimulus package is properly designed. In fact, the Administration could have created a package that stimulated the economy in the short term while improving economic performance in the long term. This package, moreover, would have been immune to criticism from Republicans. The stimulus adopted was a missed opportunity of colossal proportions.

That the Administration and Congress chose the particular stimulus adopted suggests that stimulating the economy was not their only objective. Instead, the Administration used the recession and the financial crisis to redistribute resources to favored interest groups (unions, the green lobby, and public education) and to increase the size and scope of government. This redistribution does not make every element of the package indefensible, but even the components with a plausible justification were designed in the least productive and most redistributionist way possible.

The remainder of this Essay is organized as follows. Part I discusses the arguments for and against fiscal stimulus. Parts II–IV examine the main components of the stimulus (tax cuts, energy programs, and infrastructure spending, respectively). Part V addresses other miscellaneous components. Part VI considers the broader implications of the fiscal stimulus.

I. THE KEYNESIAN MODEL

The standard justification for a fiscal stimulus relies on the Keynesian model of the economy. This model has been taught to

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3. For a standard presentation of the Keynesian model, see N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 737–826 (5th ed. 2008).

generations of college students in economics classes around the world, and economists widely—though not universally—accept it as the starting point for analyzing booms and recessions.\footnote{See MANKIW, supra note 3, at 737–826.}

According to the Keynesian model, recessions occur because of a lack of aggregate demand, and government can remedy this shortfall by stimulating demand. On the one hand, government can increase its own demand for goods and services, for example by building more highways, purchasing more military aircraft, or funding additional research and development.\footnote{See id. at 787–88.} On the other hand, government can increase demand from consumers and firms by reducing taxes or increasing transfers.\footnote{See id. at 792–93.}

Although the Keynesian model of fiscal stimulus is widely accepted, it remains controversial as a justification for policy interventions. The first difficulty with Keynesian fiscal stimulus is that the lag between recognition that an intervention might be necessary and the impact of that intervention is likely to be long and variable, so policy can easily end up stimulating when it should be contracting, or vice versa.\footnote{See id. at 830–31.} Thus, the practice of countercyclical policy is likely difficult even if the theory is unassailable. Over the past several decades, most economists have therefore gradually emphasized monetary policy as the more appropriate tool for countercyclical policy. Lags in monetary policy—although still relevant—tend to be shorter on average.\footnote{Feldstein, supra note 2, at 556.}


The second issue is that, although Keynesian theory says that the choice of spending projects does not matter, spending on projects that meet standard cost-benefit criteria makes the most sense and ensures the best use of taxpayer resources in the short term. Further, temporary programs may become long term or permanent given the political difficulties of eliminating government programs.
Even if significant numbers of productive projects exist, using them to stimulate the economy is difficult. Identifying the right projects, planning them appropriately, and undertaking them at a sensible pace can take years, not months or weeks. Thus, the desire for good projects conflicts with the desire to undertake new spending quickly.

Beyond these problems, the standard Keynesian defense of fiscal stimulus fails to recognize that attempts to stimulate might exacerbate recessions or have negative long-term implications, even if the Keynesian model is essentially correct. The lower taxes and higher spending required by the Keynesian approach mean increased taxes at some future date, assuming the government balances its budget on average. This higher taxation implies more distortions from taxation and therefore lower productivity. The stimulus approach generates uncertainty about which programs the government will support, and this uncertainty can impede private productive activity. The realization that government is handing out pots of money generates rent seeking and other unproductive behavior, leading to crony capitalism (for example, a semi-nationalized auto industry). Finally, a belief that government can moderate or eliminate recessions can encourage excessive risk taking and thereby generate instability.

Before adopting a fiscal stimulus, therefore, it is imperative to consider the evidence for the Keynesian model's validity. As it turns out, the empirical support for the Keynesian view is far from compelling. The model implies that the impact of in-


13. See, e.g., Alberto Alesina et al., Fiscal Policy, Profits, and Investment, 92 AM. ECON. REV. 571, 573-74, 579 (2002) (explaining ambiguous effects on output and investment from government spending); Alberto Alesina & Silvia Ardagna, Tales of Fiscal Adjustments, 27 ECON. POL'Y 488, 508-09 (1998) (examining empirical data indicating anti-Keynesian effects from tax cuts); Christina D. Romer & David H. Romer, The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks, AM. ECON. REV. (forthcoming) (indicating that tax cuts have large, positive multiplier effects); Alberto Alesina & Silvia Ardagna, Large Changes in Fiscal Policy: Taxes Versus Spending 13 (Nat'l Bureau of Econ. Research, Working Paper No. 15438, 2009) (finding that "controlling for initial conditions, a one percentage point higher increase in the current spending to GDP ratio is associated
creased spending should be greater than the impact of tax cuts, but the existing evidence suggests the opposite. Indeed, some empirical evidence finds minimal impacts of spending, but most research finds a robust impact of tax cuts. Plausibly, the tax cuts are effective because cuts in the marginal tax rates operate to increase efficiency regardless of their effect within a Keynesian framework.

Thus, even if one takes the basic Keynesian framework as given and accepts that government should stimulate during recessions, existing evidence suggests that an effective package should consist of lower taxes, especially decreased tax rates. This approach is likely to be beneficial whether or not the Keynesian analysis is correct because reductions in tax rates improve the incentive to work, save, and invest. This increased efficiency means higher productivity and income, so the net impact on the deficit can be smaller from a well-designed tax cut than from increased spending.

Another way to describe the choice between spending and tax cuts is to note that under increased spending, the political process decides how to spend the money, whereas under tax cuts, consumers and firms get to decide how to spend the money. Thus, the crucial difference between the two approaches is not whether one accepts the Keynesian model but whether one believes governments or markets make the best decisions about allocating resources. With this perspective, I


15. Mountford & Uhlig, supra note 13, at 3.

16. See id.
now consider the specific elements in the stimulus bill that Congress adopted and President Obama signed.

II. TAX CUTS AND TRANSFER INCREASES

The largest components of the stimulus bill are tax cuts and transfer increases aimed at low to moderate income households. This category included a payroll tax credit in 2009 and 2010, an increase in the alternative minimum tax floor, increased spending on Medicaid, extended unemployment benefits, and more money for food stamps. A few tax cuts were aimed at businesses, including a provision to allow deductions of current losses against profits made in earlier years.

The crucial feature of these changes in tax and transfer policy is that most were not reductions in tax rates and therefore did not improve incentives. Some of these provisions are neutral regarding incentives. For example, payroll tax credits and checks sent to Social Security recipients are lump-sum redistributions. Yet many other changes, such as extended unemployment insurance and additional spending on Medicaid, reduce the incentive to work. They are not reductions in tax rates, which are desirable under both the Keynesian and cost-benefit views of fiscal stimulus. What changes in tax policy would have been sensible from both the Keynesian and efficiency perspectives? Two in particular stand out.

The single best change would have been elimination of the corporate income tax. This component of the current tax system is utterly misguided, independent of Keynesian considerations. The corporate income tax means double taxation of corporate income, which distorts the incentive to save and invest, thereby lowering productivity and growth. The corporate income tax adds a huge level of complexity to the tax code, reducing the transparency of corporate accounting. The standard defense of this tax relies on a desire to redistribute income and assumes that the tax falls on high-income taxpayers because they own a disproportionate share of corporations. The tax, however, likely affects labor as

17. Getting to $787 Billion, supra note 4 (listing over $200 billion in individual tax cuts and less than $10 billion net business tax cuts).
18. Id.
19. Id.
much or more than shareholders, especially because corporate income taxation drives corporate activity overseas.

In addition to making sense on cost-benefit grounds, a reduction in corporate taxation is entirely consistent with the Keynesian framework. Yet, because it also improves incentives, it should increase output over and beyond any Keynesian impact. This increased efficiency would generate higher output and tax revenue, so future tax hikes could be less than the cut in the corporate income tax and still balance the budget.

A second change in tax policy that makes sense from both the Keynesian and cost-benefit perspective is a reduction in employment taxes such as those for Social Security or Medicare. This would lower the costs of hiring workers, thereby stimulating increased employment. This change would also improve economic efficiency because employment taxes are a wedge between worker willingness to work and firm willingness to hire. A reduction in employment taxes would especially benefit low- to moderate-income workers, precisely the group targeted by the other policies in the stimulus package.

Taxes dedicated to Social Security and Medicare are, in any case, not good policy. They exist to perpetuate the myth that any given individual's contributions pay for that individual's benefits, but because the systems are run on a pay-as-you-go basis, this story is just political spin. Eliminating these separate taxes, and if necessary raising other taxes, would produce a simpler and more transparent tax system.

The bottom line on tax cuts and transfer increases is that an alternative package, focused especially on reducing or eliminating the corporate income tax and on lowering employment taxes, would have been at least as defensible from the Keynesian perspective and far more desirable from the efficiency perspective. The Administration missed an excellent opportunity to reduce or eliminate these undesirable features of the current tax code.

III. SPENDING TO PROMOTE ENERGY EFFICIENCY

The second major component of the stimulus package is programs to increase energy efficiency. These include tax credits for investments in renewable energy, funding for a smart electric grid, upgrading government vehicles to be more energy
efficient, funding for states to undertake energy efficiency programs, and so on. Advocates of these particular programs argue that increased energy efficiency reduces air pollution, lowers reliance on foreign oil, and slows global warming. Even if these claims are valid, however, government attempts to increase energy efficiency are problematic components of a fiscal stimulus package.

First, many of these programs require time to plan and implement properly, so spending either occurs too late to counteract the recession or risks being done badly because it is rushed. A second problem is that energy-efficiency programs are not likely to use unemployed resources. Instead, they merely shift employment from existing uses to government uses. This makes it even more important that the increased spending go to projects that pass a standard cost-benefit test, which is again difficult when the spending is rushed.

The third problem is that energy-efficiency programs are ineffective methods of reducing energy use. Consider upgrades of the federal government’s vehicle fleet. Hybrid cars require less energy to operate than standard cars, but hybrids cost more than standard cars, and these higher costs result in part from additional energy required for their manufacture. Thus, upgrading the fleet might not reduce energy use and could even increase it.

Rather than trying to promote energy efficiency with slow-acting and ineffective energy programs, the right approach is higher energy taxes, which directly raise the price of energy and discourage its use. Much of the infrastructure necessary to collect these taxes already exists. The degree to which energy taxes raise prices is observable. Thus, gauging the magnitude of the intervention is straightforward.

The right way to reduce energy use and stimulate the economy, therefore, is to increase energy taxes while lowering other taxes enough to offset the higher energy taxes and provide the desired amount of stimulus.

20. Id.

IV. SPENDING ON INFRASTRUCTURE

The third main component of the stimulus package is expenditures on infrastructure, such as roads, railways, and public transportation.\textsuperscript{22} In addition to the Keynesian justification, the argument for this spending is that many infrastructure projects generate benefits in excess of costs and are not produced efficiently by the private sector.

The issues raised by this component of the stimulus are similar to those raised by energy-efficiency programs. Choosing the right projects and implementing them properly takes time, yet fiscal stimulus needs to happen quickly. Some infrastructure spending merely shifts employment from other activities, rather than putting the unemployed to work. Political influences promote the projects in districts of key congressmen rather than those with the greatest ratio of benefits to costs.

The question for infrastructure spending, moreover, is not whether some amount is beneficial; the question is whether additional spending on infrastructure is productive, given the amounts already being spent. If most of the beneficial roads have already been built (for example, those connecting major centers of population in densely populated parts of the country), then new roads will be highways to nowhere and a waste of economic resources.

V. OTHER COMPONENTS OF THE STIMULUS PACKAGE

Beyond the main components discussed above, the stimulus package includes a broad range of smaller projects. These projects raise similar issues to those discussed above, so a detailed analysis is not necessary. A few brief comments are nevertheless in order.

A significant component of the stimulus bill was increased expenditure for scientific research.\textsuperscript{23} The incentives to invest in research are potentially insufficient from the perspective of society overall, and the case for government subsidies is reasonable. But the right question is whether the United States needs sub-

\textsuperscript{22} Getting to $787 Billion, supra note 4.

\textsuperscript{23} Id.
stantial additional government funding relative to its 2009 funding levels. The Administration offered no evidence to support this claim. It just assumed that because research is good, more is better. Research spending is again unlikely to use unemployed resources and instead enriches those already employed while shifting research activity from the private sector to government.

Another substantial chunk of the stimulus consisted of transfers to state governments, some of which took the form of block grants. This shift of spending from the federal government to the states is potentially desirable because it means less centralized decision making. The lion’s share of the transfers, however, was to public education. The stated goal was to reduce teacher layoffs, and that undoubtedly occurred to some degree. Yet many school districts have excess personnel (assistant principals, specialists for everything), and layoffs might be appropriate. Some of the federal money will end up as higher wages for unionized teachers. States, moreover, could improve education on their own via charters and vouchers, reducing costs without federal infusions. Thus transfers to states would have been defensible if unconstrained, but they mostly were not.

**CONCLUSION**

A few weeks after President Obama’s victory in the 2008 election, adviser Rahm Emanuel quipped that “[y]ou never want a serious crisis to go to waste . . . [because it] provides the opportunity for us to do things that you could not do before.” Emanuel was correct: The situation in which the new Administration found itself constituted an unusual political dynamic that, properly used, would have allowed the Obama Administration both to stimulate the economy and make it more productive over the long haul.

The Administration should have endorsed a stimulus package based on a repeal of the corporate income tax and reductions in employment taxes. This policy would have accomplished its stated goals, and the budgetary implications would have been

24. Id.
25. Id.
26. Id.
less negative than those of the package ultimately adopted because this alternative plan would have enhanced rather than detracted from economic efficiency. This approach would also have been difficult for Republicans to oppose.

Yet the Administration did not take this approach, presumably because its true goals were not just economic stimulus. Instead, the Administration wanted to reward its constituencies (unions, environmentalists, public education) and increase the size and scope of government. This tactic is consistent with the Administration's policies in general. Across the board, it has taken a big government, redistributionist approach, whether regarding housing, unions, health, the auto industry, trade, antitrust, or financial regulation. The Administration's view appears to be that government is better than individuals at deciding how taxpayers get to spend their money and that government should engineer large transfers from richer to poorer.

Whether the Administration's stimulus package will be successful is still to be determined. If the extra spending ends up being productive, then the impact of the stimulus might be positive on net. My own prediction, however, is that the programs adopted will generate large distortions and substantial waste, with minor stimulus impact. This is a pity because much better alternatives were available.
CUMULATING POLICY CONSEQUENCES, FRIGHTENED OVERREACTIONS, AND THE CURRENT SURGE OF GOVERNMENT'S SIZE, SCOPE, AND POWER

ROBERT HIGGS

INTRODUCTION

The financial and economic crisis that came to a head in the late summer of 2008 has brought forth a huge government response, many elements of which are without precedent. The crisis, however, did not come from nowhere. In important regards, its roots lie, first, in government policies to promote more widespread homeownership than would occur in a free market and, second, in the Federal Reserve System’s mismanagement of interest rates and the money stock. The crisis is far from over, yet it already appears that the surge of extraordinary government actions and the new policies that the crisis has provoked will give rise to important, permanent increases in the government’s size, scope, and power. In this way, it mimics the national emergencies of the past century.

I. DIMENSIONS OF THE CRISIS AND THE GOVERNMENT’S RESPONSES

Although the National Bureau of Economic Research places the recent peak of economic activity in the fourth quarter of 2007, real gross domestic product (GDP) did not reach its peak until the second quarter of 2008. By the second quarter of 2009, real GDP had fallen by four percent. Likewise, financial strin-
gencies in certain credit markets began to appear in 2007, though they did not become widely noticed until late September 2008, when a full-fledged financial panic developed, and commentary in the news media and the statements of public officials took on a frightened tone. The civilian unemployment rate began to rise after March 2007, when it stood at 4.4%, and by October 2009, it had reached 10.2%.4

In response to the growing economic troubles, especially the perceived "credit crunch" of September 2008, policymakers in the Bush Administration (most notably, Treasury Secretary Henry Paulson), in Congress, and at the Federal Reserve System (the Fed) responded by initiating a series of unprecedented actions to rescue tottering banks and other financial institutions and to inject credit into the financial system.5 In September, the Fed took control of the insurance giant American International Group (AIG),6 and the Federal Housing Finance Authority took over the huge government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, secondary lending institutions that held or insured more than half of the total value of U.S. residential mortgages.7 On October 3, Congress passed and the President signed the Emergency Economic Stabilization Act of 2008.8 Title 1 of this statute authorizes the Secretary of the Treasury to create the Troubled Assets Relief Program (TARP) and authorizes as much as $700 billion for the purchase of so-called troubled assets, primarily mortgage-related securities, held by banks and

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other financial institutions. Unable to implement the planned acquisition of troubled assets, the Treasury instead used TARP mainly to inject funds into the banks by purchasing preferred shares and warrants to purchase common stock from them.

By the end of 2008, the Fed had made large, unprecedented types of loans and had given other forms of assistance, including loan guarantees, asset swaps, and lines of credit, to securities dealers, commercial-paper sellers, money-market mutual funds, Fannie Mae, Freddie Mac, the Federal Home Loan Banks, buyers of certain asset-backed securities based on consumer and small-business loans, Citigroup (related to losses resulting from a federal government guarantee of a specified pool of assets), and fourteen foreign central banks. The Treasury and the Federal Deposit Insurance Corporation also took a variety of other large-scale actions to prop up credit and housing markets during the final quarter of 2008.

After Barack Obama became President, his administration and Democratic leaders in Congress concentrated on gaining passage of a new “economic stimulus” bill. These efforts ultimately resulted in the American Recovery and Reinvestment Act of 2009, which the President signed into law on February 17. This statute authorizes a great variety of spending increases, as well as some tax reductions, over the period from 2009 to 2019. According to Congressional Budget Office (CBO) estimates, the combined amount of these spending increases and tax cuts comes to $787 billion over these ten years.

The Obama Administration also proceeded, at the end of April, with two complex “restructuring” arrangements that essentially amounted to government takeovers of General Motors and Chrysler, both of which were teetering on the brink of bankruptcy. Carl Horowitz called this action “one of the most radical moves in the history of American industry,” noting that it came not long after the federal government had made huge emergency loans to the

9. Id. at 3767–800.
11. For brief descriptions, see id. at 39–41.
companies. The government had also forced the resignations of the chief executive officers of the two companies, Rick Wagoner of GM and Robert Nardelli of Chrysler. By the end of July 2009, total government aid to the two firms reached $65 billion.

On June 15, 2009, the Wall Street Journal summarized the extraordinary surge of government actions as follows:

Since the onset of the financial crisis nine months ago, the government has become the nation’s biggest mortgage lender, guaranteed nearly $3 trillion in money-market mutual-fund assets, commandeered and restructured two car companies, taken equity stakes in nearly 600 banks, lent more than $300 billion to blue-chip companies, supported the life-insurance industry and become a credit source for buyers of cars, tractors and even weapons for hunting.

Although this statement falls far short of a comprehensive account of the government’s responses to the crisis, it suffices to justify the conclusion that within less than a year, the perceived emergency had provoked a huge surge in the federal government’s size, scope, and power.

This surge also entailed major fiscal eruptions, including tremendous increases in federal expenditures and an even greater percentage run-up of federal debt. According to the August 2009 CBO update, federal outlays for fiscal year 2009 would total $3.69 trillion, an increase of 24% over the total for the previous year. This increase, which is wholly without peacetime precedent in U.S. history, would raise federal outlays from 21% of GDP to 26.1%. Moreover, because federal receipts were forecasted to contract by almost 17% in 2009, the annual federal budget deficit was expected to increase from $459 billion in 2008 to $1.59 trillion in 2009, an increase of 246%. The CBO forecasted that the 2009 deficit would be equal to 11.2% of GDP, up from 3.2% in the previous year. The borrowing required to finance this gargantuan deficit in the federal budget was forecasted to increase the U.S.

15. Id.
debt held by the public from $5.80 trillion at the end of fiscal year 2008 to $7.61 trillion at the end of 2009, an increase of $1.81 trillion, or 31% in a single year.\(^{18}\)

Although these U.S. Treasury figures are mind-boggling for an economist or financial historian, the Fed’s recent actions have been even more astonishing. Figure 1 shows the most important of these actions, the abrupt increase in the monetary base, which must be seen to be believed.\(^{19}\) As the figure shows, the monetary base—currency in circulation plus commercial bank reserves—historically has increased smoothly at a fairly modest rate of growth. Between August 2008 and January 2009, however, the Fed’s actions caused the country’s monetary base to double in only five months. After January 2009, the monetary base remained in this extraordinarily elevated range. In September and October 2009, it increased even further, reaching all-time highs.

Figure 1

![Graph showing the monetary base](http://research.stlouisfed.org/fred2/series/BOGUMBNS?cid=124)

18. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE, at x tbl.1 (2009). The CBO’s estimates of spending and the deficit turned out to err on the high side. After the end of the fiscal year, the actual spending total was $3.52 trillion (equal to about 25% of GDP) and the deficit was $1.42 trillion (equal to about 10% of GDP). See US deficit surges to all-time record, DAILY FIN., Oct. 16, 2009, http://www.dailyfinance.com/2009/10/16/us-deficit-surges-to-all-time-record.

The Fed's recent monetary policy places the purchasing power of the U.S. dollar in grave jeopardy because the monetary base, as its name indicates, is the foundation on which the U.S. money stock rests. Other things being equal, more than doubling the monetary base will ultimately result in more than doubling the money stock. Hence, the dollar's purchasing power will be tremendously reduced, with a variety of negative effects on the economy. As of November 2009, the banks as a whole have simply absorbed the additional reserves, rather than using them to increase the volume of their loans and investments, which would begin to increase the money stock through the commercial banks' creation of new checking account balances. Between August 2008 and January 2009, legally excess commercial-bank reserves at the Fed increased from less than $2 billion to nearly $800 billion. In October 2009, they amounted to $995 billion, an all-time high. Should the banks begin to employ these excess reserves to make new loans and investments, however, the Fed will face a dilemma: either do nothing to mop up the excess reserves, allowing them to become the fuel for rapid price inflation; or mop them up, most likely either by traditional open-market operations or by offering the banks a much higher rate of interest on their reserve balances at the Fed. Both choices entail increasing the rate of interest, and the Fed will face political pressure opposing such an action, especially if the recession has not ended and the rate of unemployment remains high. Fed Chairman Ben Bernanke has stated that the Fed possesses "the tools" to deal with this problem, but I remain skeptical that he will do so successfully. In any event, the Fed's emergency actions since August 2008 have created serious economic risks that make private planning much more difficult and thereby impede the market economy's successful functioning.


In such circumstances, much “smart money” simply sits idle or goes into safe, low-yield investments, such as Treasury bills.  

II. CUMULATING POLICY CONSEQUENCES

The current crisis, like every major economic emergency, occurs in the context of predisposing conditions, institutions, and policies that took shape over a long period. Although many people are inclined, on each such occasion, to conclude that “capitalism has failed,” a pure market system does not just spontaneously break down. Such a system automatically produces feedback that guides and motivates producers, investors, and consumers to make constant adjustments to changing conditions. Profits and losses, with the corresponding growth, decline, and disappearance of firms that they bring forth, give market participants reliable indications of whose plans have succeeded and whose plans have failed in meeting consumer demands at prices that cover costs. No one knows the future, and therefore entrepreneurs in a pure market system may make mistakes in appraising the profitability of the various alternatives they perceive as open to them. But sustained, large-scale mistakes are unlikely to occur. The constant flow of price and profit information, combined with the knowledge that one’s own wealth is at stake, gives market participants the necessary information and the personal incentive to make appropriate forward-looking adjustments long before overall economic conditions become severely distorted on a wide scale.

When governments intervene, however, the effect is to “falsify” the market’s signals. Subsidies permit firms that would go bankrupt to continue in business, even though they are failing to cover their full costs in the market and therefore are effectively generating economic waste by transforming valuable inputs into less valuable outputs. Government price fixing (including the Fed’s manipulation of interest rates) distorts the pattern of resource allocation and misleads investors into making commitments ill-suited to future economic conditions. Government regulations and taxes penalize firms that are satisfying consumer demands successfully, diminishing their net returns and causing them to produce less or become insolvent.

notwithstanding their actual contribution to overall economic efficiency. When market participants are subject to a welter of such government interventions, they may allocate resources in a way that allows distortions and imbalances to cumulate until the burdens these mistakes entail can no longer be sustained, and a sudden crash reveals the unsoundness of the overall economic structure.

The current crisis has arisen in large part from government intervention in the housing and housing finance markets since the 1930s. During the early 1930s, the contraction of economic activity and unevenly falling prices brought about severe distress in housing and financial markets. As businesses failed, incomes fell, and unemployment rose, many homeowners could not make their scheduled mortgage or tax payments and therefore lost their homes to foreclosure or tax sale.

The Roosevelt Administration responded to this dire situation by, among other things, obtaining congressional approval for the Home Owners' Loan Corporation (HOLC) in 1933. The HOLC was terminated in 1951. This government institution restructured approximately one million mortgages on non-farm, owner-occupied homes, changing the obligations from short-term (usually three to five years), interest-only loans with balloon repayments of the entire principal into long-term (initially fifteen years, later extended by up to ten more years), fully amortized loans. The HOLC thereby prevented many foreclosures. Of course, these arrangements also amounted to a bailout for the banks and other lending institutions that held the refinanced mortgages, and therefore the Roosevelt policy foreshadowed similar bailouts the government has undertaken in 2008 and 2009.

In 1934, the National Housing Act created the Federal Housing Administration (FHA) to insure private lenders against default on conventional, long-term, amortized mortgage loans and the Federal Savings and Loan Insurance Corporation to insure deposits in savings institutions that specialized in recy-
These actions caused more money to flow into mortgage loans than would have without government intervention. The government, in effect, undertook to divert funds into housing purchases and hence to divert labor and capital into house construction and related activities.

A more portentous New Deal action occurred in 1938, when the FHA Administrator exercised his statutory authority to charter the Federal National Mortgage Association (Fannie Mae). The primary purpose of Fannie Mae was to purchase, hold, or sell FHA-insured mortgage loans that had been originated by private lenders. After World War II, Fannie Mae's authority was expanded to include VA-guaranteed home mortgages. At this time, Fannie Mae was simply part of the U.S. government. In 1968, the institution was split into two parts: the Government National Mortgage Association (Ginnie Mae) and a reconstituted, privatized Fannie Mae.

Ginnie Mae was initially and remains today a wholly government-owned corporation that guarantees the payment of interest and principal on mortgage-backed securities. This guarantee is an explicit U.S. government commitment. Ginnie Mae debt therefore has the same credit rating as U.S. Treasury debt. The institution's website explains: "[T]he Ginnie Mae guaranty allows mortgage lenders to obtain a better price for their mortgage loans in the secondary market. The lenders can then use the proceeds to make new mortgage loans available." Like all of the other government institutions engaged in this sector, from the HOLC to the presently existing ones, Ginnie Mae seeks to make homeownership less costly and therefore more widespread than it would be in a freely functioning, private-property market without government intervention.

Between 1968 and 1970, the reconfigured Fannie Mae became a private GSE, purchasing residential mortgages in the secondary market. An anomalous institution, Fannie Mae was sub-

28. Id.
29. Id.
ject to regulatory oversight by the Department of Housing and Urban Development, exempt from oversight by the Securities and Exchange Commission, not required to hold as much capital as competing private financial institutions, freed from the obligation to pay state and local income taxes, and provided with a $2.25 billion line of credit from the U.S. Treasury. Five of the eighteen members of the board of directors can be named by the President of the United States. Although the institution’s debt no longer enjoyed an explicit Treasury guarantee, many market participants believed that the government would provide backing if need be, and therefore Fannie Mae was able to borrow at interest rates only slightly above those on U.S. government debt. The general understanding was that the institution would be considered “too big to fail,” as indeed it was.

Ostensibly to provide a competitor for Fannie Mae, the government created in 1970 the Federal Home Loan Mortgage Corporation (Freddie Mac) and authorized it to purchase mortgages in the same fashion as Fannie Mae. Freddie Mac was seemingly a private, shareholder-owned corporation, yet it enjoyed the same statutory advantages as Fannie Mae in the secondary mortgage market and the same widespread perception of an implicit government guarantee of its own debt, as shown by the low interest rate it paid when selling its own securities. Freddie Mac’s website proclaims: “[W]e reduce the costs of housing finance and expand housing opportunities for all families, including low-income and minority families. It is a unique mortgage finance system that makes homeownership a reality for more of America’s families.”

To be sure, this GSE, like its giant competitor, did make homeownership more widespread than it would have been in a pure, free-market system. Eventually, however, many observers came to acknowledge that

homeownership was made too easy and too widespread for the
good of the country at large.35 Too many homeowners holding
title to “too much home,” but possessing little or no equity in it,
contributed to the creation of a fragile, excessively leveraged
economic structure.

By 2008, Fannie Mae and Freddie Mac owned or guaranteed
approximately half of the $12 trillion in residential mortgage loans
outstanding in the United States.36 According to a Staff Report of
the House Committee on Oversight and Government Reform:

Fannie Mae and Freddie Mac were in fact leaders in risky
mortgage lending. According to an analysis presented to the
Committee, between 2002 and 2007, Fannie and Freddie
purchased $1.9 trillion of mortgages made to borrowers with
credit scores below 660, one of the definitions of “subprime”
used by federal banking regulators. This represents over
54% of all such mortgages purchased during those years. If
one factors in Alt-A and adjustable-rate mortgages, this
analysis found that, at the end of 2008, Fannie and Freddie
were still exposed to $1.6 trillion of risky default-prone
loans. Thus, at year-end 2008, Fannie Mae and Freddie Mac
were responsible for 34 percent of all outstanding subprime
mortgages and 60 percent of all outstanding Alt-A mort-
gages in the United States.

... [N]onprime loans, which accounted for only 34% of the
GSEs’ risk exposure at the end of 2008, were suffering a 6%
delinquency rate, accounting for 90% of the GSEs’ losses. ... 

The continuing losses caused by Fannie and Freddie’s binge
on junk mortgages have already cost the taxpayers
dearly. ... The sum of these federal aid packages brings the
total current taxpayer exposure to GSE liabilities to over
$700 billion.37

This report also adduces substantial evidence that these
GSEs did not simply make bad decisions about lending stan-
dards on their own. For decades, especially during the past
decade, they sustained strong political pressure from members

35. See, e.g., White, supra note 31, at 272–73, 278–79.
36. Charles Duhigg, A Trickle That Turned Into a Torrent, N.Y. TIMES, July 11,
37. STAFF OF H. COMM. ON OVERSIGHT & GOV’T REFORM, 111TH CONG., THE
ROLE OF GOVERNMENT AFFORDABLE HOUSING POLICY IN CREATING THE GLOBAL
of Congress beholden to an “affordable housing” coalition of special interest groups who sought greater and greater relaxation of conventional underwriting standards for mortgage loans, even though many loans eventually were made to borrowers with low credit ratings and no documentation of their income or assets. Noting that “Fannie and Freddie used high leverage to borrow money and gamble on low-down payment affordable and speculative mortgages,” the report concludes that “[u]nlike Wall Street, however, the GSEs did this with the mandate and the blessing of Congress and successive Administrations, which encouraged them to use their government-granted competitive advantages to engage in a race to the bottom, boosting the national homeownership rate for political gain.” Most important, “[t]he consequences of these policies have also brought the entire global financial system to the brink of collapse, destroying trillions in equity and untold numbers of lives.”

To sum up the GSEs’ role in establishing important preconditions for the financial crisis, one can scarcely do better than to quote the conclusions of the House staff report:

The housing bubble that burst in 2007 and led to a financial crisis can be traced back to federal government intervention in the U.S. housing market intended to help provide homeownership opportunities for more Americans. This intervention began with two government-backed corporations, Fannie Mae and Freddie Mac, which privatized their profits but socialized their risks, creating powerful incentives for them to act recklessly and exposing taxpayers to tremendous losses. Government intervention also created “affordable” but dangerous lending policies which encouraged lower down payments, looser underwriting standards and higher leverage. Finally, government intervention created a nexus of vested interests—politicians, lenders and lobbyists—who profited from the “affordable” housing market and acted to kill reforms. . . . While government intervention was not the sole cause of the financial crisis, its role was significant and has received too little attention.

38. Id. at 5–8, 12–17, 20–23.
39. Id. at 25.
40. Id. at 26.
41. Id. at 2.
In a careful, independent analysis, Stan J. Liebowitz concurs, documenting that "mortgage underwriting standards had been under attack by virtually every branch of the government [including the Fed] since the early 1990s."42

Another factor that has not received due attention, although it may have been the most critical element of the financial crisis, is the Fed’s policy from 2001 to 2005. During these years, the Fed attempted to reverse the 2001 recession and to restore economic growth by pushing the interest rates it controls to extraordinarily low levels. The effective Federal Funds rate, which is the Fed’s principal target rate in its efforts to control the overall credit markets, was quickly pushed from 6.5% in 2000 to a low of 1% by mid-2003 and kept there for the next year. Although the Fed began to increase the effective Federal Funds rate in mid-2004, this rate did not exceed 2% until December 2004, and it reached 3% only in May 2005.43 Thus, given that the contemporary rate of inflation was roughly 2 to 3% per year, the Fed was holding the effective real Federal Funds rate in the negative range for about three years.

Small wonder, then, that related interest rates also remained unusually low during this period. Perhaps most important, the interest rate on conventional thirty-year home mortgages fell from 8.5% in May 2000 to less than 6% by January 2003, and afterward it rarely exceeded 6%, rising above that level consistently only after October 2005 and even then never exceeding 6.8% as a monthly average.44 Figure 2 illustrates this trend. Thus, allowing for price inflation of two to three percent per year, the real rate on conventional, long-term mortgage loans remained at roughly three to four percent for several years after 2002. During that period, the Fed made bank credit, including loans for house purchases, very cheap. By doing so, the Fed fueled the housing bubble. After all, no matter how easy the terms may be in a mortgage-loan market backed by reckless GSEs, transactions still require that


funds be available to the financial institutions that originate the loans. Absent this ample supply of monetary fuel, the development of the housing bubble would have been much less likely, if not impossible.

Figure 2

The brisk rate of growth of the money stock provides further evidence of the excesses of Fed action. Between December 2000 and December 2006, the money stock, as measured by the M2 monetary aggregate, increased from $4.95 trillion to $7.06 trillion, or by 42.7%, in just six years (an average annual rate of growth of 6.1%).  To put this monetary growth into perspective, one may consider that from the fourth quarter of 2000 to the fourth quarter of 2006, real GDP increased by only 15.2% (an average annual rate of growth of 2.4%). Thus, in this period, the money stock was growing at roughly 2.5 times the rate at which real output was growing.

Stanford University economist John B. Taylor argues that the Fed is primarily responsible for fueling the housing boom, and hence for causing the many unfortunate consequences that ensued when this boom ultimately went bust:

45. Id.
47. See BUREAU OF ECON. ANALYSIS, supra note 2.
Monetary excesses were the main cause of the boom. The Fed held its target interest rate, especially in 2003–2005, well below known monetary guidelines that say what good policy should be based on historical experience. Keeping interest rates on the track that worked well in the past two decades, rather than keeping rates so low, would have prevented the boom and the bust. Researchers at the Organization for Economic Cooperation and Development have provided corroborating evidence from other countries: The greater the degree of monetary excess in a country, the larger was the housing boom.48

III. FRIGHTENED OVERREACTIONS

Since the onset of the current economic troubles, U.S. policymakers have acted as if they are frightened or are seeking to frighten others—insisting that the impending dangers are so ominous that unless extraordinary measures are taken immediately, a catastrophe may occur. Policymakers have also acted as if they do not know what they are doing—devising one new measure after another, in ad hoc responses to a sequence of perceived problems, especially in the various credit markets, and frequently reversing course, even abandoning major initiatives altogether and replacing them with a new bailout du jour.

Moreover, while constantly proclaiming that they seek to remedy economy-wide or even worldwide problems, they have undertaken an unprecedented degree of tailoring in deciding which institutions to help and which to forsake. In this regard, they have given the distinct impression that rather than implementing broad-gauge monetary or fiscal policy, they are engaging in financial and economic “industrial policy,” picking winners with little or no apparent economic logic to support their decisions. Bear Stearns must be saved; Lehman Brothers may sink. Citigroup must be saved; CIT Group may fall into bankruptcy. General Motors and Chrysler must be saved; countless smaller firms scattered across the economy may go down. In

these circumstances, a firm's survival might well turn on having friends at the Treasury, at the Fed, or in Congress.

Small wonder that the pace of lobbying has quickened perceptibly. The Wall Street Journal reports: "Government spending as a share of the economy has climbed to levels not seen since World War II. The geyser of money has turned Washington into an essential destination for more and more businesses. Spending on lobbying is up, as are luxury hotel bookings in the capital." Thus, the existing policies amount to a recipe for political (that is, economically irrational) allocation of resources, which is scarcely reassuring for those seeking to divine the economy's future.

In mid-November 2008, Edmund L. Andrews observed: "White House and Treasury officials have been devising policy on the fly for months now, as what began as a panic over losses on subprime mortgages broadened into a crisis that wreaked havoc on Wall Street, at major commercial banks and in the broader economy itself." In a December 18, 2009 speech at the American Enterprise Institute, President Bush explained rather defensively why he had approved the big financial bailout bill enacted on October 3:

I was in the Roosevelt Room and Chairman Bernanke and Secretary Paulson, after a month of every weekend where they're calling, saying, we got to do this for AIG, or this for Fannie and Freddie, came in and said, the financial markets are completely frozen and if we don't do something about it, it is conceivable we will see a depression greater than the Great Depression. So I analyzed that and decided I didn't want to be the President during a depression greater than the Great Depression, or the beginning of a depression greater than the Great Depression. So we moved, and moved hard.

50. Davis & Hilsenrath, supra note 17.
John B. Taylor notes that "[t]he realization by the public that the government's [TARP] intervention plan had not been fully thought through, and the official story that the economy was tanking, likely led to the panic seen in the next few weeks." Moreover, "this was likely amplified by the ad hoc decisions to support some financial institutions and not others and unclear, seemingly fear-based explanations of programs to address the crisis."

Further evidence that policymakers were flying by the seat of their pants comes from the sheer number and variety of significant policy actions taken in the brief period from early September to mid-November 2008 and, somewhat less frantically, in the months afterward. Over this time, the government took the following actions:

Sept. 7: The Treasury takes over mortgage giants Fannie Mae and Freddie Mac, putting them into a conservatorship and pledging up to $200 billion to back their assets.

Sept. 16: The Fed injects $85 billion into the failing American International Group, one of the world's largest insurance companies.

Sept. 16: The Fed pumps $70 billion more into the nation's financial system to help ease credit stresses.

Sept. 19: The Treasury temporarily guarantees money market funds against losses up to $50 billion.

Oct. 3: President Bush signs the $700 billion economic bailout package. . . .

Oct. 6: The Fed increases a short-term loan program, saying it is boosting short-term lending to banks to $150 billion.

Oct. 7: The Fed says it will start buying unsecured short-term debt from companies, and says that up to $1.3 trillion of the debt may qualify for the program.

Oct. 8: The Fed agrees to lend AIG $37.8 billion more, bringing total to about $123 billion.

53. Taylor, supra note 48.
54. Id.
Oct. 14: The Treasury says it will use $250 billion of the $700 billion bailout to inject capital into the banks, with $125 billion provided to nine of the largest.

Oct. 14: The FDIC says it will temporarily guarantee up to a total of $1.4 trillion in loans between banks.

Oct. 21: The Fed says it will provide up to $540 billion in financing to provide liquidity for money market mutual funds.

Nov. 10: The Treasury and Fed replace the two loans provided to AIG with a $150 billion aid package that includes an infusion of $40 billion from the government’s bailout fund.  

Not since the explosion of government intervention into economic affairs at the outset of the New Deal has the government enacted such a rapid-fire succession of significant measures so quickly. Policymakers ordinarily might have studied, debated, and refined any one of these measures for months before its implementation. This time, however, scarcely any of them received more than perfunctory consideration, and many measures were adopted so hastily that it is difficult to believe that they received more than a few hours of serious thought by more than a handful of people. Never before in U.S. history did so many measures of such great importance come forth from so few decision makers in so little time.

Even when Congress voted as a whole, as it did on the bailout bill enacted on October 3, 2008, few members had a genuine grasp on the legislation. Most congressmen were stampeded into going along with the bill by the exhortations of frightened leaders in the executive and legislative branches and by Fed Chairman Ben Bernanke. Four days after Congress approved and the President signed the Emergency Economic Stabilization Act of 2008, Congressman Ron Paul wrote:

The rallying cry heard all over the Hill the past two weeks was that Congress must act. Our economy is facing a meltdown. Would this bill fix it? Nobody could really explain how it would. In fact, few demonstrated any real understanding of credit markets, of derivatives, of credit default swaps or mortgage-backed securities. If they did, they

would have known better than to vote for this bill. All they knew was that this administration was saying some frightening things, and asking for a lot of money.\footnote{Ron Paul, \textit{The Do-Something Congress}, \texttt{LEWROCKWELL.COM}, Oct. 7, 2008, \url{http://www.lewrockwell.com/paul/paul483.html}.}

It is possible to survey all of the extraordinary actions the government took in the late summer and autumn of 2008 and conclude that, given the conditions at that time, the authorities had little choice and acted only as the situation clearly required to avoid catastrophe. “There is no playbook for responding to turmoil we have never faced,” Secretary Paulson declared in mid-November.\footnote{Henry M. Paulson, Jr., Op-Ed., \textit{Fighting the Financial Crisis, One Challenge at a Time}, \texttt{N.Y. TIMES}, Nov. 18, 2008, at A27.} “We have done what was necessary as facts and conditions in the market and economy have changed, adjusting our strategy to most effectively address the crisis.”\footnote{Id. (emphasis added).}

Although this account is conceivable, it is highly implausible. Much more plausible is the interpretation that if indeed the government’s objective were simply to avert catastrophe, then it clearly overreacted. It perceived a serious potential for disaster where the actual potential was much smaller or, in many specific areas, virtually nonexistent. It consistently failed to consider how, if the government did nothing, private parties might meet the existing challenges by means of their own devising because they have such a great incentive to do so. In short, the government overreacted because the handful of government decision makers who wielded the greatest power at the time assumed that central government action ought to be the first resort in a perceived crisis.

Consider the crisis atmosphere that the government and the news media created in late September and early October 2008 and, to a somewhat lesser extent, in the four or five subsequent months. As Brian Gilmore, executive vice president of a Massachusetts trade association, stated in November 2008: “The whole psychology is that the sky is falling, even though it’s not.”\footnote{Ross Kerber, \textit{Small-business loans still flowing; Many in Mass. find no barrier}, \texttt{BOSTON GLOBE}, Nov. 21, 2008, at A1.} The media and government story line, repeated again and again, as if mere repetition made it true, was that the credit markets were “locked up,” “clogged,” “melted down,”
“frozen,” or, in other metaphors, effectively inoperative. One financial dealer after another told news reporters that “nobody is lending,” or used words to the same effect.

Yet the Fed’s comprehensive data for the volume of lending in various credit markets at the time showed nothing to warrant these hysterical views.60 Finally, in January 2009, Global Finance reported that “[a] chorus of dissenting voices has emerged that is challenging the widely held belief that interbank lending markets have dried up, commercial lending is being curtailed, and non-financial commercial paper markets have virtually ground to a halt.”61 The article cites the analysis of researchers at the Federal Reserve Bank of Minneapolis and a report by Octavio Marenzi, head of the research firm Celent, who stated:

While there is no denying that we are mired in a very serious financial crisis, this does not yet appear to have transformed into a general credit crisis. . . . In aggregate, credit and lending markets appear to be functioning well and in many cases are actually operating at historically high levels.62

Marenzi concluded that unless policymakers had undisclosed data to support their actions, it appeared that they were “making generalizations based on the situation of a particular set of businesses or banks.”63

Throughout the recent crisis, policymakers operated on the basis of two unspoken assumptions: The volume of outstanding credit should never decline, and if the volume of outstanding credit does decline, the government should act to reverse that decline. Neither assumption makes good economic sense. Past increases in the volume of credit may have been excessive; indeed, in the mortgage-lending market, one would be hard pressed to deny such excesses now that so many subprime and Alt-A loans have become delinquent.64 One

62. Id.
63. Id.
64. Paul Jackson, Alt-A Mortgage Loan Delinquencies Nearly As Bad As Subprime, NUWIRE INVESTOR, May 1, 2009, http://www.nuwireinvestor.com/articles/
cannot easily justify the idea that past foolhardy loans, now being wiped off the accounts in foreclosure proceedings, ought to be propped up or quickly replaced by loans that, under present conditions, can scarcely be any less foolhardy. Yet many of the government’s emergency policies seem designed to achieve precisely this nonsensical objective.\(^{65}\) If credit retrenchment is occurring for good reasons, then the government’s actions to offset it are unnecessary, and will most likely be mischievous, as well. Government loans or loan guarantees will prop up borrowers who ought never to have received the loans in the first place. Such measures diminish the economy’s overall efficiency and lay the foundation for a recurrence of similar troubles.

Many of the government’s crisis actions seem aimed not at doing what makes economic sense, but at saving select incumbent firms that got into trouble by making bad bets. Apart from anything that might be said about taking money from responsible parties and giving it to irresponsible parties, such policies in effect maintain an economic condition in which profits remain private, but losses are socialized. The moral hazard these policies promote may be the worst consequence of the government’s crisis response in the long run. Federal Reserve Bank of Philadelphia President Charles I. Plosser noted this danger:

This crisis, whether it’s because of the Fed or the Treasury or Congress, has created a lot of new moral hazards. . . . Once you have done this once, even though it was in a severe crisis, the temptation will be for people to figure that in the next crisis you’ll do it again.\(^{66}\)

What major firm’s managers in the future will fear having to bear the full consequences of imprudent actions? Will not all such actors appreciate that the government stands ready to bail out their firms on the grounds that they are “too big to fail” or that permitting them to fail poses too great a “systemic risk”?\(^{67}\)

Officials at the Treasury and the Fed repeatedly advanced the latter claim when explaining their action. Thus, on October 14, 2008, Secretary Paulson issued a statement that declared: "[O]ur actions are extensive, powerful and transformative. They demonstrate that the government will do what is necessary to restore the flow of funds on which our economy depends and will act to avoid, where possible, the failure of any systemically important institution." Systemic risk denotes the potential for an institution's failure to set in motion a train of other failures, ultimately bringing down the entire economic system or at least a large part of it. It is a frightening prospect, and members of Congress generally defer to Fed or Treasury officials who explain that the powers they possess or seek will be used to avert it. Despite the centrality of systemic risk in the rhetoric employed by policymakers, it has not been well established as a serious threat. In a recent substantial econometric study, the investigators concluded that "chances of systemic failure appear low even during major financial crises." Regardless of its actual likelihood of wreaking major harm, however, systemic risk is an idea that lends itself splendidly to fear-mongering.

IV. THE RATCHET EFFECT

During the past century, whenever the government abruptly expanded its size, scope, and power during a national emergency, it never returned completely to its pre-crisis dimensions or even to the dimensions that it would have attained had pre-crisis trends continued. I call this phenomenon the "ratchet effect." In view of the political logic of this

70. See ROBERT HIGGS, AGAINST LEVIATHAN: GOVERNMENT POWER AND A FREE SOCIETY 214 (2004); ROBERT HIGGS, CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE
phenomenon and the particular facts of the current crisis and the government's responses to it, it is likely that we shall see the same pattern of events in the present case.

The government's size, as measured by its fiscal dimensions, almost certainly will remain at a greater level for many years after the current emergency has passed. According to the CBO baseline-projection update in August 2009, federal outlays will jump from 21% of GDP in fiscal year 2008 to 26.1% in 2009, and then fall back to lower ratios in subsequent years. However, the retrenchment is currently forecasted to return the outlay percentage only to 22.6% in fiscal year 2013, after which it will increase slowly until 2019, when it will be 23.4%, or 2.4 percentage points greater than it was in 2008. One would be a fool to take such projections seriously for more than the very short term. Long before the ten-year projection period has run its course, unanticipated changes in economic conditions and government fiscal activities almost certainly will have occurred, displacing the government's spending ratio from its currently projected path. Nevertheless, the current projections do indicate that unless the government's future spending and taxing levels are altered from those implied by currently existing laws or unless the economy performs substantially better than the forecast predicts, the upshot of the present surge in outlays will be a permanently higher level of federal outlays relative to GDP—a fiscal ratchet effect.

The CBO's projections also show that federal taxes as a percentage of GDP will recover from their relatively low levels of 2009 and 2010, and after 2012 they will lodge in the relatively high range (by the standard of the past forty years) of nineteen to twenty percent. Federal debt held by the public is projected to rise every year, ascending from $5.80 trillion (or 40.8% of GDP) at the end of fiscal year 2008 to $14.32 trillion (or 67.8% of GDP) at the end of fiscal year 2019. The CBO report concludes:

Over the long term (beyond the 10-year baseline projection period), the budget remains on an unsustainable path. Unless changes are made to current policies, the nation will
face a growing demand for budgetary resources caused by rising health care costs and the aging of the population. Continued large deficits and the resulting increases in federal debt over time would reduce long-term economic growth by lowering national saving and investment relative to what would otherwise occur, causing productivity and wage growth to gradually slow.\(^7\)

It also seems likely that the government's responses to the crisis of 2008–2009 will permanently enlarge the scope of its intervention in the economy. The government has acquired major ownership stakes in hundreds of commercial banks and in AIG, General Motors, and Chrysler. It may retain a portion of this ownership and control for a long time. Fannie Mae and Freddie Mac are now effectively government-owned and operated enterprises, and they, along with the recently bloated FHA,\(^4\) remain the overwhelmingly dominant players in the secondary mortgage market, exerting a huge effect on mortgage financing and hence on the markets for residential housing and all the goods and services associated with it—altogether a substantial part of the economy and a sector that plays an especially important role in generating macroeconomic booms and busts.

In addition, the Fed has vastly expanded the scope of its lending and other operations, and it now effectively implements a financial industrial policy through its decisions to aid only selected firms and industries. If the Fed is not "picking winners," it is certainly deciding who will be spared a market-determined fate as a loser.\(^5\) How the Fed will exercise these new powers in the long run remains unclear. Fed officials insist that they intend to withdraw from many of the new areas they have recently entered once the crisis has passed, but it would be surprising if none of the recent "emergency" policies remained in the Fed's arsenal to bulk up its powers. Executives on Wall Street say that "the legacy could be enduring."\(^6\) Officials in the Obama Administration "bristle at even the hint that their rescue measures have ushered in a new era of 'big government.' But supporters

\(^{73}\) Id. at xii–xiii.

\(^{74}\) See Hill, supra note 65.


\(^{76}\) Cho, Mufson & Tse, supra note 49.
and critics alike worry that it will be difficult to shrink the government to anything like its former role."77 Many of the recently created vested interests in these new interventionist measures are sure to press for their perpetuation.

Moreover, if the Fed succeeds in getting the authority it has been seeking to act as a super-regulator of all firms (nonbanks as well as banks) the failure of which might pose a systemic risk to the economy,78 then the current crisis will have produced another highly significant ratchet effect on the scope of government. Indeed, even if another government agency or a council of several agencies undertakes this role, the action will amount to a major increase in the government’s regulatory power.

Unfortunately, the government’s engagement as a systemic-risk regulator serves as a perfect example of what F.A. Hayek called the pretense of knowledge.79 After all, this arrangement would be tantamount to hiring the same fox that has been devouring the chickens as the security guard for the henhouse. Moreover, it is difficult to envision how the government can conceivably attempt to regulate the firms it takes to pose a systemic risk without wreaking major economic mischief. In a passage that remains as apt today as it was in 1776, Adam Smith warned:

The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.80

77. Andrews & Sanger, supra note 66.
Smith was warning against what he had earlier called the presumptuous “man of system,” who “is apt to be very wise in his own conceit.”81 Today, that general class may include the presumptuous “man of systemic risk regulation.” In view of the seemingly limitless scope of this species of regulation and the likelihood of its being exercised in a very harmful manner, it poses an especially great risk to the economy’s successful functioning.

This is an unsettling time for those who support rigorous economic analysis in antitrust cases. Over the past four decades, numerous assumptions underlying the operation of free markets had developed to the point of being virtually unassailable. Rational profit-maximizing behavior on the part of many leads to optimal, self-sustaining equilibria. Markets self-correct, such that many (indeed most) distortions will be ephemeral. Financial markets are efficient, which means that even large-scale entry in capital intensive markets can safely be presumed where supracompetitive prices await. In cases of uncertainty, enforcers should err on the side of false negatives by presuming the existence of competitive markets. In short, the free market works. Certain of these assumptions now lie in ruins. For the antitrust proponent who developed his thinking based on such principles, the global market meltdown poses an unprecedented predicament.

Yet, when all the dust has settled, it is not clear what the objective lessons of the crisis will be for competition policy. The global recession certainly teaches that assumptions of efficiency are misplaced where systemic risk and uncertainty pervade the marketplace. It questions the wisdom of a financial system that becomes concentrated to a point where the failure of one key player triggers the collapse of others. It reveals that monetary policy alone cannot control all macroeconomic fluctuations. It raises fundamental questions about the role of regulation, not just in terms of domestic scope, but in efficacy and global reach too. But for all this, it does not say much about antitrust analysis.

Many have missed this point, and missed badly. Competition enforcers, politicians, and commentators are falling prey to an alluring, yet simplistic and myopic view. They posit that the economic dogma that ushered in today's extraordinary global recession is inextricably linked to the tenets of price theory that inform antitrust doctrine. They are mistaken.

This Article explores the normative repercussions of the global recession for competition policy and explains that minimal readjustment is counseled under the rubric of economics. Nevertheless, past shifts in substantive policy have coincided with larger changes in political thinking. The crisis has undermined U.S. faith in the free market, a development that portends a deviation from the law’s cautious approach to economic conduct of indeterminate long-run competitive effect. Such a shift is difficult to justify, but is likely inevitable.

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INTRODUCTION

The collapse of the global financial system in 2008 and the ensuing recession through 2009 raise fundamental questions about the future of free-market economics. Although macroeconomic policy and regulation of the financial sector are the most obvious candidates for revision in light of the meltdown, antitrust law—given its explicit reliance on price theory—may also be implicated. This Article surveys the worst recession in a generation and explores the normative insights the crisis provides for proper competition policy.

The market meltdown that began in the U.S. housing sector and tore through the world economy has laid bare a number of economic principles. In particular, the deregulatory movement that swept through myriad industries was premised on the notion that market forces produce results superior to government intervention. This movement relied on the assumption that rational choice theory fairly encapsulates real-world behavior, such that companies and consumers act in their best interests. So informed, this theory suggested that markets self-correct, economic distortions are ephemeral, and rational behavior produces desirable outcomes. In light of the calamitous global recession, certain of these assumptions were obviously misplaced.

Assumptions of capital-market efficiency, rational behavior, and market self-correction play at least as central a role in antitrust jurisprudence as they played in regulatory policy toward financial markets. If these assumptions have been at least partially discredited in the latter setting, what does that say about the former?

Despite a common reliance on free-market forces, the principles of economics that underlie competition law are highly distinct from the norms that justified deregulation in the financial sector. Antitrust law understands the market to self-correct where monopoly conditions attract capital, thus yielding competition, lower prices, and greater social welfare. In contrast, in the financial sector, the incentive to maximize profits spurs excessive leverage, creating systemic risk, which triggers the need

1. Cognizant of this restorative process, the law seeks to facilitate entry and to avoid mistaken findings that might insulate undesirable behavior from free-market forces. Obeisance toward the curative powers of the market has led U.S. law to adopt an agnostic approach to economic conduct of indeterminate long-run effect.
for regulation. Thus, the market failure in the banking industry need not reveal an intellectual frailty underlying antitrust jurisprudence. Were one to infer, however, that the market failure associated with the credit crisis has normative repercussions for the faith properly placed in capitalist forces generally, one might reasonably revisit substantive antitrust doctrine. This Article explores whether we should in fact interpret the recession in this manner.

Over the past several decades, competition regimes of ever-growing sophistication have played an important role in the regulation of Western economies. In the United States, the Chicago and post-Chicago Schools of thought have placed price theory at the heart of substantive policy. U.S. courts and enforcement agencies have developed an intricate body of jurisprudence that arguably renders the United States the world’s most mature antitrust jurisdiction. The European Union has slowly, but inexorably, followed suit, adopting the consumer welfare paradigm and implementing rules of growing economic sophistication. Substantive interjurisdictional differences remain, of course, especially with respect to the question of the proper level of constraints to be placed on dominant

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2. See Bruce M. Owen et al., China's Competition Policy Reforms: The Anti-Monopoly Law and Beyond, 75 ANTITRUST L.J. 231, 231 (2008) (explaining the myriad benefits competition policy has bestowed upon Western economies).


firms. Despite these differences, a belief in the power of economic analysis has largely transcended national borders.

Although the global financial meltdown demonstrates that unqualified support for the free market was dogmatic, it has revealed no systemic market failure that suggests or supports a shift in substantive antitrust policy. Competition law is concerned with the tendency of capital to flow to its highest-value uses. This phenomenon emanates from firms' incentive to maximize profits. If the banking crisis has taught us anything, it is that financial actors are myopic in their avid pursuit of short-run gains. This practice highlights the presence of incentives that justify the pre-crisis approach to competition law.

Unfortunately, it seems clear that the U.S. and EU authorities are using the crisis as a launching pad for far more aggressive enforcement against unilateral behavior and merger activity. Coupled with the possible expansion of Section 5 beyond the traditional scope of antitrust law, it appears that the United States is headed on an interventionist path more akin to Brussels than Chicago.

America's two enforcement agencies have gone so far as to speak of market concentration itself as an appropriate object of antitrust condemnation, even absent price effects. This view,


11. See DOL, EU Actions Suggest Tougher Antitrust Enforcement, TELECOMM. REP., June 1, 2009, at 43.

12. See Mark D. Whitener, Interview with J. Thomas Rosch, Commissioner, Federal Trade Commission, 23 ANTITRUST 32, 41 (2009) ("A... possibility is that the agencies will be taking a closer look to see whether or not the merger will result in a post-
most prevalent during the Warren Court era, has been resound-
ingly rejected by U.S. courts for more than thirty years. Long-run efficiency is the exclusive goal of modern competition enforce-
ment. Without the guiding norm of efficiency, antitrust policy would become untethered from any cognizable policy foundation. It would become a malleable tool subject to the idiosyn-
cratic whim of whoever wished to enforce it. Courts would lack a well-defined standard by which to judge challenged conduct.

This Article explores the events leading up to the global re-
cession, construing them in light of the revolutionary political and economic factors that yielded dramatic historical change in antitrust doctrine. It also explains the specific lessons of the cri-
sis for modern principles of competition law. Clearly, the global recession has created a challenge for antitrust policy, but a critical inquiry into the genuine lessons of the global credit crisis reveals that little alteration is needed. An economically informed body of law focused purely on maximizing dynamic

transaction firm that is too big to fail . . . . “); see also Jim Puzzanghera, Antitrust En-
forcer Vows Tough Stance, L.A. TIMES, May 12, 2009, at B1 (noting Christine Varney’s question of whether antitrust has failed if companies get too big to fail and observa-
tion that “[c]onsumers have been waiting for the markets to correct themselves, but the financial crisis has shown they haven’t”).


15. See Douglas H. Ginsburg, Synthetic Competition, 16 MEDIA L. & POL’Y 1, 7–10 (2006) (observing the vast range of ends to which antitrust laws have historically been applied, noting that the “varied goals endorsed by the Supreme Court were . . . divisive and contradictory,” and observing that the Supreme Court’s decision in GTE Sylvania “largely ended the confusion . . . [and] made the maximization of con-
sumer welfare, or allocative efficiency, the chief consideration when applying the anti-
trust laws”).

and allocative efficiency is necessary to help propel the economy back into recovery and sustainable growth.

The global crisis, properly construed, does have significant repercussions for the larger political landscape within which competition law is defined and informed. Revolutionary moments in the development of this area of law have been characterized by a broader socioeconomic context that predisposes the courts, the public, and academics toward adopting an alternative view. From the 1940s through the 1960s, for instance, the global marketplace was characterized by relatively weak competition, which surely tempered the need for the U.S. economy to emphasize efficiency. Instead, U.S. competition law reflected populist goals that included the dispersion of economic power and the protection of commercial liberty. In the 1980s, when the law evolved to reflect principles of economic efficiency, the global economy had become far more competitive. In this setting, an efficiency-based approach to antitrust policy made far more sense. More important still, the limitations of non-capitalist systems of creating and distributing wealth had become painfully apparent. Faith in the free market, especially in the United States, became deep-rooted, which facilitated an antitrust regime that reflected these principles.

We now face another juncture—one that has the potential to be equally revolutionary. Rightly or wrongly, many consider capitalism to have failed, and the public may now perceive negatively even sound tenets of price theory. Although we should meet claims that dominant firms have engaged in unilateral misconduct with skepticism, political and legal sympathy for monopoly will probably diminish. Certain fundamentals will remain unchanged, such as the prosecution of cartels


19. See Frank H. Easterbrook, The Limits of Antitrust, 63 TEX. L. REV. 1, 18 (1984) (“When a business rival brings suit, it is often safe to infer that the arrangement is beneficial to consumers.”).
and the prohibition of mergers to monopoly, but large swathes of doctrine are vulnerable to readjustment.

As a positive matter, such evolution appears inevitable. What remains to be seen is the scale of the departure from prior precedent. In justifying a new approach to controversial policy areas, policymakers must tie their reasons for change to justifiable economic theory. Unfortunately, the Federal Trade Commission (FTC), Justice Department, and others have already grounded their policy alterations in the supposed teachings of the financial crisis. This is obtuse at best, insincere at worst.

Part I of this Article explains the roles of economic analysis and political context in the historical development of antitrust policy. Part II explores the economic policy that led up to the financial catastrophe, and explains how the global recession debunks numerous assumptions often associated with the Chicago School. It reveals the lessons that we should draw from the credit crisis, but those lessons do not include meaningful contributions to proper antitrust policy. Commentators' reaction to the crisis, partial denunciation of competition policy in Europe, and aggressively enhanced U.S. enforcement actions against unilateral behavior of uncertain long-run harm bode ill for the future. Enforcers' uncritical words threaten to cause a reversal of the otherwise steady evolution of antitrust law toward greater economic sophistication. This Article explains that the better course would be to allow the recession to have little, if any, normative effect on the future direction of competition law. A brief conclusion follows.

20. Before proceeding further, a word on interpretation is needed. Specificity is the key to reasoned debate about the crisis. Sweeping references to “the market,” “deregulation,” “capitalism,” “Chicago,” and other broad terms are not likely to yield meaningful conclusions. Deregulation of industry segments that do not display natural monopoly characteristics is distinct from deregulation of banking activities predisposed to excessive leverage. “The market” performs a different role in antitrust analysis than it does when uncritically used to support wholesale deregulation. Each industry and every market must be subject to particularized analysis—conclusions about the perceived failure of capitalism in one context may have legitimate normative consequences in one setting and yet none in another.
I. FREE-MARKET ECONOMICS AND THE EVOLUTION OF MODERN ANTITRUST DOCTRINE

A. Antitrust Without Economics? The Sherman Act from Inception to the Warren Court

In modern times, and at least until the onset of the global market crisis, U.S. antitrust law promoted a narrow but well-defined goal—namely, long-run efficiency. This objective, defined by microeconomic theory, requires that competition policy condemn conduct likely to result in diminished industrial output and increased market prices. Antitrust law could conceivably forward a wide variety of alternative ends, but courts have rejected them. Populism would object to business conduct that carries the potential to interfere with individual liberty or to concentrate economic power, irrespective of price effects; yet this view carries no contemporary force. Only actions that threaten dynamic or static efficiency implicate modern competition law. It was not always so.

The Sherman Act, or the "Magna Carta of free enterprise," passed into law in 1890. As a common law statute, it leaves

21. See Robert H. Bork, Legislative Intent and the Policy of the Sherman Act, 9 J.L. & ECON. 7, 7 (1966); Michael S. Jacobs, An Essay on the Normative Foundations of Antitrust Economics, 74 N.C. L. REV. 219, 226-27 (1995). There is an important distinction between short-run static efficiency, in which a market displays allocative efficiency with zero deadweight loss, and long-run dynamic efficiency, in which markets may be subject to ephemeral bouts of monopoly that fuel ongoing innovation. In some information markets, often referred to collectively as the "new economy," there is a tension between static and dynamic efficiency, with the latter goal being far more important. See Thomas O. Barnett, Interoperability Between Antitrust and Intellectual Property, 14 GEO. MASON L. REV. 859, 860 (2007). It is for this reason that society bestows certain inventors and artists with limited exclusivity under the intellectual property laws. The key point to remember is that although efficiency is indeed the goal of contemporary antitrust policy, the particular form of efficiency mandated by theory differs depending on the particular market.


the judiciary to determine substantive law. Earlier courts interpreted the goals of antitrust broadly and sought to preserve an unhindered competitive process, particularly by ensuring the liberty of commercial actors. Judges emphasized individual freedom and the decentralization of economic power. Throughout this era, it was clear that ultimate downstream price effects were not the sole concern of the competition laws. Courts condemned numerous exclusionary practices, regardless of their impact on consumers.

An aversion to undue concentration featured prominently in U.S. antitrust policy until the 1970s, most notably throughout the Warren Court era. Perhaps the best-known example emanated from Judge Learned Hand in the famous 1945 case, *Alcoa*:

We have been speaking only of the economic reasons which forbid monopoly; but, as we have already implied, there are others, based upon the belief that great industrial consolidations are inherently undesirable, regardless of their economic results . . . . Throughout the history of these statutes it has been constantly assumed that one of their purposes was to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete with each other.

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27. See RICHARD A. POSNER, HOW JUDGES THINK 48 (2008). Notably, Senator Sherman commented on a related draft that the act “does not announce a new principle of law, but applies old and well recognized principles of the common law.” John C. Peppin, *Price-Fixing Agreements Under the Sherman Anti-Trust Law*, 28 CAL. L. REV. 297, 306 n.29 (1940) (quoting 21 CONG. REC. 2456 (1890)). The Supreme Court has explicitly recognized this, noting that the “vagueness of [the Sherman Act’s] language” left it to the courts to give “content to the statute.” *Apex Hosiery Co. v. Leader*, 310 U.S. 469, 489 (1940).

28. See *United States v. Aluminum Co. of America (Alcoa)*, 148 F.2d 416, 428–29 (2d Cir. 1945) (describing the “helplessness of the individual” before “great aggregations of capital” as an object of concern for antitrust).


Judge Hand’s comments made clear that the maintenance of an unconcentrated market structure was a legitimate goal in itself, even if the price of that goal was higher cost and inefficiency. The Supreme Court infamously made this policy explicit in the 1962 case, Brown Shoe. There, the Court held that “Congress appreciated that occasional high costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization.”

This perspective pervaded the Supreme Court’s pre-Chicago jurisprudence. Notwithstanding the efficiency and competition-enhancing virtues of a joint venture amongst fringe firms, the Supreme Court found such arrangements per se unlawful. The Court reached this decision purely because the venture limited the freedom of traders. Product tying, in which a vendor refuses to sell a good unless the buyer also purchases another product, was found to be a per se violation of the antitrust laws. Bundling and requirements contracts were condemned without further inquiry because they took away consumers’ purchasing freedom and deprived potential sellers of the tied product of access to customers. It did not matter that concerns of economic efficiency typically underlie tie-ins, or that they are ubiquitous in even the most competitive markets. Conglomerate mergers that involve economically distinct markets were found objectionable on the basis of size and scale, rather than on the basis of price effects. Vertically imposed maximum resale prices were found to be illegal not because...
cause of negative downstream price effects, but because they interfered with traders' liberty to set prices as they saw fit.42

Although modern price theory flatly contradicts much doctrine throughout this era,43 condemning the courts for abandoning economic theory might be going too far. Economists at the time largely agreed on the now-discredited "Structure-Conduct-Performance" paradigm, which erroneously predicted that less concentrated markets were more competitive and produced better results than markets in which there was considerable accumulation of economic power.44 This body of economics (often associated with the Harvard School) was given perhaps its definitive expression in the 1967 Neal Report, which ironically issued at the very end of the S-C-P model's influence.45 Adherents of the Harvard School correctly observed a relationship between industry concentration and profits, but erroneously inferred that those profits were the result of artificial market power.46 Joseph Bain, an economist whose work was very influential throughout the period, aggravated the mistake.47 He suggested that entry barriers were pervasive, and found that necessary up-front capital expenditures, incumbent efficiency, and other difficulties frustrated entry into concentrated markets and perpetuated market power.48 Combined, these factors contributed to a significant disdain for dominance. The judiciary and enforcement agencies actively sought to promote a dispersed industry structure through antitrust policy that inhibited growth.

The Warren Court embraced the theory that market structure plays a crucial role in fostering an effective and desirable com-

44. Muris, supra note 43.
47. JOE S. BAIN, BARRIERS TO NEW COMPETITION: THEIR CHARACTER AND CONSEQUENCES IN MANUFACTURING INDUSTRIES 144–66 (1956).
48. Id.
petitive process. Nevertheless, it would be incorrect to infer that economic theory alone explains the modern Supreme Court’s quite radical departure from the previous Warren Court era. Both the Warren Court and earlier courts had explicitly noted that the artificial dispersion of economic power would carry efficiency losses. Clearly then, the judiciary knew of the economic costs associated with a diffusion of power. Although the Chicago and post-Chicago Schools certainly convinced the Court of the importance of efficiency concerns—largely by highlighting the enormity of the losses associated with the S-C-P approach—the ultimate explanatory factor was a shift in political ideology. This shift, in turn, came from the public’s changing attitude toward industry structure and free market processes.

B. A Price-Theoretic Approach to Competition Law

The Warren Court’s populist interpretation of the Sherman Act proved ephemeral. Beginning in the late 1960s, a group of economists and legal academics at the University of Chicago began to subject leading antitrust doctrine to rigorous microeconomic scrutiny. It quickly became apparent that the Supreme Court had misinterpreted business conduct, using impressionistic and economically ill-informed theories of harm. Vast swathes of commercial activity that the Court condemned as exclusionary were found to have beneficial effects on consumer prices, industrial output, and innovation. Some of the


50. See Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962); United States v. Aluminum Co. of America (Alcoa), 148 F.2d 416, 428 (2d Cir. 1945).

51. See Edward A. Purcell, Jr., The Class Action Fairness Act in Perspective: The Old and the New in Federal Jurisdiction Reform, 156 U. PA. L. REV. 1823, 1916-17 (2007) ("Milton Friedman attributed the recent dominance of the 'Chicago school' to the economic crises of the 1970s and early 1980s and to the subsequent collapse of Communism and the Soviet Union. 'It wasn't my talking that caused people to embrace these ideas, just as the rooster doesn't make the sun rise,' [Friedman] explained. 'Collectivism was an impossible way to run an economy. What has brought about the change is reality, fact—and what Marx called the inevitable forces of history.'" (citations omitted)); see also NAOMI KLEIN, THE SHOCK DOCTRINE: THE RISE OF DISASTER CAPITALISM (2007).

52. See Posner, supra note 3, at 925-33.


Chicago School's adherents even counseled wholesale abandonment of the antitrust laws, believing that the free market would generate better outcomes than government intervention. This group went so far as to oppose the prosecution of cartels, believing that such entities would invite prompt entry and would naturally collapse. The more reasonable (and influential) members of the School, however, counseled an agnostic approach to competition policy. Cartels and mergers to monopoly should be prohibited, but claims of unilateral misconduct and challenges to concerted actions of indeterminate economic effect should be approached cautiously.

As Judge Posner, one of the key proponents of this school of thought, put it:

The Chicago School's approach is skeptical... about the gravity of the danger to competition posed by unilateral firm action... The approach emphasizes both the difficulty of squashing competition by such means and the danger that heavy-handed antitrust enforcement may suppress a practice that seems anticompetitive but actually is efficient.

Although an exhaustive analysis of the School's findings is beyond this Article's scope, some of the central contributions are worth mentioning. It debunked the assumption that entry barriers are pervasive, demonstrated that concentration and high profits are at least as likely to signal efficiency as market power, proved that vertical restraints a manufacturer imposes on its distributors are highly unlikely to be anticompetitive,


57. See Frank H. Easterbrook, Workable Antitrust Policy, 84 Mich. L. Rev. 1696, 1701 (1986) (discussing the Workable Antitrust Policy School, which advocates a "profoundly skeptical program" that would consist of "little other than prosecuting plain vanilla cartels and mergers to monopoly").

58. Posner, supra note 35, at 251; see also Richard A. Posner, Keynote Address: Vertical Restrictions and "Fragile" Monopoly, 50 Antitrust Bull. 499, 500 (2005) ("[E]ven the early versions of Chicago school thinking recognized that there could be cases in which single-firm abuses would give rise to a serious antitrust concern.").
and explained that a wide variety of unilateral practices by dominant firms—including predatory pricing, product tying, exclusive contracting, and price squeezing—are unlikely to injure consumers in the long run.\footnote{59. See Bork, supra note 16 (explaining these points in detail); Posner, supra note 3, at 925–33 (same).}

The post-Chicago School has refined these findings by introducing dynamic models that use modern game theory.\footnote{60. See Jacobs, supra note 21, at 240–50.} Some of the Chicago School’s more extreme conclusions, such as Robert Bork’s suggestions that entry barriers do not exist and that unilateral behavior cannot exclude equally or more efficient competitors,\footnote{61. See ROBERT H. BORK, THE ANTITRUST PARADOX 310 (1978).} have been shown to be dogmatic.\footnote{62. See Hovenkamp, supra note 3, at 278; Steven C. Salop, Economic Analysis of Exclusionary Vertical Conduct: Where Chicago Has Overshot the Mark, in HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST (Robert Pitofsky ed., 2008); Lawrence A. Sullivan, Post-Chicago Economics: Economists, Lawyers, Judges, and Enforcement Officials in a Less Determinate Theoretical World, 63 ANTITRUST L.J. 669, 672 (1995).} As a result, the post-Chicago School generally counsels a reserved approach that entails a rule-of-reason inquiry.\footnote{63. See Hovenkamp, supra note 3, at 258, 279; Keith N. Hylton & Michael Salinger, Tying Law and Policy: A Decision-Theoretic Approach, 69 ANTITRUST L.J. 469, 497 (“[T]he post-Chicago literature arose in response to the Chicago School’s implication that tying should be legal per se. The post-Chicago models indicate that tying can be anticompetitive, not that it must be anticompetitive or that it is likely to be anticompetitive. Indeed, the models cannot tell us even that anticompetitive tying is more than a remote possibility.”).}

The Chicago School’s contributions were not limited to economic theory alone. Rather, the movement sought to establish efficiency as the exclusive political goal of competition policy.\footnote{64. See Jacobs, supra note 21, at 219.} It was remarkably successful in doing so, in part due to the intellectual incoherence of the Warren Court and preceding eras.\footnote{65. See POSNER, supra note 35, at viii (characterizing the pre-Chicago School body of antitrust doctrine as an “intellectual disgrace”).} Chicago scholars demonstrated that the cost of the Court’s jurisprudence was higher market prices at the expense of consumers.\footnote{66. See BORK, supra note 61, at 4.}

It is clear that the Chicago School succeeded in convincing the Supreme Court of a number of issues. Ultimately, the Court accepted Robert Bork’s contention that the Sherman Act serves as a
“consumer welfare prescription.”67 This statement had the great benefit of pushing the importance of price effects toward the fore of antitrust analysis and served as the bedrock of several revolutionary decisions that overruled prior cases.68 The Court also put a premium on price competition and has explicitly linked that form of rivalry with consumer welfare.69 Moreover, the Court has displayed sensitivity to concerns of aggregate welfare, most obviously with respect to monopsonistic conduct.70 Perhaps most importantly, several influential courts have defined consumer welfare as coterminous with allocative efficiency.71

The glaring distinction between the present and the past is political.72 Whereas the concentration of economic power and

68. See Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007) (overruling its 1911 Dr. Miles decision, which had held that vertical minimum price fixing is illegal per se); Ill. Tool Works, Inc. v. Indep. Ink, 547 U.S. 28 (2006) (overruling presumption that patents confer market power for the purposes of the antitrust laws); State Oil Co. v. Kahn, 522 U.S. 3 (1997) (overruling its 1968 Albrecht decision, which had held that vertical maximum price fixing was a per se antitrust violation); Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993) (requiring that an antitrust plaintiff who alleges predatory pricing establish a dangerous probability of recoupment); Cont'l T. V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977) (advocating the abandonment of per se rules that are inconsistent with prevailing economic theory and analyzing vertically-imposed nonprice constraints under the rule of reason).
69. See Brooke Group, 509 U.S. at 223.
71. See Rebel Oil Co. v. Atl. Richfield Co., 51 F.3d 1421, 1433, 1444 n.15 (9th Cir. 1995); see also MetroNet Servs. Corp. v. U.S. West Commc’ns, 329 F.3d 986, 1006 (9th Cir. 2003).
72. Of course, it is not possible to delineate politics and economics into two distinct and mutually exclusive disciplines. The teachings of each influence the other. Nevertheless, they are not coterminous. Fundamentally, price theory provides the policy-maker with a means by which to ascertain the economic consequences, both positive and negative, of a particular course of action. That theory does not dictate a single right approach, however. Society can, and often does, pursue policies that are inconsistent with aggregate welfare. One need only think of minimum wage laws. Economics teaches that such laws will prevent certain labor markets from clearing at optimal levels, with ensuing deadweight loss. This loss takes the form of jobs that would have existed, but for the government policy. While those who receive jobs gain from these laws, economics predicts on the whole that workers are made worse off. Mindful of this theory, society nevertheless concludes that certain political factors—the belief that an individual's effort has to be worth at least a certain amount, the concern that employers may force wages to suboptimal levels due to the homogeneity of the workforce, and others—are of sufficient value that the laws are nonetheless justified. The case is no different with antitrust economics, which approximate the impact of challenged business conduct on allocative efficiency. An electorate can choose to adopt this
obstacles to economic freedom were once viewed as antithetical to a “healthy and unimpaired competitive process,” courts no longer view these factors as inconsistent. This evolution in the law is surely a result of the U.S. experience with free markets over the last three decades, which have yielded great levels of innovation and consumer benefit, even in cases of quite extreme concentration. Such gains have been most evident in the new economy where society has reaped vast long-run gains by foreclosing short-run access to markets and facilitated ephemeral monopoly power via the intellectual property laws. An obvious tension exists between the goal of free access to markets and dispersion of economic power, on the one hand, and the pursuit of social wealth, on the other. It is now clear that adhering to the former often forecloses the latter, with serious economic repercussions.

Although the tradeoff between dynamic and static efficiency is a fundamental principle of modern economics, the ultimate question involves a policy choice. A suitably minded electorate could legitimately favor populist goals of diversified economic power and unconcentrated markets, but it would have to pay a high price. Clearly, in modern times, society has deemed this price not worth paying. Such has been the recent U.S. experience with dominance that the Supreme Court saw fit to describe monopoly conditions in laudatory terms in *Trinko*. Such a result would have been unthinkable during the Warren Court era.

As Part II explores, however, this political calculus may have changed. The credit crunch that brought the global economy to

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73. The most dramatic example is the Supreme Court’s decision in *Trinko*. There, the Court opined that “[t]he opportunity to charge monopoly prices—at least for a short period—is what attracts ‘business acumen’ in the first place; it induces risk taking that produces innovation and economic growth.” *Verizon Commc’ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004).


76. See Barnett, supra note 21, at 865.

77. See id.

78. See *Trinko*, 540 U.S. at 407.

a standstill has fundamentally altered the way that many view
dominance, market concentration, the diffusion of economic
power, and the equity and efficacy of the free market process. Antitrust commentators have reacted viscerally, framing the
recession as a refutation of Chicago School economics. They argue that continuing faith in the market is ill-placed and that substantive competition policy must change as a result.

This Pavlovian response is misplaced. As this Article explains, the lessons of the credit crisis for antitrust law are not economic. The tenets of price theory that indicate a close relationship between efficiency and concentration remain, as do the associated inferences that suggest the primacy of allocative efficiency as the proper inquiry under the Sherman Act. It remains true that the "primary concern of the antitrust laws is the corruption of the competitive process." Business practices that price theory deemed likely to corrupt the competitive process before the crisis will surely remain likely to corrupt it after. Certain changes in policy will be necessary throughout the credit crunch, of course, most notably with respect to the prospect of entry into capital-intensive markets. But such alterations in policy will prove fleeting and will disappear as the flow of credit returns.

The real result is political. Those who were opposed to the largely laissez-faire rules suggested by rigorous economic analysis (and decision theory in cases of uncertainty) are now optimally placed to promote their alternative perspectives. To the extent such efforts might result in the repeal of policies that are

80. Illustratively, Albert Foer, president of the American Antitrust Institute, has opined that the crisis will cause the public mood to shift "from worship of big corporations to skepticism of the role they play." David R. Francis, How Obama could prevent firms from becoming 'too big to fail', CHRISTIAN SCI. MONITOR, Apr. 26 2009, at 32.
81. See supra note 11.
82. See infra Part II.B.
83. Tal v. Hogan, 453 F.3d 1244, 1258 (10th Cir. 2006).
84. For an example of a position that would not be appropriate in current market conditions, see Deborah Platt Majoras, Deputy Ass't Att'y Gen., Antitrust Div., U.S. Dept't of Justice, GE-Honeywell: The U.S. Decision, Remarks Before the Antitrust Law Section, State Bar of Georgia 8 (Nov. 29, 2001) (opining that the capital requirements for entry into a market should not be construed as an entry barrier because "capital markets generally work very efficiently and there is no obvious reason ... why [an incumbent's] cost of capital for a particular project should be any lower than that of its rivals").
likely to promote long-run efficiency, they should be resisted. Paramount amongst these is the suggestion that antitrust law again forecloses scale- and scope-based market concentration.

Other, less dramatic but nevertheless politically motivated moves have also resulted. Given the divisive nature of the George W. Bush Administration’s Section 2 Report, it is not surprising that the Obama Administration has revoked it. It has done so, of course, under the rubric that free-market presumptions can no longer be relied upon in formulating enforcement policy. Price theory—even in light of the crisis—dictates no such result. Given the indeterminate nature of some unilateral conduct by the dominant firm, economics does not necessarily mandate adherence to the status quo either, but it is intellectually dishonest to frame the revocation in economic terms and to suggest that it is compelled by the global recession.

Before proceeding, it is necessary to address the broader role of Chicago School economics. The School’s intimate reliance on neoclassical price theory and support of libertarianism had revolutionary repercussions beyond antitrust policy. Unlike its more narrow influence on competition law, the legitimacy of the School’s contribution to regulatory policy has been validly called into question by the present crisis. This policy—like Chicago’s approach to antitrust—places great weight on the efficacy of free-market forces.

C. Chicago and the Deregulatory Movement

Although Chicago’s influence on U.S. antitrust policy has been profound, its promotion of capitalist, free-market, and libertarian principles found a warm political welcome throughout U.S. policy. The School’s ascension, which coincided with

87. See Puzzanghera, supra note 12.
88. This Part is intentionally concise because an exhaustive treatment of Chicago’s influence on macroeconomic and regulatory policy would demand a book in itself.
a rise of conservatism in the United States and United Kingdom throughout the 1980s, ushered in an era of deregulation and non-interventionist economic policies.89 Chicago-oriented principles place deep-rooted faith in the ability of unbridled free-market forces to yield efficient outcomes.90 This conviction promoted not only a non-interventionist and inherently skeptical approach to competition policy, but underlay the normative case for removing certain sectors of the economy from government control.91 This Part provides some brief background on the Chicago School's larger effect on regulatory policy, which, unlike antitrust law, may be subject to some criticism.

Before the 1970s, large swathes of the airline, electricity, and telecommunications industries were thought to display characteristics of natural monopolies such as diminishing long-run average cost.92 This trait does not suggest (as many mistakenly believe) that the market will bear only a single firm, but indicates that the optimal market structure from the view of productive efficiency is monopoly.93 The ensuing company sets monopoly prices, which cause allocative inefficiency. In re-

89. See Kovacic, supra note 55, at 25 n.71 (quoting various authorities for the proposition that Ronald Reagan's acceptance of Chicago School theories informed the deregulatory movement in the 1980s).

90. An exception to the Chicago School's free-market approach lay in its promotion of government-controlled monetary policy. Milton Friedman's revolutionary work on monetarism, which rejected the prevailing Keynesian and post-Keynesian theories of the day to focus on money supply, grew in influence throughout the 1970s. The body of thought, perhaps best summarized by the conclusion that "inflation is always and everywhere a monetary phenomenon," typically regarded markets as inherently stable. As a result, monetarist thought concludes that governments need merely control the money supply and need not employ the fiscal policies associated with Keynes.

91. See Ashutosh Bhagwat, Unnatural Competition?: Applying the New Antitrust Learning to Foster Competition in the Local Exchange, 50 HASTINGS L.J. 1479, 1485-86 (1999) (observing that "[t]he impact of the Chicago School on regulatory policy is less obvious than on antitrust policy, but is almost certainly reflected in the massive wave of deregulation and unbundling that has swept through regulated industries in the past two decades").


sponse, the government regulates those prices and attempts to constrain them to competitive levels.\textsuperscript{94}

Such regulation is subject to numerous systemic flaws. For one, it is notoriously difficult to subject an entity to effective price regulation. Companies react to constraints in a variety of unanticipated ways. The classic form of regulation—rate-of-return constraints that allow the regulated entity to charge a price no higher than a specified percentage of its costs—is ineffective.\textsuperscript{95} An entity subject to such a constraint has little to no incentive to operate efficiently or to minimize costs—goals that firms facing open competition must strive to meet if they are to survive.\textsuperscript{96} Moreover, a company subject to a rate of return limitation will rationally "gold plate" its facilities by creating a system of greater quality than would be justified on a cost-benefit basis.\textsuperscript{97}

Given the severe limitations associated with this form of price constraint, it eventually gave way to incentive-based approaches, exemplified by price-cap regulation.\textsuperscript{98} This system establishes an upper boundary on the price set by the regulated entity. So constrained, the company has strong incentives to

\textsuperscript{98} See Ronald R. Braeutigam & John C. Panzar, Effects of the Change from Rate-Of-Return to Price-Cap Regulation, 83 AM. ECON. REV. 191, 193 (1993).
lower costs and thus to generate an economic profit. As the regulated entity succeeds in cutting costs (via the “X-Factor”), the regulator can then lower the cap, thus transferring some of the efficiency savings onto consumers. While unquestionably more effective than rate-of-return regulation, price caps are themselves subject to numerous frailties. First, they are not, and can never be, superior to market processes in yielding cost-cutting. Second, to even attempt this form of regulation, one must identify an appropriate metric of cost by which to judge an optimal price. This is also problematic. In the economics literature, a key figure is the marginal cost of a firm’s production, which will equal price under perfect competition. Unfortunately, marginal cost—being a theoretical construct—is notoriously difficult to estimate in practice. Even if a suitable proxy is employed—most often average variable cost—few regulated industries can be subjected to marginal-cost pricing, as it would lead to insolvency in the presence of any fixed costs. How great a mark-up to allow proves to be a troublesome question in practice. Third, it is difficult for a regulator credibly to commit to not increasing the cap if the monopolist fails to lower costs sufficiently to achieve profitabil-


105. See Carlton & Perloff, supra note 22, at 89.


ity. Political factors would make it difficult for such a regulator to perpetuate a system that appears on course to cause the regulated company’s insolvency.

Adherents to the Chicago School successfully exposed these shortcomings. In addition to demonstrating the inefficacious nature of price regulation, they questioned the actual scope of natural monopoly and pointed to empirical evidence of regulation’s ineffectiveness. In doing so, they convinced the government that many aspects of the so-called regulated industries were not subject to diminishing long-run average cost. They also emphasized that certain portions of industry that were characterized by natural monopoly conditions could be left regulated, while the rest of the market could be opened up. The result was revolutionary. Vast swathes of the economy that had never before been subject to free-market forces were exposed to competition. Government regulation of the airline, trucking, energy, telecommunications, securities exchanges, and commercial banking industries was scaled back considerably in the 1970s and 1980s.


111. See PIERCE & GELLHORN, supra note 92, at 343–44; Hovenkamp, supra note 95, at 825.


113. See PIERCE & GELLHORN, supra note 92, at 343–78; Posting of Gary Becker to The Becker-Posner Blog, Greater Regulation of Financial Markets?, http://www.becker-posner-blog.com/ (Apr. 28, 2008, 19:37 EDT). The results were largely satisfactory, even if all were not convinced. Even before the onset of the current crisis, which itself strongly suggests that unbridled deregulation can produce far from desirable results, some were skeptical of the curative powers of deregulation. See, e.g., Richard D. Cudahy, The Folklore of Deregulation (with Apologies to Thurman Arnold), 15 YALE J. ON REG. 427 (1998).
Much of this deregulation has yielded great benefits for consumers, and the current economic crisis should not compel a drastic reversal in the deregulatory movement generally. But deregulation that led to the withdrawal of government oversight from vast swathes of the financial sector was a mistaken approach—the uncritical result of an ideology taken too far.\textsuperscript{114}

There is a fundamental distinction between industries like transportation and energy, on the one hand, and financial institutions on the other: The latter are not regulated on the basis of natural-monopoly conditions. Instead, banks are subjected to myriad rules that are designed to prevent excessive leverage, to ensure adequate capitalization, and to facilitate the dissemination of accurate information to the market. Such regulation creates stability. Banks are unusually vulnerable to market shocks. Because they mostly lend borrowed money, changes in market conditions that result in seemingly modest increases in default rates can render banks insolvent—a risk that can be greatly exacerbated by runs. In times of economic growth, banks also have strong incentives to enhance profitability by increasing leverage (the ratio of borrowed to owned assets). Because the interest that banks pay on borrowed money is independent of the return those funds are used to obtain, favorable economic conditions make increased leverage highly attractive. Yet, this same fact portends disaster in the event of a downturn, as leverage magnifies losses as much as it does gains. Banks' myopic pursuit of profits in booms can therefore lead to mass bankruptcy in less-favorable economic conditions.

These factors suggest that banks are unusually likely to fall prey to their own actions, but this fact alone does not present a strong case for regulation. After all, it is a fundamental principle of free-market economics that losers should perish. The internalization of this expected cost will cause managers' decision making to mirror the social optimum. But the prospective loss of shareholder value does not remotely encapsulate the social cost of a large bank's failure. Banks are regulated because, in providing critically important liquidity, they occupy a position of unique importance within the economy. If a bank's role within the economy is systemic, then the cascade effect of its

\textsuperscript{114} See Richard A. Posner, \textit{A Failure of Capitalism: The Crisis of '08 and the Decent into Depression} (2009).
failure will greatly exceed the cost of rescuing it. This connection is especially strong in a recession, where such a failure could significantly exacerbate a grave economic situation. To prevent such an outcome, the government regulates banking activities to ensure adequate capitalization and a sufficient equity cushion.

Although the Chicago School’s critique of price regulation in many industries is well taken, its promotion of deregulation is less well suited to certain aspects of the financial sector. The industries formerly regarded as natural monopolies are relatively enclosed, such that their fate is largely independent of the rest of the economy. Banks’ activities, in contrast, pervade the entire economy—providing liquidity and facilitating maturity transformation. Notwithstanding the great need to regulate banking activities, large parts of the financial system were removed from, or never subjected to, stringent oversight.

II. CHICAGO AND THE GLOBAL FINANCIAL CRISIS

A. Chicago as a False Ideology?

“One thing is clear to me: the orthodox and unvarnished Chicago School of economic theory is on life support, if it is not dead.” This view, expressed by Commissioner Rosch, is certainly no outlier. Real-world collapse has, in the most compelling way possible, eviscerated the notion that markets operate with such efficiency that regulation is unnecessary. Alan Greenspan, a prominent and highly influential disciple of free-market economics, characterized himself as being in a “state of shocked disbelief” as he watched the free market that had been built on an edifice of rational behavior collapse around him. How did it all happen? And what will be the policy ramifications of the recession? This Part seeks to provide an answer to

116. See PITOFSKY, supra note 62, at 7 (discussing various economists’ growing “unease” with Chicago School analysis).
these crucial questions.\textsuperscript{118} In short, the crisis cannot be explained on economic grounds that are attributable to antitrust policy.

The 2008 economic crisis, the worst since the Great Depression,\textsuperscript{119} began in the summer of 2007. A large housing bubble had developed within the U.S. economy, accompanied by unprecedented levels of consumer debt,\textsuperscript{120} which ultimately burst in 2007 with devastating economic effect.\textsuperscript{121} Financial institutions that had accumulated vast quantities of vulnerable asset-backed securities suffered massive losses,\textsuperscript{122} which they were required to recognize immediately under mark-to-market accounting rules.\textsuperscript{123} The ensuing write-downs threatened the solvency of many leading institutions, which portended a catastrophic cascade effect in the event of a critical bankruptcy. This perilous prospect required the U.S. government to rescue Fannie Mae and Freddie Mac at enormous expense to taxpayers.\textsuperscript{124} In what was widely, though not unanimously, considered a mistake, the Federal Reserve ("the Fed") decided that Lehman Brothers, a venerable investment bank, was not so critical to the economy that it had to be saved.\textsuperscript{125} As a result, Lehman filed for bankruptcy in mid-September 2008,\textsuperscript{126} which, at over $600 billion, was the largest filing in the history of the United States.\textsuperscript{127} The event significantly exacerbated the crisis.\textsuperscript{128} In the same month, Bank of America acquired Merrill Lynch, and the

\textsuperscript{118} For a consideration of the normative conclusions to be drawn from the recession, see infra Part II.B.
\textsuperscript{119} See POSNER, supra note 114, at vii.
\textsuperscript{120} See id. at 31–34 (noting the vast increase in consumer debt and further observing that "in the years leading up to the current depression, the personal savings rate of Americans had plummeted").
\textsuperscript{121} See id. at vii–xi.
\textsuperscript{122} See id. at 66–68.
\textsuperscript{123} See id. at 68.
\textsuperscript{124} See id. at 209.
\textsuperscript{125} See id. at 133, 274 (characterizing the decision "to allow Lehman Brothers to slip into bankruptcy . . . as the single biggest blunder to date in the response to the gathering storm").
\textsuperscript{126} See What Next?, ECONOMIST, Sept. 20, 2008, at 19–20 (surveying the week's events, opining that "[i]t is no hyperbole to say that for an inkling of what is at stake, you have only to study the 1930s," and concluding that it had been "a black week").
\textsuperscript{128} See POSNER, supra note 114, at 274; Accelerating Downhill, ECONOMIST, Jan. 17, 2009, at 13–14.
U.S. government nationalized American International Group (AIG). Serious questions began to arise regarding the solvency of the U.S. financial system.

Crippled by large amounts of toxic securities tied to falling house prices and short of capital from the ensuing losses, banks began hoarding cash. Credit markets froze, the issuance of commercial paper ceased, and, lacking the ability to borrow, companies were unable to conduct business as usual. Housing prices began to drop sharply. Consumer spending, which had depended in significant part on credit, fell as refinancing became more difficult. The U.S. economy was officially in recession since December 2007. Stocks plummeted. $30 trillion in global stock market value was lost in 2008. Although at first the world economy appeared sheltered from these effects by continuing growth in developing economies, these, too, suffered catastrophic effects as the crisis went global.

One Western country, Iceland, went bankrupt, resulting in significant popular unrest and the collapse of its government.

In an attempt to stem the tide, the U.S. government passed the $700 billion Emergency Economic Stabilization Act in October 2008, which created the Troubled Assets Relief Program (TARP) to rescue banks from what was erroneously considered to be a liquidity problem. This action was followed by the $787 billion American Recovery and Reinvestment Act on February 17, 2009 to counter the economic downturn and lead

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129. See POSNER, supra note 114, at viii.
133. See POSNER, supra note 114, at 275.
141. In fact, it was a solvency problem. See POSNER, supra note 114, at 64–74.
the U.S. economy back to growth. \footnote{142} The latter legislation allocated $499 billion for federal spending programs, designed to compensate for the decrease in spending from the private sector, and $288 billion in tax relief to spur consumer spending. \footnote{143}

The U.S. economy has largely stabilized and has returned to a modest level of growth. \footnote{144} Nevertheless, the long-term economic outlook remains worrisome. \footnote{145} Unemployment remains stuck at an unwelcome 9.7\%, \footnote{146} which understates matters when one considers people who are working part time or not in their preferred line of work. Including the stimulus package, total U.S. financial commitments aimed at tackling the crisis have neared $13 trillion—a figure that approaches the U.S.'s annual GDP. \footnote{147} U.S. public debt now exceeds sixty percent of GDP. The risk of inflation looms, especially given the Federal Reserve's share of the liability. \footnote{148} In this event, policymakers will be faced with a decidedly unpleasant set of choices—pay for government debt through inflation or induce a recession, either by dramatically hiking taxes or by having the Fed increase interest rates significantly and take cash out of the system. \footnote{149}

\footnotetext[145]{145. See Annys Shin, Federal Reserve Leaders See Economic Progress, WASH. POST, May 21, 2009, at A15.}
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\footnotetext[148]{148. Id.; see also POSNER, supra note 114, at 273.}
\footnotetext[149]{149. Posner, supra note 147.}
How did this economic catastrophe occur? The explanation is of the utmost importance for regulatory policy, macroeconomics, and antitrust law. Although policy experts will debate how we can prevent a similar crisis in the future, most people will agree that a number of major institutional weaknesses must be addressed. These include asymmetric regulatory policy, which leaves a truly global financial system subject to national control with limited international harmonization; gaps in regulatory oversight, including hedge and private equity funds; the inadequate performance of credit rating agencies; and the lack of proper enforcement of adequate capitalization requirements. The pressing question for this Article is what guidance the recession provides for future competition policy—an issue that the following Part addresses in detail. Despite the Justice Department’s and FTC officials’ pronouncements to the contrary, the crisis has scant relation to the economic principles that inform competition policy.

B. The Causes of the Crisis Have Little to Do with Price Theory in Antitrust Markets

A dispassionate inquiry into the crisis reveals remarkably little about the specific assumptions that underlie antitrust theory. Notwithstanding this fact, many employ the global recession to justify an aggressive expansion in antitrust enforcement, particularly against unilateral conduct and merger activity. The head of the Justice Department’s Antitrust Division, Christine Varney, has opined that “[c]onsumers have been waiting for the markets to correct themselves, but the financial crisis has shown they haven’t.” She has promised that the DOJ will

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150. Although this Part seeks to provide a reasonably detailed explanation of how and why the economic crisis occurred, such that the reader can properly interpret the consequences of the global recession for macroeconomic and, more importantly for this Article, antitrust policy, a full and authoritative treatment of the subject would require space far in excess of what is feasible for an article. Readers who seek a more detailed treatment of the crisis should look to any of a number of excellent books. See, e.g., POSNER, supra note 114; JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSED, PROLONGED, AND WORSENED THE FINANCIAL CRISIS (2009); MARK ZANDI, FINANCIAL SHOCK: A 360° LOOK AT THE SUBPRIME MORTGAGE IMPELSON, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS (2008).

151. Notably, some weaknesses are already being resolved. For example, the market for credit-default swaps has transformed itself in the short time since the onset of the crisis.

152. Puzzanghera, supra note 12.
engage in a far more interventionist policy than it did during the Bush administration. She even suggested that lax antitrust enforcement permitted companies to grow so big that their looming failure fueled the crisis. The reasons behind the recession do not support these positions.

An impressionistic appraisal of the credit crisis might lead an antitrust activist to spout platitudes about capitalism having failed, free markets being defective, and economic theory having been undermined. These assertions, however, are uncritical. Free-market ideology indeed pervades modern antitrust jurisprudence, at least in the United States. At first glance, one might draw the casual inference that a systemic failure in the financial markets undermines assumptions governing free-market processes in other contexts. But this inference is far too general to yield reliable conclusions.

Markets are said to self-correct for antitrust purposes when supracompetitive returns spur entry that is sufficient to restore market output to optimal levels. The tendency of capital to move toward markets bearing the highest return is a critical component of the restorative process. This trait, long considered to be a definitive characteristic of free markets, is driven by the incentive to maximize profits. In the process, it spurs a variety of socially desirable phenomena such as innovation, risk-taking, and price-cutting.

The ensuing flow of capital creates a self-restoring process of competition. In assessing the commercial impact of a challenged practice, antitrust enforcers place great—often dispositive—weight on the ability of the market to correct any distortions created by the behavior under scrutiny. Often, there will be some uncertainty as to whether an anticompetitive effect exists. In such cases, U.S. law typically errs on the side of underenforcement, trusting the process of entry, incumbent output expansion, and competition to produce optimal outcomes.

Thus, antitrust law is not a system of direct government regulation. Rather, it is a policy tool designed to protect the function-
ing of the free market.\textsuperscript{157} The law presumes that an unhindered competitive process allows capital to flow to its highest value uses, thus ensuring that allocative and dynamic efficiency will follow. A company may legally set monopoly prices,\textsuperscript{158} injure and destroy its rivals on the basis of innate superiority,\textsuperscript{159} and engage in almost any conduct that results in only fleeting power over price.\textsuperscript{160} Only "where a firm with monopoly power interferes with natural economic forces which would otherwise dissipate its monopoly" will antitrust law be implicated.\textsuperscript{161}

In short, market forces tend to erode anticompetitive effects. U.S. law places considerable faith in the ability of the market to have this effect, but this trust in market forces is far from absolute. Instead, regulators make case-by-case inquiries into the nature of specific industries to judge the likelihood, speed, and efficacy of entry in response to supracompetitive prices. Free-market economics as applied to contemporary antitrust policy is not an ideology; it is a nuanced tool. Faith in the market becomes most obvious—and controversial—when it is employed to produce policy conclusions to empirically and theoretically indeterminate problems. Dominant-firm misconduct, which produces short-run harm, but possibly overrides long-run gains, is the paradigmatic example. But the role of the market in macroeconomics is quite different, as is the need for government intervention. Government action is central to macroeconomic policy; few have suggested that market forces alone produce optimal long-run growth and stability. The definition

\textsuperscript{157} See Cascade Health Solutions v. PeaceHealth, 515 F.3d 883, 902-03 (9th Cir. 2008) ("One of the challenges of interpreting and enforcing the amorphous prohibitions of §§ 1 and 2 of the Sherman Act is ensuring that the antitrust laws do not punish economic behavior that benefits consumers and will not cause long-run injury to the competitive process.").


\textsuperscript{160} See Colorado Interstate Gas Co. v. Natural Gas Pipeline Co., 885 F.2d 683, 695-96 (10th Cir. 1989); Williamsburg Wax Museum, Inc. v. Historic Figures, Inc., 810 F.2d 243, 252 (D.C. Cir. 1987); Dimmitt Agri Indus., Inc. v. CPC Int’l, Inc., 679 F.2d 516, 530 (5th Cir. 1982); see also William M. Landes & Richard A. Posner, Market Power in Antitrust Cases, 94 HARV. L. REV. 937, 959 (1981). The only exception relates to per se illegal conduct, such as naked price-fixing and market allocation.

\textsuperscript{161} In re Borden, Inc., 92 F.T.C. 669, 795 (1978).
of market self-correction in antitrust law (monopoly profits attract entry) obviously is quite different from self-correction in the macro-economy (recovery from recession, deflation, excessive inflation, or the myriad other conditions that can afflict an economy). Although the macro-economy tends to reach equilibrium, various shocks can upset that balance in a way that capitalist forces will not self-correct.\footnote{162. See POSNER, supra note 114, at 5–7.}

One such shock involves deflation brought about by recession, which creates a particularly dangerous downward spiral.\footnote{163. See Ben S. Bernanke, Remarks Before the National Economists Club: Deflation: Making Sure "It" Doesn't Happen Here (Nov. 21, 2002), available at http://www.federalreserve.gov/BOARDDOC/SPEECHES/2002/20021121/default.htm.} As the value of money increases, consumers' savings increase in real value, and if they are acting rationally, consumers will cease spending. This results in a drop in industry demand, which requires companies to cut output and lower prices further, in part by reducing wages and laying off workers. This, in turn, steepens the increase in the value of money and accentuates the deflation. The market cannot rescue itself in these circumstances. The government will need to act by implementing a significant monetary or fiscal measure, or both.\footnote{164. See POSNER, supra note 114, at 7–8.} The response of the United States to the current crisis has focused precisely on such corrective action, in an enormously costly—though apparently successful—attempt to stave off a ruinous downward spiral of deflation.\footnote{165. Id.}

The crucial distinction between the relevance of free-market forces to antitrust and to macroeconomics is that competition law is just a single, limited tool that can prevent market failures at the micro level. The law seeks to prevent failures by ensuring a robust, dynamic, and competitive market process. If failures distinct from company-level misconduct arise, antitrust law has nothing to say. Market failures in the macro context require urgent government intervention. But the cause, and hence normative consequences, of these macro failures may be entirely irrelevant to the factors of concern at the antitrust level.

With respect to financial-sector policy, the role of the market is again distinct. The incentive to maximize profits, which fuels the self-correcting nature of the market in antitrust cases,
causes problems in the banking industry. Here, faith in the market is in many ways reversed. Antitrust is not concerned with the larger functioning of the economy; it is concerned only with the distortion-creating activities of firms with market power. Bank regulation is concerned with, and certainly implicates, the economy as a whole, but profit maximization—a phenomenon that induces trust in the market from a competition standpoint—also counsels limits on faith in the market for larger regulatory purposes. The pursuit of ever-greater profits in the banking sector, which is magnified by risk-taking incentives in the form of FDIC insurance, securitization, and high discount rates, will not yield a desirable and stable equilibrium. Profit maximization in an entirely unregulated banking environment will yield successive boom and bust cycles.

The preceding discussion illustrates some of the major distinctions between the principles of regulation and the far narrower area of antitrust economics. This Part proceeds by considering in greater detail three particular areas of competitive concern: concerted conduct, mergers, and unilateral behavior. The Article considers the impact of the crisis on the economic theory applicable to each area, and concludes that few substantive alterations are necessary. The approach of the United States to antitrust law—long dominated by price theory and economic conservatism—is likely to coalesce to a significant degree with the jurisdiction whose competition policy it has long criticized, the EU.166

1. Concerted Conduct

The instructive power of economics provides the most assured normative guidance in the area of concerted conduct, which involves various forms of collaborative arrangement be-

between entities that share a horizontal or vertical relationship. Economic theory is sufficiently definite within this field that the economic crisis could not conceivably justify any substantive alteration. Price theory illustrates the evil of monopoly and explains why cartels should be prosecuted on all possible bases.\textsuperscript{167} Game theory demonstrates the circumstances in which communication among competitors threatens to act as a facilitative component of tacit collusion in a concentrated market.

So informed by economics, the law has developed a rich set of principles for facilitating the efficient flow of information through trade associations and similar vehicles, but also for prohibiting such interchanges as might prove conducive to nefarious outcomes.\textsuperscript{168} Similarly, the economics of joint ventures indicate that fringe rivals acting in concert to exclude others may prove to be highly competitive, as they compete with an otherwise more efficient, dominant company.\textsuperscript{169}

Section 1 enforcement will remain largely untouched by the crisis because the economic analysis at issue generally does not entail the balancing of indeterminate and incalculable long-term effects with immediate and observable results. Cartels restrict output, causing harm in the short run, without yielding a concomitant, offsetting positive effect in the future.\textsuperscript{170} They can therefore be summarily condemned. Similarly, economic theory is sufficiently robust that the exchange of much information, including cost and price specifics, will likely yield greater competition in unconcentrated market structures.\textsuperscript{171} These principles are widely accepted and largely uncontroversial.

The meltdown of the financial markets has revealed many weaknesses in macroeconomic and regulatory policy, but it has not demonstrated any weaknesses in the long-established rules that govern conduct and communication between horizontal competitors. Neither U.S. nor EU enforcement agencies have

\textsuperscript{167} See Posner, supra note 35, at 9–32.


\textsuperscript{169} See generally id. at 1; Posner, supra note 35, at 136–40.

\textsuperscript{170} In some circumstances, however, cartels will not have long-run anticompetitive effect, as the increase in price to supracompetitive levels will spur rapid entry. See Roger D. Blair, James Mak & Carl Bonham, Collusive Duopoly: The Economic Effects of the Aloha and Hawaiian Airlines' Agreement to Reduce Capacity, 74 Antitrust L.J. 409, 436 (2007).

advocated a shift in ideology other than to maximize the number of cases brought against cartels.\textsuperscript{172} This is precisely the appropriate approach, especially in a time of economic contraction, because cartels depress output and therefore exacerbate recessions.\textsuperscript{173} One who doubts this point need only look at the consequences of President Roosevelt’s decision to suspend the antitrust laws at the onset of the Great Depression.\textsuperscript{174}

2. Merger Policy

Merger enforcement is a more contentious area of antitrust concern. It tends to implicate political biases concerning the appropriate size and scope of merging entities,\textsuperscript{175} as well as the proper frequency of merger challenge.\textsuperscript{176} Nevertheless, the underlying economics are clear and the only major debate within contemporary academic discourse is whether to derive sanction decisions from consumer or aggregate-welfare models.\textsuperscript{177} Sophisticated empirical techniques often allow the government to ascertain the degree of price competition in specific geographic markets between two merging entities.\textsuperscript{178} These tools

\textsuperscript{172} See Whitener, supra note 12; Puzzanghera, supra note 12.
\textsuperscript{173} See John D. Harkrider, Lessons from the Great Depression, 23 ANTITRUST 6, 9 (2009).
\textsuperscript{174} See id.
\textsuperscript{175} One need merely observe the debate leading up to the XM-Sirius merger, which largely divided along party lines. For a discussion of the economics applicable to that merger, see J. Gregory Sidak & Hal J. Singer, Evaluating Market Power with Two-Sided Demand and Preemptive Offers to Dissipate Monopoly Rent: Lessons for High-Technology Industries from the Antitrust Division’s Approval of the XM-Sirius Satellite Radio Merger, 4 J. COMPETITION L. & ECON. 697 (2008).
\textsuperscript{176} Democratic administrations are likely to be significantly tougher on merger enforcement than their Republican counterparts are. See Julie Johnsson et al., 346 Days: With less than a year left in the Bush administration’s tenure, some see an urgency to push through mergers in a pro-business climate, CHI. TRIB., Feb. 8, 2008, at 1.
\textsuperscript{177} Aggregate-welfare models place as much relevance on producer-side cost savings as they do on merger-specific consumers’ benefits. Oliver Williamson famously demonstrated that output-restricting mergers, which increase prices for consumers, may be socially desirable if even a relatively small productive efficiency gain is achieved. See Oliver E. Williamson, Economics as an Antitrust Defense: The Welfare Tradeoffs, 58 AM. ECON. REV. 18 (1968). At present, so-called “Williamson mergers” are not allowed in the United States. Debate on whether this prohibition is appropriate continues. See Alan Devlin & Bruno Peixoto, Reformulating Antitrust Rules to Safeguard Societal Wealth, 13 STAN. J.L. BUS. & FIN. 225, 231–32 (2007) (making the case for an aggregate-welfare approach to antitrust policy).
\textsuperscript{178} The classic example is FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997). See POSNER, supra note 35, at 157–58 (explaining the econometric techniques employed in
have enabled the government to make unlawful any acquisition that might result in a substantial lessening of competition.\textsuperscript{179} These tenets of modern merger analysis remain undisturbed. In light of the crisis, then, one must ask: Apart from the changes in the political climate, what applicable rules of economics have been called into question? The only conceivable answer is that assumptions of prompt entry into some markets may need to be revisited throughout the credit crisis.\textsuperscript{180} Lending has yet to return to pre-crisis levels, though the government has succeeded in loosening the credit markets.\textsuperscript{181} Although the Chicago School has debunked the prior assumption that capital requirements constitute barriers to entry, the cost of capital is unquestionably an entry barrier when it is higher for an entrant than it is for an incumbent.\textsuperscript{182} In situations where prompt entry is a condition for post-merger competition, or in conglomerate mergers where rivals’ access to capital is an important consideration in analyzing the danger of cross-subsidization, a dearth of credit may be highly relevant to the decision to sanction.\textsuperscript{183}

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\textsuperscript{180} The feasibility, likelihood, and effect of post-merger entry arguably play the most important role in the merger assessment process after market definition. See \textit{Fed. Trade Comm’n \& U.S. Dep’t of Justice, Horizontal Merger Guidelines} §§ 3.0–3.4 (1997). Indeed, U.S. courts have previously chastised the enforcement agencies for seeking to enjoin combinations when post-merger entry is likely. Perhaps the most important case under this heading is \textit{United States v. Syufy Enters.}, 903 F.2d 659 (9th Cir. 1990).


\textsuperscript{182} See \textit{Posner}, supra note 35, at 115.

\textsuperscript{183} For example, the U.S. Justice Department approved a controversial merger between General Electric and Honeywell that was subsequently blocked by the European Commission. The Commission was concerned, in part, by GE’s large capital reserves, which GE-Honeywell would be able to use to fund its activities in various markets. GE-Honeywell’s competitors, by contrast, would not have access to such funds. The Justice Department rejected this contention, reasoning that “[c]apital markets generally work very efficiently and there is no obvious reason, absent some clearly defined market imperfection, why GE’s cost of capital for a particular project should be any lower than that of its rivals.” \textit{Majoras}, supra note 84, at 8. Such a conclusion might lie on shakier foundation were it reached in the present, credit-deprived economy.
How much weight should we put on this concern? Not much. If credit seizes up, the assumption that prompt entry will occur—financed by the capital markets—may need to be revisited. But this is likely to be an ephemeral concern. Once the financial industry sufficiently deleverages and markets stabilize, the flow of credit is likely to resume once more. Thus, the dearth of lending itself reveals no systemic, long-term weakness that requires us to revisit a priori assumptions governing the expectation of market entry. Indeed, no such controlling assumption exists, as inquiries into the speed, efficacy, and likelihood of entry are necessarily conducted on a case-and-market-specific basis. Ultimately, capital will resume flowing to markets where supracompetitive profits prevail.

In lieu of any sweeping or substantive alteration to current merger doctrine, the better course in close cases is to consider enhanced use of Section 7 to challenge consummated mergers once anticompetitive effect has in fact been demonstrated. This approach would have significant advantages. First, it shifts the challenge decision from an information-deprived ex ante setting to a fully informed ex post context, where actual direct effects can be measured. Second, the threat of ex post attack may powerfully inhibit the decision of a newly merged entity to restrict output and raise price, knowing that such actions could draw the wrath of enforcement agencies. The downside lies in the relative legal uncertainty from the perspective of the merging entities, though this should not be exaggerated, given that the risk of ex post challenge has always been a factor for companies that are considering a merger.

The more fundamental issue relates to the systemic tension between concentration, efficiency, and stability. Because the prohibition on entities carrying out both investment and commercial banking activities was lifted, global financial markets have been increasingly dominated by a small number of enormous institutions. This concentration is driven by innate

184. See Reazin v. Blue Cross & Blue Shield of Kan., Inc., 899 F.2d 951, 968 (10th Cir. 1990).
186. See HOWARD DAVIES & DAVID GREEN, GLOBAL FINANCIAL REGULATION 8–9 (2008).
characteristics of the market, including certain “winner-takes-all” traits.187 Such outcomes arise in markets that display diminishing long-run average cost over a significant range of output—a phenomenon known as subadditivity.188 But this alone cannot be the full story. Given the conglomerate nature of the markets involved, such that these huge banks provide a vast array of different services, significant economies of scope must be at play.189 Unfortunately, quantifying these gains seems impossible, though one might reasonably infer that a forced reduction in scale and scope would be enormously costly if conducted on a large scale.

As noted, however, this efficiency-driven consolidation has a serious downside. The failure of banks carries huge externalities because of the unique position banks occupy in financial markets by providing liquidity and facilitating maturity transformation.190 Certain banks, given their size and the volume of commerce they affect, may be so important to the economy that their failure would be devastating.191 In such circumstances, the social cost of rescuing the relevant institutions will be less than the ruinous cascade effects that may surge through the financial sector. This is the state of being “too big to fail,” which both the FTC and Justice Department have identified as an outcome that antitrust law can and should prevent.192

This concern is legitimate. The crisis has revealed unacceptable systemic weaknesses in the financial sector, frailties that required the U.S. government’s urgent—some would say frantic—bailout of numerous key banks lest their failure lead to the collapse of the broader economy. If these traits are the result of efficiency gains, then a very real cost-benefit analysis

187. Id. at 9.
190. For the classic discussion of this point, see WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (2005).
192. See Whitener, supra note 12; Puzzanghera, supra note 12.
193. See POSNER, supra note 114, at ix.
must be undertaken. To prevent this phenomenon, however, regulators would have to restructure the existing market radically. Banks would have to be broken up and their various constituent parts divested. All associated economies would be lost.

Even if it were justified—and this is the key point—there is no basis in contemporary antitrust doctrine for such a course of action.\textsuperscript{194} Competition enforcers have no mandate to engage in such interventionist conduct. As the Seventh Circuit has observed, “the antitrust laws do not deputize district judges as one-man regulatory agencies.”\textsuperscript{195} Presumably, neither Commissioner Rosch nor Ms. Varney had in mind the idea of active reorganization of the market. Instead, they surely meant to signal an end to merger clearance that would facilitate further concentration within the market. Of course, if such mergers were expected to yield negative price effects, they would be prohibited under today’s guidelines. But should the agencies seek to enjoin combinations that result in greater size, but not higher prices?

At first glance, one might think so, but prohibiting mergers that will not result in price increases would require the rewriting of over three decades of antitrust jurisprudence.\textsuperscript{196} Conglomerate mergers, which are combinations of firms that are neither vertically nor horizontally related, do not bear the potential for unilateral or coordinated price effects and have not been an object of U.S. antitrust concern in this generation.\textsuperscript{197}

\textsuperscript{194} As the Seventh Circuit classically explained, “[n]o court has yet said that the accumulation and use of great power is unlawful per se. Bigness is no crime . . . .” United States v. N.Y. Great Atl. & Pac. Tea Co., 173 F.2d 79, 87 (7th Cir. 1949); accord Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263, 274 (2d Cir. 1979) (distinguishing mere size from market power); Bailey’s Bakery, Ltd. v. Cont’l Baking Co., 235 F. Supp. 705, 718 (D. Haw. 1964), aff’d, 401 F.2d 182 (9th Cir. 1968) (“Mere size, nor continued exercise of lawful powers by even a monopolist, is not illegal . . . .”).

\textsuperscript{195} Chi. Prof’l Sports, Ltd. v. Nat’l Basketball Ass’n, 95 F.3d 593, 597 (7th Cir. 1996).

\textsuperscript{196} Alcoa, the landmark case that stood for the proposition that a company can violate the antitrust laws by monopolizing a market on the sole basis of efficiency, has been characterized as “discredited,” “defunct,” and “no longer the law.” J. Gregory Sidak, Abolishing the Price Squeeze as a Theory of Antitrust Liability, 4 J. COMPETITION L. & ECON. 279, 304 (2008) (quoting POSNER, supra note 35, at 103, 196, 250, 263).

The economic literature suggests that conglomerate mergers do not result in the direct acquisition of monopoly power and therefore are least likely to be worthy objects of antitrust concern.\textsuperscript{198} This is especially true where antitrust is applied in favor of allocative efficiency.\textsuperscript{199} Debate continues regarding the possible anticompetitive consequences of conglomerate mergers, including raising rivals’ costs through cross-subsidization, bundling, tie-in, range effects, and control of potential upstream and downstream channels of commerce.\textsuperscript{200} The Chicago School has found such claims to be attenuated and unworthy of attention and has been successful in persuading the U.S. courts and enforcement agencies to adopt its view.\textsuperscript{201} For jurisdictions whose sociopolitical climates are adverse to sheer size and to efficiency that threatens to yield a long-run monopoly, however, the approach is quite different.\textsuperscript{202} The European Commission and courts have been actively hostile toward conglomerate mergers that yield scope efficiencies and large entities that threaten the viability of incumbent, less efficient competitors.\textsuperscript{203}

If the FTC and the Justice Department wish to prevent companies from growing too big to fail, they will have to reorient antitrust policy away from concerns of efficiency. Since the 1960s, courts have rejected the view that antitrust can prevent a com-


\textsuperscript{201} See BORK, supra note 61, at 257; POSTER, supra note 35, at 131 n.30; George Stephanov Georgiev, Recent Development, \textit{Bridging the Divide? The European Court of First Instance Judgment in GE/Honeywell}, 31 YALE J. INT’L L. 518, 519 (2006).

\textsuperscript{202} This includes the Warren Court era in the United States where antitrust largely reflected populist principles. For a contemporaneous articulation of the view at that time, see Harlan M. Blake, \textit{Conglomerate Mergers and the Antitrust Laws}, 73 COLUM. L. REV. 555, 586 (1973).

pany from growing too large in size.\textsuperscript{204} The Chicago School demonstrated that industry concentration and increasing profits are more likely to reflect enhanced efficiency than market power.\textsuperscript{205} If one constrains the efficiency-enhancing growth of a company, both consumers and the economy will pay a price.\textsuperscript{206} Judge Learned Hand’s implicit suggestion in \textit{Alcoa} that a company can violate Section 2 merely by being efficient\textsuperscript{207} “has been questioned by just about everyone who has taken a close look at it.”\textsuperscript{208}

Of course, such criticism of \textit{Alcoa} and its progeny was based on the premise that the efficiency benefits associated with scale and scope are not associated with larger social costs, such as the potential for cataclysmic market instability. From the wider perspective of public policy, Ms. Varney’s and Commissioner Rosch’s concern with concentration is understandable. It is precisely the degree of scale and scope, combined with the interconnected nature of modern global finance, that made the crisis so dangerous as to require such urgent intervention.

Nevertheless, if the interconnected nature and increasing concentration of the financial system are problematic, it is not at all clear that the solution lies with competition policy. The closing of regulatory loopholes, proper application of existing securities laws, oversight of previously unregulated activities, international cooperation by financial services authorities, and stringent enforcement of capitalization rules should stabilize the financial system. But if society prohibits growing concentration, which is mandated by Coasian theories of internal efficiency,\textsuperscript{209} whatever gain in stability that might thereby be attained may be outweighed by the associated efficiency losses.

\textsuperscript{204} See, e.g., United States v. Aluminum Co. of America (\textit{Alcoa}), 148 F.2d 416, 421, 429–30 (2d Cir. 1945).
\textsuperscript{207} Alcoa, 148 F.2d at 430–32.
\textsuperscript{208} United States v. Syufy Enters., 903 F.2d 659, 668 (9th Cir. 1990) (citations omitted).
Two further factors suggest that the FTC and the Justice Department's desire to challenge size-increasing mergers is ill-placed. First, there is tremendous benefit to tying competition doctrine to a specific, identifiable goal. Of course, antitrust law is a manifestation of public policy. On that basis, one could quite reasonably posit that public policy rues the presence of companies whose economic power is such that their failure threatens the larger economy. But competition law is not well-placed to incorporate such a principle in addition to efficiency. Self-contradictory and incongruous principles do not lend themselves to harmonious application. One need merely observe the Sisyphean efforts of the Warren Court in attempting to reconcile economics, populism, and constrained protectionism in its jurisprudence. The result has been characterized in variously colorful terms, perhaps most poignantly by Judge Posner as an "intellectual disgrace."  

There is a second, likely fatal, objection to the enforcement agencies' plan to prevent further concentration within the financial markets. If strong economies of scale and scope are indeed present in this industry, then concentration is inevitable irrespective of merger policy. Companies can achieve precisely the same result by merger as they can through internal growth—a process with which antitrust law is much less concerned. If efficiencies are indeed at play, then the banking industry will remain concentrated and Ms. Varney's and Commissioner Rosch's efforts will prove futile. The only "solution" in this eventuality—a notably inferior one to adopting a proper system of regulation—would be to introduce legislation akin to the now-repealed Glass-Steagall Act.

3. Unilateral Behavior by the Dominant Firm

The constraints properly brought to bear on dominant-firm behavior likely make up the most contentious, divisive, and uncertain area of competition policy. The difficulty arises from the epistemological limitations inherent in economic analysis of such conduct. The regulation of unilateral behavior raises a variety of difficult issues. Most important is that imposing behav-

210. POSNER, supra note 35, at viii.
ioral limitations on monopolists invariably reduces their profits, thus diminishing the incentive to succeed in the first place. Yet, much conduct by a dominant firm carries potential exclusionary effect, which restricts the ability of rival firms to compete, with negative consequences for short-term consumer welfare. To complicate matters, short-term exclusivity and anticompetitive effect can be potent fuel for dynamic innovation and long-term consumer welfare. A wide variety of unilateral conduct—including bundling, requirements contracting, refusals to supply rivals, and refusals to cooperate with rivals—implicates both short- and long-term effects. The immediate economic effects are often negative, but these may mask offsetting future gains. Economists currently lack the ability to ascertain and quantify the consequences of this conduct. Thus, cost-benefit analyses cannot be performed, resulting in a critical knowledge deficit and leaving policymakers in a difficult position.

Interpreting these factors, U.S. antitrust law has developed a body of jurisprudence based largely on the teachings of decision theory.212 Adopting Judge Easterbrook’s contention that antitrust should err on the side of avoiding Type I errors213 because Type II errors214 will be corrected by free-market forces, the law has approached claims of dominant firm misconduct with skepticism.215 This agnosticism reached its zenith in the Justice Department’s September 2008 Guidelines on Section 2 enforcement, which counseled challenging unilateral conduct only where “its anticompetitive effects are shown to be substantially disproportionate to any associated procompetitive effects.”216

The new Justice Department Antitrust Division has dismissed this approach because, in light of the global recession, “we can no longer rely upon the marketplace alone to ensure that competition and consumers will be protected.”217 Ms.
Varney's conclusion would be justified if the crisis revealed a failure of rationality. But the crisis has revealed no such thing. The primary assumption underlying antitrust economics—that commercial entities will seek to maximize profits—remains unscathed. Indeed, if the crisis has taught anything, it is that corporate entities have been myopic in their pursuit of short-run profits. Although this inadequately constrained conduct proved costly to the financial system as a whole, such behavior is precisely what spurs entry into monopolized markets. The former result of unconstrained profit-maximization can and should be subject to regulatory constraints that prevent excessive externalities. But the broad expectation that firms will act in their best financial interests, at least in the short run, is not undermined by the crisis.

One prominent enforcer appears to have reached an opposing conclusion. Surveying the economic crisis, Commissioner Rosch suggested that antitrust enforcers might benefit by looking to the literature on behavioral economics. This discipline incorporates insights from psychology to enrich economics with a more realistic set of assumptions. The independent relevance of this branch of economics continues to be controversial, with some leading commentators positing that the accuracy of predictions is far more important than the realism of assumptions. But its invocation by Commissioner Rosch can be explained only on the basis that he sees some assumptions underlying antitrust law as either unrealistic or undermined by the global recession.

Given that the only assumption that underlies all modern economic analysis applied to antitrust is profit maximization, one can surmise that this assumption is what Commissioner Rosch questions. But the concept of rational choice, much derided in some
fields of its purported application, would seem to be a reasonably accurate depiction of real-world corporate behavior. Of course, it is an imperfect assumption, given the well-known asymmetry between shareholders' interests and direct management. And the global recession has demonstrated that rationality is indeed bounded in that firms do not seem to internalize the small risk of a financial crisis in their decision making. But directors who repeatedly lead their company away from profit-maximizing practices are certain to face resistance and, ultimately, replacement. More fundamentally still, in a vibrant economy where competition demands efficiency for a company to survive, irrational firms are likely to fail. Unsurprisingly, then, the Supreme Court has embraced this assumption, requiring that antitrust plaintiffs' theories make "economic sense." Indeed, the accuracy of profit-maximization as a normative tool for guiding antitrust policy has been so influential that behavioral economists have paid virtually no attention to the field.

Commissioner Rosch's promotion of behavioral economics within the field of antitrust would not only be unprecedented, but it would also fly in the face of prevailing opinion. This objection is by no means fatal, but one would expect some basis for abandoning the edifice of rational choice upon which virtually all antitrust doctrine is built. Instead, all we are left with is a broad assertion that markets have been shown not to work efficiently.

The sole exception, as in merger analysis, is a symptom of the recession, not an inherent trait of the free market. It is neither a harbinger nor a cause of the crisis. This exception, of course, is the freezing in the credit markets that reached a peak in October 10, 2008 when the LIBOR/Overnight Index Swap spread (a proxy for bank solvency and hence the need for capital) hit 364 basis points, up from an established ten before the

224. See POSNER, supra note 114, at 79.
Although the passage of gargantuan stimulus packages, including the $700 billion TARP, has eased the dearth of lending, credit remains more costly than before the onset of the recession. This phenomenon unquestionably implicates the ability of the market to respond to artificial distortions created by dominant-firm behavior. It limits the ability of markets to self-correct, and legitimately calls into question the exclusionary conduct of incumbent firms. Nevertheless, as noted above, the credit crisis will not last forever; already credit markets have sputtered back to life. As the flow of credit resumes, this factor will become defunct.

In sum, dominant-firm misconduct is a divisive area of antitrust policy and will continue to be so in light of the crisis. Nevertheless, the various causes of the recession—government distortions in the form of low interest rates and quasi-guarantees of mortgage providers, an influx of foreign capital, swathes of commercial activity not subject to regulatory oversight, the excessive complexity of financial derivatives that made them impossible to value, concentration and interdependence within the financial sector, and mark-to-market accounting rules—say nothing about the specific policies underlying Section 2 enforcement. The inability of the macroeconomy to self-correct, as explained above, emanates from a downward spiral in the event of deflationary pressures, and has little relation to the process by which antitrust markets self-correct by spurring entry.

Of course, given the indeterminism that characterizes the business phenomena at issue in abuse-of-dominance cases, the Justice Department acted reasonably in advocating more interventionist antitrust policy against monopoly and in withdrawing the prior administration’s Section 2 report. Nevertheless, the proclaimed justification for the move—that the market will no longer self-correct—is either an obtuse or intellectually dishonest reading of the crisis.

228. See id.
4. Political Repercussions

Because nothing in the global market crisis necessarily seems to implicate microeconomic theory, at least insofar as distinguished from the embrace of political ideology, the only remaining question is whether political theory itself has been affected by the crisis. No doubt it has, although the precise long-run shift in ideology remains to be seen. Prior revolutions in competition policy have taken place amid larger sociopolitical changes. Faith in the free market—a critical feature of the post-Warren Court era—has unquestionably been undermined, with the result that the public, and hence politicians, are likely to become less accepting of dominance. Antitrust condemnation of potentially abusive monopoly behavior will surely intensify. In this political respect—and in this respect only—the agnosticism of the Chicago School may indeed be mortally wounded.

U.S. enforcement agencies have long spoken of a serious transatlantic asymmetry concerning the degree of faith properly placed in the market to yield desirable outcomes and the relative ability of regulators to remedy imperfections before the market can do so. Yet, there is already much talk of the U.S. antitrust regime becoming more harmonious with EU competition law. The shift in ideology brought about or facilitated by the crisis is, apparently, significant.

Although political reaction to the recession is worrisome in the United States, it is far worse in Europe—a jurisdiction that was likely predisposed against the free market principles that have long pervaded U.S. politics even before the crisis. In 2007, French President Nicolas Sarkozy succeeded in removing from the European treaty the explicit objective that the “Union shall offer its citizens... an internal market where competition is

229. See Kolasky, supra note 14, at 537 (“In the U.S., we have very little confidence in the ability of regulators to make these judgments, which would necessarily involve predictions far out into the future. U.S. antitrust agencies believe, in the immortal words of my favorite golfer, Tin Cup McAvoy, that they need to ‘be humble.’ The agencies also have more confidence in the self-correcting nature of markets. This confidence is especially strong when the markets are populated by strong rivals and strong buyers, who will usually find ways to protect themselves from an aspiring monopolist. This strong belief in markets and humility in their predictive abilities lead U.S. authorities to be skeptical of claims by rivals that a merger will lead to their ultimate demise and to demand strong empirical proof before we will accept such claims.” (footnotes omitted)).
An objective that the “Union shall establish an internal market” is all that is left in its place. This coup served as an effective backdrop to the ensuing crisis. Mr. Sarkozy has made clear that his rejection of Chicago principles is absolute, asserting that “[l]aissez-faire is finished. The all-powerful market that is always right is finished.”

The removal of the explicit free-market objective is a serious loss for EU competition policy, and for the European Commission in particular, whose efforts to combat member states’ promotion of state champions and attempts to bypass competition rules have been most valiant. As the global crisis lends substantive support to Sarkozy’s and others’ rejection of free-market competition, the myriad fruits of a dynamic single market will be diluted. Now, more than ever, U.S. promotion of free competition and the economic policy that supports it is needed.

CONCLUSION

The global credit crisis counsels a new direction to antitrust enforcement only if one engages in obtuse reasoning. Assertions that the market and capitalism have failed may be justified in the context of macroeconomic and regulatory policy, and certainly appeal to the populace, but they have no relevance to competition policy. The fundamental tenets of microeconomics that underlie modern U.S. antitrust jurisprudence remain unscathed.

The key to construing antitrust law in light of the crisis is to focus on the distinct role the market plays within this area of the law. Markets self-correct for antitrust purposes when monopoly conditions attract entry. The inability of the macroeconomy to self-correct promptly without government intervention following the 2008 crisis has nothing to do with entry into monopolized markets. It has to do with the urgent need for deleveraging, widespread uncertainty, and the well-understood inability of the market to recover independently from severe deflationary pressures. Though the economy has stabilized and will rebound modestly once the financial sector has sufficiently deleveraged, such recovery is also unrelated to

231. Id.
the idiosyncratic meaning of self-correction for purposes of competition law. Similarly, the market failure that gave rise to the crisis emanated from a wide variety of phenomena—none of which seems to implicate competition policy. Only if one defines "the market" in a wholly overbroad manner can the crisis be read as disproving the restorative nature of markets at the microeconomic level.

When one dissects the crisis with sufficient specificity, it becomes clear that minimal adjustment in competition doctrine is necessary under the rubric of economics. Obviously, the recession has no impact on the theory underlying the rules that currently govern concerted conduct. Cartels restrict output and create deadweight loss—effects that mirror and exacerbate the symptoms of a recession. Enforcers on both sides of the Atlantic have correctly vowed to condemn all instances of improper collaboration between rivals.

The more interesting issue concerns rules that should apply to merger clearance and unilateral conduct. In both fields, antitrust doctrine puts considerable faith in the market. Notwithstanding this fact, however, the market failure associated with the recession has no normative consequence for the antitrust assumption that monopoly conditions attract entry. The financial market meltdown has revealed that commercial actors avidly pursue courses of action that increase profit, at least in the short run. This phenomenon magnifies, rather than dilutes, the economic theory that informs contemporary antitrust rules. The only factor that supports more scrutinizing antitrust standards—the dearth of lending activity—is merely a short-lived symptom, rather than a cause, of the recession. If credit markets freeze, assumptions of entry into capital-intensive industries should be made with some caution.

Thus, enforcers' denunciation of antitrust policy founded on free market ideals is misplaced. Although there are few, if any, normative insights to draw from the crisis as far as antitrust is concerned, the positive effect of the recession is apt to be far greater. Antitrust law, as a tool of public policy, inevitably will reflect the sociopolitical mood of the day. The free market principles of modern antitrust law may be anathema to those who have tired of unbridled capitalism. Nuanced arguments in defense of the status quo may fall on deaf ears. For those who advocate a more interventionist competition regime, the financial crisis provides the perfect backdrop for promoting an agenda
of aggressive enforcement. The new Justice Department and certain FTC commissioners seem to be making use of the opportunity. Of course, the crisis provides a false foundation for such enforcers to reverse course on precedent. Illustratively, the new Justice Department's rejection of the 2008 Section 2 guidelines cannot be tied to any specific teachings of the crisis, but merely to political interpretation. This rejection seems to mark the beginning of a larger movement toward a more intrusive antitrust policy, which is an unfortunate consequence of a crisis that requires no such result.
FACILITATING ECONOMIC RECOVERY AND SUSTAINABLE GROWTH THROUGH REFORM OF THE SECURITIES CLASS-ACTION SYSTEM: EXPLORING ARBITRATION AS AN ALTERNATIVE TO LITIGATION

BRADLEY J. BONDI∗

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INTRODUCTION

In the aftermath of the global economic collapse of 2008, policymakers from around the world have been considering regulations designed to reduce the risk of future economic turmoil. Their focus has been on powers and procedures designed to reduce systemic risk and to help ensure financial stability in the world markets. Although policymakers should explore prophylactic measures and use counterfactual reasoning, they should not confine their analysis to preventing the next crisis. Regulating against the risk of unpredictable disaster—a so-called "black swan"—is imprecise and, if done improperly, can hinder economic growth. Along these lines, policymakers must be cautious to avoid a regulatory overreaction to the current economic problems. In an effort to promote long-term economic prosperity, policymakers should avoid the temptation to overregulate in the near term.

Policymakers also must alleviate unnecessary burdens to economic growth, both in the United States and abroad. But a monetary response, such as a stimulus spending package, provides only short-term economic relief and could cause a host of problems not discussed in this Article. To promote long-term and sustainable growth, policymakers must consider regulatory measures designed to facilitate capital formation and encourage investment, while providing appropriate safeguards against fraud to investors. Of course, the legal and regulatory systems may pose the greatest impediment to economic growth.

1. See GROUP OF TWENTY, DECLARATION: SUMMIT ON FINANCIAL MARKETS AND THE WORLD ECONOMY 1 (2008) (stating that recent efforts to support the global economy and stabilize financial markets must be followed with reforms to prevent another crisis).
3. See Lawrence Leibowitz, Group Executive Vice President & Head of U.S. Mkt. & Global Tech., NYSE Euronext, Inc., Address at the NYSE Euronext Securities Industry and Financial Markets Association Market Structure Conference, Key Issues Facing the Financial Markets: Time to Re-Engage (May 20, 2009), available at http://www.nyse.com/about/nyseviewpoint/1243591675565.html ("We have to be really careful about regulatory and legislative overreaction, at the same time realizing that the Wild West doesn’t serve the public good either.").
4. For example, a recent study by the Committee on Capital Markets Regulation noted that "excessive regulatory costs and risk of litigation are the most likely causes of" the decline in U.S. market share of the global IPO market. LUIGI ZINGALES ET AL., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 38 (2006).
The United States has its own unique hindrance to economic growth: private securities class-action litigation. Along with Canada and Australia, the United States is one of three G-20 nations to permit securities class actions. Although originally envisioned as a means to provide relief to aggrieved investors, securities class-action litigation has become an inefficient and grossly incomplete means of redress for investors, a costly encumbrance to businesses, and a threat to capital formation in the United States.

To be sure, access to a properly administered class-action framework provides aggrieved plaintiffs with a valuable legal recourse. Despite the drawbacks, class actions—as opposed to individual actions—are necessary to avoid the collective action problem that exists when investors accrue claims against publicly held corporations. In the absence of a class action, an individual shareholder might have little incentive to litigate an alleged securities law violation because he would be forced to bear all the costs of litigation while receiving only a fraction of the potential benefits paid to all shareholders. Class-action litigation avoids the collective action problem by allowing a class of shareholders, following the efforts of lead plaintiffs and plaintiffs' attorneys, to share the costs and benefits of a unified action proportionately.

The problem with the existing class-action framework in the United States is the overuse and abuse of the litigation system. The magnitude of securities class-action litigation in the United States is astonishing. Nearly half of all class-action lawsuits in 2004 involved allegations of federal securities law violations. In 2008, 210 securities class-action lawsuits were filed. The number of securities class-action lawsuits appears to have dou-

5. John C. Coffee, Jr., Foreign Issuers Fear Global Class Actions, NAT'L L.J., June 14, 2007, at 12 (stating that foreign issuers now fear entering the U.S. market because “listing on a U.S. exchange exposes the foreign issuer to potentially bankrupting securities liabilities if its stock price were to decline sharply” and that “the securities class action is not available as a practical matter elsewhere in the world, with the possible exceptions of Canada and Australia”).


bled in each recent year, and the total number of securities class-action settlements in 2008 was three times that of 1998.

The threat of securities class actions is more pronounced in periods of increased volatility in stock prices. A two-year trough in securities class-action filings from June 2005 through June 2007—a period characterized by a strong and stable stock market—was followed by a period of increased class-action filings through June 2008—during which stock market volatility doubled.

The current system of securities class-action litigation is an inefficient means to redress the harm to investors. Prominent studies have concluded that securities class-action litigation fails to compensate adequately those harmed by fraud. The median ratio of settlement amount to total alleged investor loss has ranged between two and three percent. Securities class-action lawsuits are essentially wealth transfers among shareholders and often are circular in nature. Existing shareholders bear the burden of compensating aggrieved shareholders, some of whom also may be existing shareholders.

Although individual class members receive relatively little of the ultimate recovery that is spread across a class, the plaintiffs’ attorneys receive customarily twenty to twenty-five percent of the total recovery. During the past ten years, plaintiffs’ lawyers, along with other middlemen, have obtained nearly $17 billion in fees from securities class actions. The diffused investors in the

8. See id. at i.
12. SECURITIES CLASS ACTION LITIGATION, supra note 6, at ii.
13. Fischel v. Equitable Life Assur. Soc., 307 F.3d 997, 1006 (9th Cir. 2002) (describing a “25 percent ‘benchmark’” in percentage-of-the-fund cases that can be altered as required by the needs of the case). Of those persons who were class members of various class actions, fifty-three percent reported in a survey that they did not receive anything of meaningful value. See U.S. CHAMBER OF COMMERCE, INSTITUTE FOR LEGAL REFORM, POLLING ON THE CLASS ACTION SYSTEM: NATIONAL RESULTS 1 (2003) [hereinafter POLLING ON THE CLASS ACTION SYSTEM].
14. SECURITIES CLASS ACTION LITIGATION, supra note 6, at ii.
class lack the ability to bargain over attorney fees and courts rarely reduce the fees proposed by the plaintiffs' attorneys.\textsuperscript{15}

In class-action litigation, the interests of the plaintiffs' attorneys and class members may not be aligned in some instances. The plaintiffs' attorneys bear the full costs of pursuing the litigation but receive only a portion of the ultimate award. Consequently, the decisions of the plaintiffs' attorneys may be driven by concern over litigation costs and personal gain rather than by an interest in obtaining the best result for class members. Indeed, the recent scandals involving plaintiffs' attorneys paying large sums to repeat plaintiffs illustrate how class-action litigation can be abused at the expense of harmed investors.\textsuperscript{16}

Companies and their shareholders incur enormous costs to defend against securities class-action lawsuits. In one recent study, approximately forty-one percent of the companies listed on the major stock exchanges had been named as defendants in at least one federal securities class action.\textsuperscript{17} The total monetary value of securities class-action settlements in 2008 was $3.09 billion.\textsuperscript{18} The average settlement value from 2002 to 2008 was $45.6 million, which represents approximately a 175% increase from the average value of $16.6 million from 1996 to 2001.\textsuperscript{19}

\textsuperscript{15} See Polling on the Class Action System, \textit{supra} note 13, at 1 (stating that in a 2003 survey sponsored by the U.S. Chamber of Commerce, sixty-seven percent of persons surveyed believe that lawyers benefit most from the current class-action lawsuit system). But see In re Baan Co. Sec. Litig., 288 F. Supp. 2d 14, 22 (D.D.C. 2003) (rejecting a request by plaintiffs' attorneys for thirty-two percent of the settlement fund and instead awarding twenty-eight percent of the fund).


\textsuperscript{18} 2008 Class Action Settlements, \textit{supra} note 9, at 1.

\textsuperscript{19} Stephanie Planich & Svetlana Staryhk, Recent Trends in Securities Class Action Litigation: 2009 Mid-Year Update 22 (2009) [hereinafter 2009 Mid-Year Update].
Private securities litigation has become a real concern, particularly for new businesses that do not have the resources to handle a large lawsuit. A major lawsuit could sound the death knell for new companies that already bear a disproportionate amount of the total business tort costs in the United States. Although small companies account for nineteen percent of business revenue in the United States, they bear sixty-nine percent ($98 billion) of the business tort costs. To cope with the cost of securities litigation, companies must raise the prices of their goods and services. Doing so, in turn, logically harms the competitiveness of U.S. businesses in a global marketplace that is dominated by low-cost goods and services in the nations where providers do not face such threats.

Securities class actions impose a competitive disadvantage on U.S. capital markets relative to markets in other countries. Indeed, foreign companies are reluctant to list in U.S. markets due to concerns with the American litigation system. According to the Committee on Capital Markets Regulation—an independent, bipartisan body composed of twenty-two corporate and financial leaders from business, finance, law, accounting, and academia—since the late 1990s the percentage of the world’s Initial Public Offerings (IPOs) conducted in the United States has dropped from forty-eight percent to six percent in 2005. Of the world’s twenty-five largest IPOs in 2005, only one of them took place in the United States. That trend continued in 2006, when a report dated November 30 observed that, in the year to date, nine of the ten largest IPOs had occurred in markets outside of the United States. Dollar figures are also staggering: Between 2000 and 2005, the percentage of

21. A 2003 survey found that seventy-four percent of Americans surveyed think that the class-action system drives up prices. POLLING ON THE CLASS ACTION SYSTEM, supra note 13, at 1.
22. MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 101 (2007) [hereinafter MCKINSEY REPORT] ("[N]ot only are foreign companies staying away from U.S. capital markets for fear that the potential costs of litigation will more than outweigh any incremental benefits of cheaper capital, but a number of interviewees also suggested that the legal environment is detrimental to America’s spirit of entrepreneurialism and innovation.").
23. ZINGALES ET AL., supra note 4, at 2.
24. Id.
25. Id.
dollars raised in global IPOs in the United States decreased by a factor of ten, dropping from fifty percent to five percent.\textsuperscript{26}

Where is the IPO activity going? The Committee report states that over the same time, London’s share of the global IPO market nearly quintupled from five percent to almost twenty-five percent.\textsuperscript{27} United States exchanges attracted only about one-third of the share of the global IPO volume in 2006 that they had in 2001\textsuperscript{28} and only three of the twenty largest IPOs of 2008 were listed on U.S. stock exchanges.\textsuperscript{29} In 2009, the United States regained the global lead in amount of funds raised in IPOs, boasting a robust twenty-seven percent share of global capital raised.\textsuperscript{30} But this number may be of little comfort when one considers that the share is mostly attributed to the $19.6 billion Visa IPO—the largest IPO in U.S. capital market history.\textsuperscript{31} Looking beyond this single outlier, it is apparent that capital formation has moved overseas in droves.

An unwieldy class-action regime impacts not only the market for public offerings, but also the market for private offerings. The success of the venture capital industry relies, in large part, on how readily a start-up or other privately held company can be taken public. Absent a desire to access the public equity markets in the United States, the amount of private equity activity in the United States also suffers.\textsuperscript{32}

In contrast to federal litigation, securities arbitration appears to provide a more efficient and cost-effective mechanism to resolve disputes with integrity while minimizing the burdens on our judicial system. Arbitration ensures that all relevant facts

\textsuperscript{26} Id.

\textsuperscript{27} Id. at 3; see also MCKINSEY REPORT, supra note 22, at ii (“[T]he legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation . . . .”).

\textsuperscript{28} MCKINSEY REPORT, supra note 22, at 43.

\textsuperscript{29} See id. at 16.

\textsuperscript{30} ERNST & YOUNG, SHIFTING LANDSCAPE—ARE YOU READY?: GLOBAL IPO TRENDS REPORT 18 (2009).

\textsuperscript{31} Id.

\textsuperscript{32} Brief for the Nasdaq Stock Mkt., Inc. and NYSE Euronext as Amici Curiae Supporting Respondents at 6, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (No. 06-43) (explaining that “the contribution of strong capital markets to overall economic growth is well documented”). The damage to capital markets caused by securities class actions does not stop at U.S. shores. One of the more recent developments in the universe of securities class-action litigation is the so-called “F-cubed” class action, which pits a foreign-listed, foreign corporation against a foreign investor in U.S. federal court.
are presented to the panel without the evidentiary hurdles of federal court. In addition, the use of arbitrators knowledgeable about the securities industry may reduce the uncertainty of resolving securities claims in jury trials.

The arbitration system used by the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization that oversees certain securities firms, could be a model for the resolution of class actions, but an arbitration forum for securities class-action claims would have to account for the unique circumstances of those claims. Unfortunately, the federal court system provides the only permissible avenue at present to resolve class-action claims under the federal securities laws. Although arbitration is an avenue to adjudicate scores of different types of claims, the self-regulatory organizations expressly prohibit arbitration of securities class-action claims.

This Article analyzes the impediments to arbitration of securities class-action claims. It describes the concerns with the current system of shareholder class actions and discusses the benefits and criticisms associated with arbitration. Finally, this Article recommends that policymakers explore options to use arbitration for securities class-action claims. One option is to permit arbitration of a limited number of securities class-action lawsuits following a federal court’s denial of a defendant’s motion to dismiss. Another option is to allow new public companies the opportunity to choose between arbitration and litigation at the time of the initial public offering of securities. By providing new public issuers the choice of forum at the time of the IPO and then providing sufficient ongoing notice to the marketplace of the chosen forum, investors can decide for themselves the significance of the arbitration forum prior to the decision to purchase the stock. This scenario may provide relief to smaller companies from the class-action lawsuits that have plagued them, while protecting investors and providing the opportunity to further study and evaluate the use of class-action arbitration in a real-world context.

I. THE ECONOMIC COSTS AND BENEFITS OF SECURITIES CLASS-ACTION LAWSUITS

A. The Burdens on the Federal Judiciary

Securities class-action lawsuits dominate the federal docket. In 2004, securities class actions accounted for forty-eight per-
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cent of all federal class actions in the United States. Due to their legal and factual complexity, securities class actions require more judicial time and attention than other types of lawsuits. They require unusual procedural attention (due to the selection of a lead plaintiff and lead counsel), often require multiple attempts at repleading and multiple motions to dismiss, and generally take longer to resolve as a result of the voluminous document requests and depositions following the denial of a motion to dismiss.

Despite opinions by the Supreme Court that aim to curtail frivolous lawsuits, the number of securities class-action lawsuits continues to grow. There was a fifty-eight percent increase in new lawsuits from 2006 to 2007. In 2008, securities class action filings reached a six-year high with 259 filings. Filings have kept pace in 2009, with 127 cases filed in the first half of the year. Filings of securities class-action lawsuits may have some correlation with stock market volatility. According to a report by NERA Economic Consulting, market volatility is positively correlated with the number of securities class-action filings, and “if market volatility is higher during a quarter, controlling for market returns, filings are likely to be higher in the same quarter.”

B. The Costs to Individual Companies

In addition to the costs to the judicial system, the costs of securities class actions to individual companies are enormous. Since 1996, at least 3,013 securities class actions have been filed. Approximately 2,465 public companies—forty-one percent of the approximately 6,000 companies currently listed on the major stock exchanges—have been named as defendants in at least one

33. SECURITIES CLASS ACTION LITIGATION, supra note 6, at 3.
35. SECURITIES CLASS ACTION LITIGATION, supra note 6, at i.
36. 2009 MID-YEAR UPDATE, supra note 6, at 1.
37. Id.
federal securities class action. In 2009, 4.6% of all S&P 500 listed companies were defendants in a newly filed class action.

Another alarming threat to the competitiveness of United States markets is the growing and disproportionate number of securities class-action lawsuits against foreign companies. In 2008, class actions filed in federal court against foreign companies increased by seven percent. The increase in lawsuits has been so sharp that foreign issuers currently face a disproportionately higher percentage of lawsuits than domestic issuers. As of June 30, 2009, foreign companies account for fifteen percent of all securities class-action defendants, but comprise only thirteen percent of exchange-listed companies.

In addition to the increasing number of securities class-action lawsuits, the claims against companies have increased dramatically in size. There are two measures that illustrate this point: the disclosure dollar loss and the maximum dollar loss. With the disclosure dollar loss, the size of a claim is measured by reference to the decline in market capitalization from the day before the class period ends to the day after the corrective disclosure. With the maximum dollar loss, the size of a claim is measured by reference to the decline in market capitalization from the maximum price point during the class period to the day after the corrective disclosure. The total disclosure dollar loss in 2008 was $227 billion, which represents a forty-eight percent increase from 2007 and a seventy-five percent increase relative to the eleven-year average from 1997 to 2007. The maximum dollar loss in 2008 was $856 billion, which represents a twenty-seven percent increase from 2007.

The larger the claim, the greater the leverage plaintiffs’ attorneys have to obtain a settlement. This leverage exists even

40. CHAMBER COMMISSION REPORT, supra note 17, at 30.
42. 2009 MID-YEAR UPDATE, supra note 19, at 9 (showing a rise from 27 to 29 class actions).
43. See id. at 10.
44. See 2008 MID-YEAR ASSESSMENT, supra note 10, at 9; see also SECURITIES CLASS ACTION FILINGS 2008, supra note 7, at 14–15.
45. See SECURITIES CLASS ACTION FILINGS 2008, supra note 7, at 14. It is important to recognize that investors should have redress for valid claims under the law. Redress should be achieved, however, in the most cost-effective and efficient means possible, which may not be achieved under the current private securities litigation framework.
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for claims lacking merit. This leverage is significant because nearly every securities class-action lawsuit settles before trial. If a defendant loses its motion to dismiss, it is faced with a Hobson's choice: settle the case for millions (or sometimes billions) of dollars or incur large legal bills and divert company resources to fight the claims at trial while facing the risk that a jury will render a potentially catastrophic verdict against the company. For new and small issuers, a large judgment can be especially devastating. Since the enactment of the Private Securities Litigation Reform Act, approximately forty-four percent of securities class-action lawsuits have been either dismissed or had a summary judgment entered for the defendant, and fifty-six percent have settled with all defendants, leaving only a small percentage of cases to reach a verdict at trial.

The concerns with securities class-action litigation transcend party lines. Former Attorney General Dick Thornburgh, who served in the Reagan and George H. W. Bush administrations, observed: "Outcomes [of securities class-action lawsuits] are often less a matter of justice than of negotiation, as many defendants decide it is better to settle than to incur the enormous costs, inconvenience and risks associated with what may become virtually endless litigation." Robert E. Litan, a former Clinton Administration official, similarly stated: "Some defendants can feel financially pressured to settle even if they have done nothing wrong, believing it not to be worth betting their companies on a subsequent mistaken jury verdict that can be difficult to overturn on an appeal." The Supreme Court acknowledged these concerns in the landmark Stoneridge case. The Court stated that "extensive discovery and the potential

47. See Anjan V. Thakor, U.S. Chamber Inst. for Legal Reform, The Unintended Consequences of Securities Litigation 9–10 (2005).
48. 2009 Mid-Year Update, supra note 19, at 15.
for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies."\(^{52}\)

The settlement amounts of private securities class-action lawsuits have increased dramatically over the past decade. The average settlement amount from 2002 to 2007 was $70.1 million, which represents approximately a 250% increase from the average amount of $28.2 million from 1998 to 2001.\(^{53}\) These figures are driven, in part, by several large settlements in the past few years. According to a study by the Chamber of Commerce, “Nine of the ten largest securities class action settlements of all time occurred in the past three years, and nine of those top ten exceeded 1 billion dollars.”\(^{54}\) Nevertheless, excluding settlements over one billion dollars, the average settlement amount from 2002 to 2007 was $24.4 million, which represents approximately a 200% increase from the average amount of $11.5 million from 1996 to 2001.\(^{55}\) The total amount of all securities class-action settlements in 2008 was $3.09 billion.\(^{56}\) Although the average settlement in 2008 decreased approximately fifty percent from 2007,\(^{57}\) the average settlement amount is expected to increase in the coming years as the claims currently pending are resolved.

C. The Costs to the United States Capital Markets and Economy

Securities class-action lawsuits pose a strong impediment to economic growth in the United States. The threat of private securities class-action lawsuits is among the primary disincentives to listing on U.S. exchanges. The Financial Services Roundtable, a financial services industry trade group, opined both that “[e]xcessive litigation and the threat of litigation are the most significant impediments to the competitiveness of U.S. businesses”\(^{58}\) and that “the growth in class action lawsuits, especially securities class-action cases, imposes substantial uncer-

\(^{52}\) Id. at 163.
\(^{53}\) 2007 CLASS ACTION SETTLEMENTS, supra note 9, at 1–2.
\(^{54}\) SECURITIES CLASS ACTION LITIGATION, supra note 6, at 8.
\(^{56}\) 2008 CLASS ACTION SETTLEMENTS, supra note 9, at 1.
\(^{57}\) See id. at 2.
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... and presents a major competitive challenge to U.S. financial services firms in comparison to foreign firms that are not subject to a similar risk." 59

One of the most comprehensive studies of the effects of private securities litigation on the competitiveness of the United States markets was commissioned by Senator Charles E. Schumer and Mayor of New York Michael R. Bloomberg and conducted by McKinsey & Company. McKinsey's 2007 report concluded that "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of doing business — and driven away potential investors." 60 The report found:

[T]he high legal cost of doing business in the U.S. financial services industry is of real concern to corporate executives. When asked which aspect of the legal system most significantly affected the business environment, senior executives surveyed indicated that propensity toward legal action was the predominant problem. 61

Indeed, eighty-five percent of CEOs surveyed indicated that they preferred London to New York due to the litigation risk associated with U.S. markets. 62

Another recent survey conducted by the Financial Services Forum—which polled 334 senior executives of companies based in the United States, United Kingdom, Germany, France, China, Japan, and India—confirms these conclusions. According to the survey,

[o]ne out of three companies in the survey that considered going public in the United States rated litigation as an 'extremely important' factor in their decision, and nine out of 10 companies who de-listed from a U.S. exchange in the last four years said the litigation environment played some role in that decision. 63

The survey also stated that "[o]ne out of four U.S.-listed public companies cited litigation reform as the most significant

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59. Id.
60. MCKINSEY REPORT, supra note 22, at ii.
61. Id. at 75.
62. Id.
step the U.S. can take to improve the attractiveness of U.S. capital markets.”64

These results are confirmed by figures showing that a growing number of companies are looking overseas to raise capital. As previously noted, in 2006, U.S. exchanges attracted only about one-third of the share of the global IPO volume as compared to 2001.65 Indeed, “[i]n 2006, more capital was raised through initial public offerings ... on the Hong Kong Stock Exchange than on the New York Stock Exchange and NASDAQ combined.”66

D. Analysis of the Purported Benefits of Securities Class-Action Lawsuits

Proponents of securities class-action lawsuits have argued that securities litigation deters wrongdoing and compensates injured shareholders. Neither of these purported reasons has much support in theory or practice. The Committee on Capital Markets Regulation has concluded that “[t]he modern securities class-action lawsuit creates a heavy burden for public companies; without a substantial social benefit, this burden cannot be justified. ... [T]he public value of the securities class action litigation is questionable.”67

The Committee made three key findings to support its conclusions. First, “the potential deterrent function of private securities litigation is debatable because virtually all the costs fall on the corporation and its insurer, which means they are ultimately borne by the shareholders.”68 Second, “the notion that securities class actions do a good job of compensating injured parties is belied by data suggesting that the average securities class action settles for between two percent and three percent of the investors' economic losses.”69 Third,

even if there is a net recovery, contemporary securities class action litigation is still suffering from a problem of circularity. The recovery is largely paid by diversified shareholders to diversified shareholders and thus represents a pocket-shifting wealth transfer that compensates no one in any

64. Id.
65. MCKINSEY REPORT, supra note 22, at 43.
66. 2007 GLOBAL CAPITAL MARKETS SURVEY, supra note 63, at 2.
67. ZINGALES ET AL., supra note 4, at 78.
68. Id.
69. Id. at 79.
meaningful sense and that incurs substantial wasteful transaction costs in the process.\textsuperscript{70}

Investors who held shares at the time of the fraud pay the settlement to investors who purchased or sold during the period of the fraud.\textsuperscript{71}

The notion of any benefit to injured shareholders from securities class-action lawsuits is further belied by the fact that most investors have a diversified portfolio,\textsuperscript{72} and thus may suffer little or no net harm from securities fraud. Diversified investors are essentially protected against fraud in an individual security by having a portfolio of other investments with low correlation to one another.\textsuperscript{73} When considering all costs associated with securities litigation, such as the negative effects on raising capital, distraction of management, and attorney fees—which customarily exceed twenty percent of the recovery for plaintiffs attorneys,\textsuperscript{74} and perhaps a comparable amount for defense attorneys\textsuperscript{75}—both society and investors in the aggregate are net losers under the current private securities litigation regime.

Professor Joseph Grundfest, a former SEC commissioner, summarized the problems with securities class-action litigation:

The conclusion is clear. The class action securities fraud litigation system is broken. It fails efficiently to deter fraud and fails rationally to compensate those harmed by fraud. Its greatest proponents seem to be the class action counsel and

\textsuperscript{70} Id.
\textsuperscript{71} See id.
\textsuperscript{73} See Brian M. Rom & Kathleen W. Ferguson, “Portfolio Theory is Alive and Well”: A Response, J. INVESting, Fall 1994, at 24, 26.
\textsuperscript{74} See ZINGALES ET AL., supra note 4, at 79.
\textsuperscript{75} See id.; see also Tom Baker & Sean J. Griffith, Predicting Corporate Governance Risk: Evidence from the Directors’ & Officers’ Liability Insurance Market, 74 U. Chi. L. REV. 487, 495 n.29 (2007) (discussing defense costs and how they may amount to twenty-five percent or more of a settlement amount).
others who profit as a consequence of the irrationally large
damage exposures generated by the current regime.76

II. ARBITRATION OF SECURITIES LAW CLAIMS

A. The Development of the Law

Arbitration has become a widespread practice in resolving
disputes between broker-dealers and their customers. Virtually
every customer agreement contains an explicit clause requiring
that disputes be heard in arbitration. Under the Federal Arbi-
tration Act (FAA),77 agreements to arbitrate future disputes are
generally enforceable.78 Although the FAA has existed for over
three quarters of a century, arbitration of claims under the Se-
curities Act of 193379 and the Securities Exchange Act of 193480
is a relatively recent concept.

In 1953, the Supreme Court in Wilko v. Swan held that the FAA
does not apply to the provisions of the Securities Act of 1933 de-
dsigned to protect investors.81 Although the FAA specifically per-
mits parties to elect contractually to arbitrate their claims,82 Section 14 of the Securities Act of 1933 expressly voids any attempt to
waive the securities laws.83 The Court held that Section 14 would
therefore invalidate any clause requiring parties to arbitrate
claims under the Securities Act of 1933.84 The Court expressed
concern with arbitration as a forum to adjudicate provisions of the
Securities Act, stating that “their effectiveness in application is

76. Joseph A. Grundfest, Professor of Law and Bus., Stanford Law Sch., State-
ment at the Meeting of the Advisory Committee on the Auditing Profession 4
submissions/02042008/Grundfest02042008.pdf.
78. See 9 U.S.C. § 2 (“A written provision in ... a contract evidencing a transaction
involving commerce to settle by arbitration a controversy thereafter arising out of such
contract ... shall be valid, irrevocable, and enforceable, save upon such grounds as
exist at law or in equity for the revocation of any contract.”).
82. See 9 U.S.C. § 3.
83. 15 U.S.C. § 77n (“Any condition, stipulation, or provision binding any person ac-
quiring any security to waive compliance with any provision of this subchapter or of
the rules and regulations of the Commission shall be void.”).
84. Wilko, 346 U.S. at 437–38.
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lessened in arbitration as compared to judicial proceedings." The Court conceded the difficulty in reaching that conclusion:

Two policies, not easily reconcilable, are involved in this case. Congress has afforded participants in transactions subject to its legislative power an opportunity generally to secure prompt, economical and adequate solution of controversies through arbitration if the parties are willing to accept less certainty of legally correct adjustment. On the other hand, it has enacted the Securities Act to protect the rights of investors and has forbidden a waiver of any of those rights. Recognizing the advantages that prior agreements for arbitration may provide for the solution of commercial controversies, we decide that the intention of Congress concerning the sale of securities is better carried out by holding invalid such an agreement for arbitration of issues arising under the Act.

Several federal courts subsequently extended Wilko to the Securities Exchange Act of 1934. In 1987, however, the Supreme Court in Shearson/American Express, Inc. v. McMahon held that Wilko did not apply to claims under the Securities Exchange Act of 1934. Two years after McMahon, the Supreme Court in Rodriguez de Quijas v. Shearson/American Express, Inc. overruled Wilko and held that pre-disputed arbitration agreements would be upheld, even concerning matters arising under the Securities Act of 1933. The Court stated: “Our conclusion is reinforced by our assessment that resort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act.”

In the midst of the Rodriguez de Quijas and McMahon litigation, the Securities and Exchange Commission, under the direction of Chairman David Ruder, directed all the self-regulatory organizations (SROs) “to consider adopting procedures that would give investors access to the courts in appropriate cases, including class actions.” In response, the Securities Industry

85. Id. at 435.
86. Id. at 438 (footnote omitted).
89. 490 U.S. 477, 484 (1989).
90. Id. at 485–86.
Conference on Arbitration (SICA) met and unanimously adopted a rule to exclude the arbitration of securities class-action lawsuits. The National Association of Securities Dealers, Inc. (NASD) submitted that proposed rule to the SEC, and the Commission approved the proposed rule on October 28, 1992. In approving the rule, the Commission explained:

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the NASD. Specifically, the Commission finds that the proposed rule change is consistent with the requirements of section 15A(b)(6) of the Act. Section 15A(b)(6) requires, in part, that the rules of the NASD be designed "to protect investors and the public interest ***." Over the years of the evolution of class action litigation, the courts have developed the procedures and expertise for managing class actions. Duplication of the often complex procedural safeguards necessary for these hybrid lawsuits is unnecessary. The Commission believes that investor access to the courts should be preserved for class actions and that the rule change approved herein provides a sound procedure for the management of class actions arising out of securities industry disputes between NASD members and their customers.

The Commission did not base its approval of the proposed rule on concerns over the integrity of the arbitration process. Indeed, NASD represented—and the SEC agreed—that "arbitration provides adequate due process procedures and that arbitrators are well-trained and possess the expertise to manage complex cases." Instead, the Commission recognized that the judicial system already had developed procedures to manage class-action lawsuits, and thus "[e]ntertaining such claims through arbitration at the NASD would be difficult, duplicative and wasteful." Other SROs sought and received approval for the same rule.

93. Id. at 52,661.
94. Id.
95. Id.
In the 1980s and leading up to the SROs’ decision to prohibit arbitration of class-action claims, securities arbitration received harsh criticism for being biased towards the securities industry. For example, Justice Blackmun in his dissenting opinion in *McMahon* wrote: “[T]here remains the danger that, at worst, compelling an investor to arbitrate securities claims puts him in a forum controlled by the securities industry. This result directly contradicts the goal of both securities Acts to free the investor from the control of the market professional.”

Concerns with arbitration have subsided in large part since *McMahon*. In 2002, the Securities and Exchange Commission sponsored a study by Professor Michael Perino regarding the operation of arbitrator disclosure requirements in securities arbitration. From his review of data from more than 30,000 SRO arbitrations, Professor Perino found that the evidence suggested that SRO arbitrations are fair—favoring neither industry member nor investor—and that any undisclosed conflicts of interest do not present any significant problems. Professor Perino found persuasive the General Accounting Office's (GAO) 1992 report, *Securities Arbitration: How Investors Fare*, which examined results in arbitration over an eighteen-month period between 1989 and 1990. That report concluded that there was “no evidence of pro-industry bias” in arbitrations sponsored by the NASD, NYSE, and other SROs when compared to arbitrations.

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98. MICHAEL A. PERINO, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE ARBITRATIONS 2 (2002).

99. Id. at 3–5, 48.

100. U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 23 (1992) [hereinafter GAO REPORT]. Oddly, this GAO study occurred contemporaneously with the SEC’s decision to approve rules to bar securities class-action arbitration. See supra notes 91–92 and accompanying text.
conducted by the American Arbitration Association (AAA),\textsuperscript{101} an independent organization involved in arbitrations in a variety of areas. The GAO found that panels in SRO arbitrations ruled in favor of investors in about fifty-nine percent of arbitrations versus sixty percent in AAA-sponsored arbitrations, and prevailing investors received average awards of about sixty-one percent of the damages, as opposed to awards averaging fifty-seven percent of amounts claimed in AAA proceedings.\textsuperscript{102}

More recently, in October 2007, the Securities Industry and Financial Markets Association (SIFMA) issued a \textit{White Paper on Arbitration in the Securities Industry}.\textsuperscript{103} The \textit{White Paper} concluded that Securities Arbitration is "fair" to investors based, in part, on statistical evidence collected by the GAO and others showing that arbitrations are conducted fairly and not biased in favor of the industry.\textsuperscript{104} A survey of securities arbitration participants found that approximately ninety-three percent of those surveyed—more than fifty percent of whom were investors—believed their case had been handled fairly and without bias.\textsuperscript{105} In addition, from a review of all 2005 and 2006 arbitration decisions, the \textit{White Paper} stated that "the presence of an 'industry' arbitrator has no material impact on customer wins."\textsuperscript{106} According to the \textit{White Paper}, "[s]ecurities arbitration is in fact fair because arbitrators understand the law and ensure it is properly followed and applied in each case."\textsuperscript{107}

Not all of the recent studies, however, have reached the same results. Under funding by FINRA, SICA conducted a survey in 2007 of participants in the securities arbitration process. In its February 2008 report, SICA indicated that seventy-five percent of investors surveyed who compared the arbitration process to civil litigation indicated that arbitration was "very unfair" or "somewhat unfair."\textsuperscript{108} The survey also indicated that, of those

\begin{itemize}
\item \textsuperscript{101} GAO REPORT, \textit{supra} note 100, at 60.
\item \textsuperscript{102} \textit{Id.} at 38–39.
\item \textsuperscript{103} \textit{SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY} (2007) [hereinafter \textit{WHITE PAPER}].
\item \textsuperscript{104} \textit{Id.} at 34–37.
\item \textsuperscript{105} GARY TIDWELL ET AL., \textit{PARTY EVALUATIONS OF ARBITRATORS: AN ANALYSIS OF DATA COLLECTED BY NASD REGULATION ARBITRATIONS} 3-5 (1999).
\item \textsuperscript{106} \textit{WHITE PAPER, supra} note 103, at 4, 67.
\item \textsuperscript{107} \textit{Id.} at 4.
\item \textsuperscript{108} JILL I. GROSS & BARBARA BLACK, \textit{PERCEPTIONS OF FAIRNESS OF SECURITIES ARBITRATION: AN EMPIRICAL STUDY} 47 (2008).
\end{itemize}
participating, approximately half of the investors in the survey believed that their arbitration panel was biased,\(^{109}\) approximately fifty-two percent would not recommend arbitration to others,\(^{110}\) approximately seventy-one percent were dissatisfied with the outcome of their arbitration,\(^{111}\) and forty-nine percent stated that the arbitration process was too expensive.\(^{112}\)

Of course, each of the studies investigating the "fairness" of arbitration suffers from an inherent flaw on its face. To the extent that "fairness" is an appropriate standard, the concept is ambiguous and difficult to measure—that is, entirely subjective. An investor may feel arbitration was unfair simply because he received a low monetary award. Measuring satisfaction in the outcome is thus entirely subjective and ripe for misinterpretation. Accordingly, SIFMA criticized the SICA survey for its flawed statistical methodology, claiming it focused solely on subjective perceptions over a narrow time frame.\(^{113}\)

**C. Key Benefits of Arbitration**

Despite survey results suggesting that participants are displeased with the cost, arbitration does not burden litigants with the costly and time-consuming procedures present in federal litigation. In federal court, parties generally "may obtain discovery regarding any nonprivileged matter that is relevant to any party's claim or defense."\(^{114}\) Parties in federal litigation also may depose ten witnesses without leave of court and more with leave, which is usually freely given in securities class actions.\(^{115}\)

By contrast, discovery in arbitration is narrowly tailored, less costly, and faster than in federal court litigation.\(^ {116}\) Discovery gen-

\(^{109}\) Id. at 53.

\(^{110}\) Id. at 43.

\(^{111}\) Id. at 38.

\(^{112}\) Id. at 41.

\(^{113}\) See SEC. INDUS. & FIN. MCTS. ASS'N, THE THINKING PERSON'S GUIDE TO INTERPRETING THE LATEST SURVEY ON SUBJECTIVE PERCEPTIONS OF FAIRNESS OF SECURITIES ARBITRATION 1-3 (2008).

\(^{114}\) FED. R. CIV. P. 26(b)(1).

\(^{115}\) FED. R. CIV. P. 30(a)(2).

\(^{116}\) See WHITE PAPER, supra note 103, at 28–29; see also Arbitration Fairness Act of 2007: Hearing on S. 1782 Before the Subcomm. on the Constitution of the S. Comm. on the Judiciary, 110th Cong. 211 (2007) (testimony of SIFMA) ("In contrast [to litigation], arbitration allows for a simple statement of claim, an answer, focused and limited discovery, and then a full merits hearing. While pre-hearing motions are permitted, they are disfa-
erally is limited to the exchange of documents and information of presumptively discoverable material specified on discovery lists. Although parties may request additional information, those additional requests are limited to "identification of individuals, entities, and time periods related to the dispute." Interrogatories and depositions are permitted only in limited circumstances. The result is perhaps a less costly and more efficient discovery process for the parties. Indeed, a former president of the American Bar Association said that a "ratio of 3 or 4 to one, litigation versus arbitration, is a fairly realistic estimate [of the cost savings from arbitration] and a reasonable expectation is that the cost of an arbitration will not be in excess of half the cost of litigating." Although he was not speaking about arbitration of class actions, cost savings likely would be significantly larger for securities class actions, which often last several years.

Motion practice is limited in arbitration. In federal court, a defendant may file a motion to dismiss, and both plaintiffs and defendants may file a motion for summary judgment. Although motions are permitted in arbitration, their use was curtailed significantly by FINRA on September 26, 2007, when it limited the number of motions permitted. Therefore, it is

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118. Id. § 12507(a)(1).
119. Id. § 12510.
120. WHITE PAPER, supra note 103, at 29 (quoting William G. Paul, Remarks at First Annual Energy Litigation Program: Arbitration v. Litigation in Energy Cases 3 (Nov. 7–8, 2002)).
121. See id. at 26–28; see also J.S. “Chris” Christie, Jr., Preparing for and Prevailing at an Arbitration Hearing, 32 AM. J. TRIAL ADVOC. 265, 266 (2008).
122. See FED. R. CIV. P. 12(b)(6).
123. See FED. R. CIV. P. 56.
124. See FINRA, supra note 117, § 12503.
Arbitration as an Alternative to Litigation

... extremely unlikely that a claim will be dismissed on pleading grounds in arbitration.126

Unlike litigation in federal district court, arbitration does not impose any rigorous evidentiary hurdles to examining witnesses and presenting information. Arbitrators generally permit parties to submit information into the record without requiring strict adherence to evidentiary foundations. Witnesses can be questioned not only by the lawyers but also (and often) by the arbitrators. These relaxed evidentiary standards mean more information gets before the arbitration panel for consideration in reaching an outcome and the process is driven more by the parties, not the lawyers.127

Another possible benefit associated with arbitration—although continually debated—is the use of skilled arbitrators with experience in resolving such disputes. For example, FINRA carefully selects arbitrators from a broad cross-section of applicants, diverse in culture, profession, and background. Potential arbitrators must have at least "five years of full-time, paid business or professional experience."128 Potential arbitrators also must be recommended in writing by two persons who can personally attest to their integrity and skills.129 Arbitrators must provide regular disclosures regarding employment history, education, training, conflicts, and associations with industry members.130

Before serving on an arbitral panel, a potential arbitrator must complete FINRA's comprehensive arbitrator training program, which consists of an eight-hour online training course and a

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126. See White Paper, supra note 103, at 28 (finding that "it is highly unlikely that a claim will be dismissed solely on pleading grounds in arbitration"). Claims in court, however, are commonly dismissed on pleading grounds. See id. at 27 (stating that between 2005 and 2007, motions to dismiss accounted for 39.1% of the dispositions in securities class action suits).


129. Id.

four-hour classroom course that provides "practical guidance for resolving common issues that arise during arbitration." An arbitrator seeking to serve as chairperson of an arbitration panel must complete an additional nine-hour course.

Under existing FINRA arbitration, claims may be heard depending on their size by either a sole "public" arbitrator or a panel of three arbitrators, two of whom must be public and one of whom is "non-public" (also known as an "industry" arbitrator). A non-public arbitrator is a person who within the past five years was associated with a broker or dealer, registered under the Commodity Exchange Act, a member of an exchange or a futures association, or associated with a person or firm registered under the Commodity Exchange Act. In addition, arbitrators may be defined as non-public if they have spent a substantial part of their careers, including legal careers, engaging in, or working on behalf of, the above listed businesses, or if they are employed by a financial institution that effects transactions in securities or monitors compliance with securities laws. By contrast, a public arbitrator is a person who is not engaged in any of the activities described above, has not been engaged in those activities for over twenty years, and is not affiliated in certain respect to persons or entities in the securities industry. Therefore, panels with three arbitrators have one arbitrator that has relevant experience in the securities business.

Some argue that the non-public (industry) arbitrators assist arbitration panels in reaching the right decision by providing much-needed expertise. By understanding the industry, non-public arbitrators may be better able to distinguish violations from non-violations. Others argue that non-public arbitrators

133. FINRA, supra note 117, § 12100(p).
134. See id.
135. Id. § 12100(u).
136. See, e.g., WHITE PAPER, supra note 103, at 35-37.
may be biased in favor of defendants.\textsuperscript{137} In response to that concern, FINRA launched a two-year pilot program beginning in fall 2008 that allows some investors in arbitration to choose a panel composed of three public arbitrators instead of the normal panel of two public arbitrators and one non-public arbitrator.\textsuperscript{138} Six major brokerage firms have volunteered to participate in the pilot program.\textsuperscript{139} The investor making the arbitration claim may elect to participate in the pilot program, but the firms are not permitted to elect whether or not to do so.\textsuperscript{140}

FINRA indicated that it will evaluate the pilot program according to the percentage of investors who opt into the pilot and the percentage of investors who choose an all-public panel after opting in, among other criteria.\textsuperscript{141} "FINRA will compare the results of pilot and non-pilot investor cases, including the percentage of cases that settle before award (and how quickly they settle)." \textsuperscript{142} FINRA also has indicated that it will study the length of hearings and the use of expert witnesses in pilot and non-pilot cases.\textsuperscript{143}

The results to date of the pilot program show that investors are choosing to have a non-public (industry) arbitrator on their panel about half the time even when they have had the opportunity to choose an all public arbitrator panel.\textsuperscript{144} FINRA announced on October 5, 2009:

To date, in the 225 pilot cases where ranking lists have been returned, investors have ranked one or more non-public arbitrators half the time and struck all eight non-public arbitrators in the other half. Thus, investors are choosing to have a non-public arbitrator in 50 percent of the pilot cases.\textsuperscript{145}

\textsuperscript{137} See, e.g., Gretchen Morgenson, Is this Game Already Over?: Critics Say Arbitration Panels Often Have Hidden Conflicts, N.Y. Times, June 18, 2006, \S 3 (Sunday Business), at 1.


\textsuperscript{139} See id.

\textsuperscript{140} See id.

\textsuperscript{141} See id.

\textsuperscript{142} Id.

\textsuperscript{143} See id.


\textsuperscript{145} Id.
As a result, FINRA announced that it would expand the pilot program from eleven to fourteen broker dealers, and the number of eligible cases will increase from 276 to 411. The results of this pilot program and other studies may be informative in shaping a system for class-wide arbitration of securities claims.

D. Criticisms of Arbitration

Unlike claims brought in federal court, arbitration claims are not subject to strict pleading standards. In federal court, the Federal Rules of Civil Procedure require a plaintiff claiming fraud to allege "with particularity" the specific facts upon which his claim is based. In addition, the Private Securities Litigation Reform Act of 1995 (PSLRA) has heightened further the pleadings standards. It requires that a plaintiff bringing an action under the Securities Exchange Act of 1934 include in his complaint "each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." Under the PSLRA, a plaintiff also must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The Supreme Court further explained in 2007 that "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."

By contrast, pleading standards in arbitration are relaxed in order to encourage claimants to pursue their disputes. A claimant simply may file a Statement of Claim, "specifying the relevant facts and remedies requested." Motion practice is limited in arbitration, and as a result dismissals are rare at that stage. The relaxed pleading in arbitration allows panels to award damages to customers even where the same claims may not have survived a

146. Id.
151. FINRA, supra note 117, § 12302(a)(1).
152. See WHITE PAPER, supra note 103, at 26–28.
motion to dismiss in federal court. The statistics are consistent with such a supposition: Twenty percent of all arbitration claims ultimately are decided by arbitrators, while less than two percent of civil claims filed in court are decided by a judge or jury.

Other criticisms of arbitration concern the autonomy of arbitrators and the lack of review of their decisions. Arbitrators have greater flexibility than federal judges to fashion an outcome based on the amorphous principles of fairness and equity. Because arbitration decisions are rarely published, arbitrators are free to fashion equitable remedies without fear of public reprisal. This raises concerns of a "shadow" common law system for securities law claims in arbitration. Moreover, appellate challenges are constrained by statute. Under the Federal Arbitration Act, a court "must" confirm an award "unless [it] is vacated, modified, or corrected as prescribed in sections 10 and 11." Section 10 lists grounds for vacating an award, including where the award was procured by "corruption," "fraud," or "undue means," and where the arbitrators were "guilty of misconduct," or "exceeded their powers." The grounds for modifying or correcting an award under Section 11 include "evident material miscalculation," "evident material mistake," and "imperfect[ions] in [a] matter of form not affecting the merits."

Congress has taken note of this trend towards arbitration. Concerns over arbitration in general (not limited specifically to securities arbitration) prompted some members of Congress to introduce legislation providing additional safeguards to individuals in the arbitration process. On July 12, 2007, Representative Hank Johnson of Georgia and eight other members of the United States House of Representatives introduced House bill

153. See id. at 26 ("Whereas motion practice is standard in courts, SRO arbitration generally discourages dispositive motions.").
154. See id. at 3.
155. See SEC. INDUS. CONFERENCE ON ARBITRATION, THE ARBITRATOR'S MANUAL, at i (2007) ("Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail." (citation and internal quotation marks omitted)).
156. The concept of a shadow common law system in arbitration that parallels the Article III judicial system is a fascinating topic, but it is beyond the scope of this Article.
158. 9 U.S.C. § 10(a).
159. 9 U.S.C. § 11.
The findings set forth in the bill state that “[m]ost consumers . . . have little or no meaningful option whether to submit their claims to arbitration” and that “[m]any corporations add to their arbitration clauses unfair provisions that deliberately tilt the systems against individuals, including provisions that strip individuals of substantive statutory rights, ban class actions, and force people to arbitrate their claims hundreds of miles from their homes.” The findings also reiterate some longstanding criticisms concerning arbitration, such as the lack of judicial review of decisions and the lack of published decisions. Based on these and other findings, the proposed legislation prohibits a pre-dispute arbitration agreement for arbitration of a “consumer” dispute or “a dispute arising under any statute intended . . . to regulate contracts or transactions between parties of unequal bargaining power.” The language arguably seems to cover securities class actions. Hearings were held on the bill, and it was referred out of the House Judiciary Committee’s Subcommittee on Commercial and Administrative Law. As yet, the bill has not been brought to a vote.

III. ARBITRATION OF SECURITIES CLASS-ACTION CLAIMS AFTER THE MOTION-TO-DISMISS STAGE

As discussed, the primary criticisms of securities class-action litigation are the enormous costs associated with discovery, the distraction to management of prolonged litigation, and the large settlements extracted due to uncertainty with the jury system. As a practical matter, however, these concerns do not manifest themselves until after the district court has ruled against a defendant’s motion to dismiss. Prior to the motion to dismiss, discovery is stayed under the PLSRA’s automatic stay, which states: “In any private action . . . all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss.”

161. Id. § 2(3), (7).
162. See id. § 2(5)–(6).
163. Id. § 4(4).
165. 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B) (2006). In creating the automatic stay, Congress found that approximately eighty percent of the costs of litigating securities
Theoretically, a system could be developed to allow issuers to amend their state charters to allow arbitration of securities class-action claims. However, certain limitations should be imposed to avoid abuse and to help ensure integrity in the process. First, arbitration of a securities class-action claim could be permitted only after a district court's denial of a motion to dismiss. Such a system would enable the federal district courts to retain jurisdiction over the difficult legal questions and to provide guidance to the arbitration panel concerning the governing law. This system would avoid the criticism that arbitration panels are ill-suited to handle motions practice. Moreover, because the majority of litigation costs to the parties in securities litigation are not incurred until after the motion to dismiss, the use of arbitration following the denial of a motion to dismiss would alleviate some of the litigation costs.

Second, using their existing authority, arbitrators could determine in their discretion whether to allow for depositions and interrogatories, and, if so, to what extent. Arbitrators should determine when certain cases warrant these forms of discovery. Unlike federal court litigation, which provides for depositions and interrogatories as a matter of right, arbitration allows for the panel to tailor discovery to the individual facts of the cases.

Third, to serve as a disincentive to parties bringing frivolous claims, the prevailing party (as determined by the arbitration panel) could be entitled to have its attorney fees paid by the losing party. The amount of fees could be determined by the arbitration panel based on various factors such as attorney and paralegal hours spent on the case and the complexity of the case. They could in no event exceed a maximum percentage of the recovery unless a special need exists. This fee structure would encourage lawyers to represent clients in arbitration, yet it would avoid a windfall to lawyers at the expense of their clients.

Fourth, the ultimate rulings by the arbitration panel, including the amount of damages and attorney fees awarded, could be reviewed by a federal district court applying an abuse-of-discretion standard. If the court finds that the damages awarded by the arbitration panel are not based on a sound
economic analysis, the court could modify the amount as it deems appropriate.

Although such a system might address many of the concerns associated with securities class-action litigation, it admittedly would not be a panacea. Indeed, damage awards may be higher, the number of claims may increase, and uncertainty may grow. Of course, a full and complete study would be necessary before launching such a program. Conceptually, however, by allowing arbitration as a way to handle claims, the system would recognize the freedom of contract and allow an alternative avenue to adjudicate claims that could be priced into the value of an issuer’s securities. Policymakers should explore whether such a system appropriately balances the interests of the various stakeholders while adequately protecting investors.

IV. ALLOWING NEW ISSUERS TO ELECT ARBITRATION AT THE TIME OF THE INITIAL PUBLIC OFFERING

Another alternative use of arbitration could permit companies to elect arbitration as the forum for dispute resolution at the time the companies file their registration statements to go public. The investors receiving shares in the primary market would be on notice that class claims will be arbitrated. Disclosure mechanisms would need to be put into place to inform potential investors in the secondary markets prior to investing. For instance, the consolidated tape could be marked with an indicator and an additional disclosure requirement could be added to a company’s 10-K and 10-Q to alert investors that claims related to that security will be arbitrated. Provided that existence of an arbitration clause for securities class-action claims is disclosed adequately to the entire market, investors can make a conscious and informed decision about whether to invest.

By offering arbitration as an option for new issuers, this approach may help to energize the IPO market and encourage capital formation. Although businesses often can rely on private placements and venture capital to raise capital, the public markets provide a better, more efficient, and lower cost avenue to raise capital over time to grow the business.¹⁶⁸ It is essential

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¹⁶⁸. Of course, the class-action regime not only influences the market for public offerings, but also influences the market for private offerings. The success of the venture
that the United States government encourage companies—both domestic and foreign—to avail themselves of U.S. public markets. The injection of new capital, particularly foreign capital, into U.S. markets and the availability of new enterprises for investment are critical to creating growth in the economy. Allowing new public companies to avoid the inefficient, costly, and risky litigation system when defending class claims may be a simple, low-cost catalyst for attracting new capital. Indeed, as mentioned above, research indicates that excessive regulatory costs and the risk of litigation inhibit the IPO market in the United States and contribute to its decline relative to those markets abroad.\textsuperscript{169}

This approach may provide much-needed relief to smaller companies from the class-action lawsuits that have curbed their growth and threatened their existence, while providing the opportunity to further study and evaluate the use of class-action arbitration in an actual setting. It likely would provide objective criteria—stock prices—to evaluate investor perceptions of litigation versus arbitration. If investors are concerned with arbitration, that concern should be reflected in a depressed stock price. In other words, there might be a discount in the share price if investors are concerned with the inability to litigate in federal court. If, on the other hand, investors deem the arbitration clause to be beneficial to the company and their investment, then the stock should trade at a premium.

By permitting companies at the time of their initial public offering to choose their forum of dispute resolution, this approach effectively provides investors with the choice of forum. Investors unwilling to relinquish the right to litigate in federal court simply can choose not to invest in the security. On the other hand, investors may find it attractive to invest in a company not subjected to the burdens and uncertainties of class-action litigation. Over time, the marketplace should help to dictate a company’s decision, while providing a meaningful choice to investors.\textsuperscript{170}

\footnotesize{169. See CHAMBER COMMISSION REPORT, supra note 17, at 38.}

\footnotesize{170. The interests of investors should not be secondary to the interests of a company, of course. Shareholders (in other words, investors holding equity in a company) \textit{are} the company, and any system of adjudication must protect their interests over those of their lawyers and provide appropriate safeguards to protect the integrity of the process.}
As policymakers grapple with the recent economic turmoil, they undoubtedly will consider measures to reinvigorate and strengthen global capital markets worldwide. A system of securities arbitration as an alternative to securities class-action litigation in federal courts may facilitate capital formation, make U.S. markets more competitive on the global stage, and ultimately spur economic growth by reducing the costs of capital. There are indications that a significant deterrent to capital formation in the United States is the risk of an expensive class-action lawsuit likely to result in a corporation paying millions of dollars to settle claims with questionable merit. Indeed, the likelihood that the corporation will settle for many millions of dollars is increased by the expense and unpredictability of the system of securities class actions. As the large number of securities class actions that settle once the plaintiffs overcome the motion to dismiss demonstrate, corporations often prefer to settle class-action lawsuits than to incur significant litigation costs and risk losing at trial.

Aggrieved investors need a method to receive redress for legitimate securities claims, but reforming the current securities class-action system is long overdue. When considering methods to reinvigorate and strengthen capital markets, policymakers should explore whether arbitration provides an efficient mechanism to address many of the concerns identified with securities class-action litigation. Concerns about arbitration appear to have been rebutted by research indicating that the arbitration process is unbiased and that participants are generally satisfied with the process. Nevertheless, policymakers should continue to study the arbitration system to determine whether it presents an appropriate means to resolve class-action claims. In the process, they should consider alternatives such as allowing litigants to elect arbitration following the denial of a motion to dismiss or allowing a new issue to elect arbitration in its initial public offering documents. These approaches may strike the appropriate balance of protecting the interests of investors while providing for a more efficient and less costly resolution of claims.
THE DISTORTING INCENTIVES FACING THE U.S. SECURITIES AND EXCHANGE COMMISSION

JONATHAN R. MACEY*

INTRODUCTION

This Article is about the incentives that motivate the Securities and Exchange Commission (SEC) and the ways in which those incentives influence the SEC’s policies. Unlike most other treatments of bureaucratic incentives,¹ this analysis begins with the assumption that the SEC is populated by honest, professional, and skilled personnel who work hard and are motivated to succeed. Despite the high quality of its staff, the SEC has not been successful in recent years. This Article argues that the SEC’s lack of success results from the way that staff members respond to three sets of endogenous incentives.

First, of course, the SEC wants approval from its congressional overseers and from the general public. Unfortunately, however, these constituencies have short attention spans and are not particularly sophisticated observers. Consequently, the SEC tends to pursue high profile matters, to change its priorities frequently in accordance with public opinion, and perhaps most significantly, to pursue readily observable objectives, often at the expense of more important but less observable objectives. In particular, the SEC’s performance is measured by Congress and in the court of public opinion on the simplistic basis of how many cases it brings and on the size of the fines it collects. This inclination to value only what can be easily measured has not served the SEC well. For example, the SEC’s nar-

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row focus on such measurable indicia of success as the raw number of cases brought explains, among other things, the SEC's complete lack of interest in exposing the fraud at Bernard L. Madoff Investment Securities, LLC.

A second major factor that influences the SEC's conduct is the metamorphosis of the SEC from an administrative agency dominated by a combination of industry experts, economists and lawyers into an agency dominated exclusively by lawyers. This metamorphosis has affected the culture of the SEC profoundly. In particular, the glacial speed at which the SEC operates is largely attributable to the Commission's lawyer-dominated culture. The culture has also exacerbated the problems associated with the revolving door connecting the SEC with Wall Street. SEC staffers are now focused narrowly on maximizing their reputations within the legal community rather than within economics and business as well as law.

Thirdly, the SEC has strong incentives to promote the appearance that the capital markets are in crisis and to eschew the development of market mechanisms that might solve the very problems that the SEC is tasked with solving. So long as people believe that the SEC is needed in times of crisis and that there are no superior substitutes for the SEC's style of crisis intervention, then there will be a need for the Commission. Ironically, the more financial crises there are, the more the SEC can claim a need for greater resources to meet such crises.

Nonetheless, the SEC is virtually untouched by scandal. This fact is in keeping with the argument, advanced in this Article, that the SEC as an institution, and its staff as individuals, are both professionally ambitious and ethically honest. Because corruption weakens the future mobility of SEC personnel, it is highly costly and studiously avoided. In this narrow context, at least, the SEC's response to incentives has produced positive social results.

At the same time, there have been significant, ongoing, and valid criticisms of the SEC's performance over the past decade. These criticisms became very loud when the SEC failed to recognize the fraud and attendant abuses at Enron in 2001, shortly followed by similar problems at Adelphia, WorldCom, Global

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Crossings, Tyco, and a host of other companies. Only months later, Eliot Spitzer issued scathing attacks on the SEC's dismal performance in regulating mutual fund abuses. This was followed by the SEC's failure to respond to, or even to comprehend, the excessive risk-taking at Bear Stearns, Lehman Brothers, and other broker-dealer firms. The parade of shortcomings ended most recently with the SEC's failure to respond to glaring warnings about the massive fraud of Bernie Madoff.

Part I of this Article develops several arguments about the factors that motivate the SEC. Part II attempts to link the incentives facing the SEC to particular failures in the agency over the past decade.

I. WHAT MOTIVATES THE SEC?

Bureaucrats are people, too. They respond to incentives just like everybody else. Strangely, however, the theories about precisely what incentives bureaucrats respond to are sketchy. Of course bureaucrats care about their professional futures and their reputations, and perhaps even the amount of 'regulatory turf' they control. Bureaucrats at the SEC and elsewhere also seem to be concerned with congressional oversight, because Congress controls the budgets of the bureaucrats' administrative agencies. They also care about public opinion because public opinion deeply affects most of the other concerns (reputation, professional advancement, and budgets) that matter to bureaucrats.

At the same time, the SEC is staffed by highly capable, extremely well-qualified professionals, most of whom are lawyers, and many of whom come from or move on to extremely...
successful careers in the most rigorously competitive parts of
the private sector (primarily law, but also investment banking). Finally, but
by no means least of all, there is little corruption at the SEC. Although
potential future employers of top SEC personnel appear to have considerable clout, few SEC employees have been seriously accused of generating bad public policies or enforcement decisions for corrupt motives. The lawyers and

that regulates the world's largest securities markets to be so dominated by lawyers is ill-advised."

6. A notable exception to this general situation is the apparently successful effort by the investment banking firm Morgan Stanley to limit the SEC's insider trading investigation of a hedge fund called Pequot Capital Management. For a retelling of the story, see 153 CONG. REC. S1381-91 (daily ed. Jan 31, 2007). The SEC's investigation was going to require taking testimony from—and perhaps investigating—John Mack, Morgan Stanley's CEO who had worked with Pequot during the time period of the alleged insider trading. Maneuvering within the SEC delayed Mack's testimony until after the statute of limitations had lapsed. Congressional investigators found that:

In June 2005, Morgan Stanley's Board of Directors hired former U.S. Attorney Mary Jo White to determine whether prospective CEO John Mack had any exposure in the Pequot investigation. White contacted Director of Enforcement Linda Thomsen directly, and other Morgan Stanley officials contacted Associate Director Paul Berger. Soon afterward, SEC managers prohibited the staff from asking John Mack about his communications with Arthur Samberg at Pequot. . . .

SEC management delayed Mack's testimony for over a year, until days after the statute of limitations expired. After Staff Attorney Aguirre complained about his supervisor's reference to Mack's "political clout," SEC management offered conflicting and shifting explanations for blocking Mack's testimony. Although Paul Berger claimed that the SEC had always intended to take Mack's testimony, Assistant Director Mark Kreitman said that definitive proof that Mack knew about the GE-Heller deal was the "necessary prerequisite" for taking his testimony. The SEC eventually took Mack's testimony only after the Senate Committees began investigating and after Aguirre's allegations became public, even though it had not met Kreitman's prerequisite.

The SEC fired Gary Aguirre after he reported his supervisor's comments about Mack's "political connections," despite positive performance reviews and a merit pay raise. Just days after Aguirre sent an e-mail to Associate Director Paul Berger detailing his allegations, his supervisors prepared a negative re-evaluation outside the SEC's ordinary performance appraisal process. They prepared a negative re-evaluation of only one other employee. Like Aguirre, that employee had recently sent an e-mail complaining about a similar situation where he believed SEC managers limited an investigation following contact between outside counsel and the Director of Enforcement.
other professionals want to be successful and have rewarding careers. They want to be viewed as successful by their professional peers outside of the SEC.

In light of these facts, it is puzzling why the honest, competent people at the SEC appear to perform so poorly at their appointed tasks. Another question is why their behavior never seems to improve from crisis to crisis. This Article argues that the fault lies not with the bureaucrats, but rather with the incentives that motivate them. To understand the failures of the SEC, one has to look at precisely how the personnel are motivated to do their work.

First, it is clear that the SEC is largely evaluated on the basis of how well its Division of Enforcement performs. The SEC is divided into five divisions. Four are rather obscure and have not attracted much controversy, including: the Division of Corporate Finance, which reviews SEC registration statements; the Division of Trading and Markets, which pursues the SEC’s mandate for maintaining fair, orderly, and efficient markets; the Division of Investment Management, which is supposed to protect individual investors by overseeing and regulating the $26 trillion investment management industry; and the Division of Risk, Strategy, and Financial Innovation, which was established in 2009 “to help further identify developing risks and trends in the financial markets” by “providing the Commission with sophisticated analysis that integrates economic financial and legal disciplines.”

The principal SEC division is the Division of Enforcement. The SEC describes itself as: “first and foremost . . . a law enforcement agency.” The Division of Enforcement exists to enable the Commission to investigate possible securities law violations, and, where appropriate, it recommends to the Commission that a civil action be brought against individuals and companies that have violated such laws. Upon obtaining the necessary approval from the Commission, the Division of Enforcement then prosecutes on behalf of the Commission the cases it has inves-


8. Id.
An additional component of the Division of Enforcement mandate is to work closely with law enforcement agencies in the United States and around the world to file criminal charges. In the United States, this task is done through a referral process in which the SEC refers cases to the Criminal Division of the U.S. Department of Justice and then works with the Assistant U.S. Attorneys to bring criminal actions.

At the SEC, "enforcement actions have traditionally defined the mission of the agency." In fact, economic sociologist William Bealing has posited correctly that it is the activities of the Enforcement Division of the SEC that legitimize the Commission’s existence and its federal budget allocation to Congress. It certainly appears that "the SEC is carrying out its (enforcement) duties so as to maintain a base of support within the Congressional budget process."

Assuming that the SEC is deeply concerned with its budget and that the performance of the Enforcement Division is critical to the SEC’s success, the strategy that the SEC employs to maximize its appeal to Congress, and more generally to maximize the overall notion that it is effectively using the resources that Congress has allocated to it, is to focus on available, salient criteria. In particular, the SEC focuses on the raw number of cases that it brings and on the sheer size of the fines that it collects. For example, when criticized recently for failing to respond to numerous tips from whistle-blowers and red flags in the case of Bernard Madoff’s massive fraud, the SEC noted in congressional testimony that:

[C]omparing the period from late January to the present to the same period in 2008, Enforcement has:

- opened more investigations (1377 compared to 1290);
- issued more than twice as many formal orders of investigation (335 compared to 143);

9. Id.
- filed more than twice as many emergency temporary restraining orders (57 compared to 25); and
- filed more actions overall (458 compared to 359).13

The SEC’s 2008 Annual Report is similarly clear in its emphasis on the easily measurable criteria of number of enforcement actions brought and the amount of fines assessed:

During FY 2008, the Enforcement Division also brought the highest number of insider trading cases in the agency’s history. In addition, the SEC brought a record-high number of enforcement actions against market manipulation in 2008, including a precedent-setting case against a Wall Street short seller for spreading false rumors. Overall for the fiscal year just ended, the SEC completed the highest number of enforcement investigations in any year to date, by far. We also initiated the second-highest number of enforcement actions in agency history.

Not just in 2008, but in each of the last two years, the Commission set the record for the highest number of corporate penalty cases in the agency’s history. And for the second year in a row, the SEC returned more than $1 billion to harmed investors using our Fair Funds authority under the Sarbanes-Oxley Act. To support this record level of law enforcement, the SEC now devotes more than one-third of the entire agency staff to our enforcement program. That is a higher percentage of the SEC’s total staff than at any time in the past 20 years. The SEC’s internal allocation of funds for enforcement in FY 2008 was the highest in the agency’s history. In this past year, we also increased the number of enforcement personnel by 4 percent.14

The SEC’s 2008 Annual Report was written when the Commission’s reputation was under severe stress. Three events in particular—the collapse of Enron, the emergence of regulatory competition from state attorneys general (particularly Eliot


Spitzer), and the SEC’s incompetence in its handling of the $50 billion securities fraud orchestrated by Bernard Madoff—tarnished the SEC’s traditional standing as America’s foremost administrative agency in terms of quality and integrity.

Many have criticized the SEC in recent years, and it is difficult to imagine that the Commission’s position at the center of a political maelstrom has not affected the agency’s behavior. For example, the report makes salient “a long-standing criticism that the SEC has largely failed to prosecute cases against corporate executives, opting for quick settlements in which companies themselves are penalized instead of their leaders.”

The SEC has rationally pursued this policy of opting for quick settlements because the agency is largely judged on the basis of the number of cases it wins. The agency needs fewer resources to sue companies than individuals because companies do not defend themselves as vigorously as individuals do. In addition, and for the same reasons, the SEC has moved to a policy of suing and settling with industry groups. Similarly, the SEC in recent years has attempted to expand the contours of the law, which makes it easier for them to bring cases, and to keep the law vague by refusing to define insider trading. The SEC has thus pursued a policy that is consistent with the Commission’s rational self-interest but clearly suboptimal from a societal perspective of economizing the performance of investigations.

In particular, as social psychologists would predict, the SEC’s enforcement effort is evaluated both internally and externally in overly simplistic ways because of the trust and reliance that those evaluating the SEC place in readily available evaluative heuristics. The focus is on the number of cases brought by the Division, and, to a lesser extent, on the size of the fines collected by the SEC. The more cases that are brought and the greater the amount of fines collected during a particular time frame, the better the enforcement staff at the SEC is thought to perform.

In light of this metric of success, it is not surprising that the SEC focuses on low-hanging fruit. Because investigations take time, the SEC focuses on bringing cases that do not require much, if any, investigative effort. Indeed, the SEC makes no secret of the limited amount of detective work it does. It de-

rives its docket of cases from scandals that are reported in the press and from tips from whistleblowers. Indeed, as Maureen O’Hara and I have argued in other work, the SEC often does not even pay attention when evidence of fraud appears in well-known scholarly journals in corporate finance. Instead, enforcement comes only after an issue is made politically salient by the financial press.

A major theme of this Article is that the performance-based incentives to which even the most able bureaucrats respond are perverse and lead to perverse results. The number of enforcement actions and the size of fines may not be the best criteria by which to evaluate the conduct of the SEC, but they are data that are “available,” a factor that social psychology and behavioral finance tell us often drives decision making. In social science, the availability heuristic posits that people tend to use evaluative techniques on the basis of “the ease with which instances or associations come to mind.”

Thus, the SEC’s apparent focus on how many cases it brings and on the size of the fines collected appears to represent the availability heuristic in action. As in other contexts, this reliance on availability leads to predictable biases. In other words, the SEC’s apparently odd behavior in recent years is not due to corruption or incompetence on the part of the agency. Rather, the SEC simply has been responding, more or less rationally, to the rather odd set of incentives that it faces from its overseers in Congress and from the general public.

In addition to its focus on the number of cases that it brings and on the size of the fines it collects, another factor that influences the SEC’s conduct is the dominance of lawyers within the

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17. See id.
18. Herbert Bless et al., Ease of Retrieval as Information: Another Look at the Availability Heuristic, 61 J. PERS. & SOC. PSYCH. 195, 195 (1991). In addition to the SEC, it also appears that the Financial Industry Regulatory Authority (FINRA) is evaluated on the basis of how many cases it brings and how big the fines are that it collects. See Susanne Craig, Finra’s Susan Merrill to Exit as Enforcement Chief, WALL ST. J., Mar. 18, 2010, at A1 (“The executive hired by Wall Street to enforce its rules is stepping down after nearly three years in which the organization’s disciplinary actions and fines against the brokerage industry have declined, the group said.”).
agency. The consequences of this domination include increased concern with process and decreased concern with social science evidence in decision making. Moreover, because lawyers are less knowledgeable about how the financial markets operate than actual participants in the industry, the rise of a lawyer-dominated culture at the SEC has resulted in less understanding of complex financial instruments and the operation of financial markets during an era in which complexity has been increasing rapidly.

The glacial speed at which the SEC operates is largely attributable to the Commission’s lawyer-dominated culture. Harry Markopolos, the industry whistle blower who tried unsuccessfully to bring the SEC’s attention to Bernie Madoff’s Ponzi scheme, has described the SEC as “too slow” and further observed that the Commission “was hindered by lawyers, did not understand red flags, could not do the math and was captive to the financial industry.” Mr. Markopolos also testified that “the SEC staff lacks the financial expertise and is incapable of understanding the complex financial instruments being traded in the 21st century,” and that “the SEC is overlawyered and has [too few] staff with relevant industry experience and professional credentials to find fraud even when a multi-billion dollar case is handed to them on a silver platter.” Combating simple fraud and old-fashioned Ponzi schemes may help the capital markets and protect small investors, but it does little to help SEC officials develop the skills and expertise that will make them valuable to Wall Street law firms, the clear focus of SEC staffers today.

In addition to slowing things down, the SEC’s domination by lawyers has affected Wall Street. For example, the people heading the Enforcement Division of the SEC in recent years all have moved to jobs as advisers to banks. The most recent Director is now a partner at Davis, Polk & Wardwell. Her predecessor is the general counsel at JPMorgan Chase. His predecessor became general counsel at Deutschebank. Others in recent years have gone to Credit Suisse and Morgan Stanley. One “could be forgiven for thinking that the whole point of landing a job as the SEC’s Director of Enforcement is
to position oneself for the better paying one (as a lawyer) on Wall Street." The available empirical evidence supports the conclusion that SEC lawyers have significant mobility. The turnover rate for SEC attorneys is almost twice as high as the turnover rate for all government attorneys. SEC officials thus want to develop practice specialties in technical legal fields that will help them to find jobs in high-powered law firms when they leave the SEC, rather than do their job as financial regulators.

Finally, the SEC has strong incentives to promote the appearance that the capital markets are in crisis and to eschew the development of market mechanisms that might solve the very problems that the SEC is tasked with solving. The SEC is thus in a difficult position. On the one hand, of course, the SEC wants to be viewed as successful. On the other hand, if financial crises do not arise every so often the SEC might well come to be viewed as unnecessary. From the SEC's perspective, the optimal way to handle this balancing act is to blame any and all failures on a lack of resources. The SEC pursued this strategy with great success after the collapse of Enron in 2002. The SEC long claimed that it faced a "staffing crisis" due to its "inability to compensate [its] employees adequately." As Table 1 indicates, the collapse of Enron in 2001 led to unprecedented budget increases for the SEC staff in 2002 and 2003. In fact, the SEC budget more than doubled between 2001 and 2004 from $422.8 million to $913 million, and the SEC was the only federal agency to receive substantial budget increases both in 2003 and 2004.

25. See, e.g., Macey, supra note 1, at 937, 948.
Table 1: SEC Budget History\textsuperscript{28}

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Budget Authority (in thousands of $)</th>
<th>Change from Previous Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>166,633</td>
<td>---</td>
</tr>
<tr>
<td>1991</td>
<td>189,083</td>
<td>13%</td>
</tr>
<tr>
<td>1992</td>
<td>225,792</td>
<td>19%</td>
</tr>
<tr>
<td>1993</td>
<td>253,235</td>
<td>12%</td>
</tr>
<tr>
<td>1994</td>
<td>269,150</td>
<td>6%</td>
</tr>
<tr>
<td>1995</td>
<td>300,437</td>
<td>12%</td>
</tr>
<tr>
<td>1996</td>
<td>300,921</td>
<td>0.2%</td>
</tr>
<tr>
<td>1997</td>
<td>311,100</td>
<td>3.4%</td>
</tr>
<tr>
<td>1998</td>
<td>315,000</td>
<td>1.3%</td>
</tr>
<tr>
<td>1999</td>
<td>341,574</td>
<td>8%</td>
</tr>
<tr>
<td>2000</td>
<td>377,000</td>
<td>10%</td>
</tr>
<tr>
<td>2001</td>
<td>422,800</td>
<td>12%</td>
</tr>
<tr>
<td>2002</td>
<td>513,989</td>
<td>22%</td>
</tr>
<tr>
<td>2003</td>
<td>716,350</td>
<td>39%</td>
</tr>
<tr>
<td>2004</td>
<td>811,500</td>
<td>13%</td>
</tr>
<tr>
<td>2005</td>
<td>913,000</td>
<td>13%</td>
</tr>
<tr>
<td>2006</td>
<td>888,000</td>
<td>-3%</td>
</tr>
<tr>
<td>2007</td>
<td>888,000</td>
<td>0%</td>
</tr>
<tr>
<td>2008</td>
<td>906,000</td>
<td>2%</td>
</tr>
<tr>
<td>2009</td>
<td>960,000</td>
<td>6%</td>
</tr>
</tbody>
</table>

The crisis also led to increases in the salaries for SEC staff. SEC Chairman Harvey L. Pitt testified in early 2002 that the SEC did not have adequate resources or staff to deal with the regulatory and enforcement demands created by the collapse of Enron, and asked Congress for an extra $91 million to boost salaries and to hire one hundred new accountants and lawyers.29 Shortly thereafter the SEC Executive Director stated that "[t]he SEC cannot afford to continue suffering the staffing crisis it has endured for the past decade at such an important juncture."30 In fact, SEC staffers received the largest pay increases of any administrative agency in the U.S. government in 2001 when Congress elevated the pay of SEC staff members to the same pay scale as employees of the Board of Governors of the Federal Reserve System.31

The next Part of this Article will attempt to provide support for the predictions and implications articulated in the previous paragraphs about the direction that the SEC is taking with examples and case studies from the SEC's recent history.

II. THE SEC IN ACTION: HEURISTICS AT WORK

A. The SEC is More Likely to Sue Companies Than to Sue Individuals

It has long been said that the SEC is more likely to sue companies than to sue individuals within those companies for securities fraud and other SEC rule violations.32 This longstanding practice has "effectively allowed corporate managers to buy immunity (for themselves) with their shareholders' money."33

The SEC's tendency to resist prosecuting corporate executives and instead to pursue prompt settlements against corpo-

32. Kouwe, supra note 15.
33. Id.
rate defendants is consistent with the hypothesis that the SEC maximizes the number of cases it brings and the size of the fines it collects for two reasons. First, individual defendants are far more likely than corporate defendants to take cases to trial because fines paid by individual defendants are likely to come from their own pockets. Corporations, conversely, quickly settle cases by paying with their shareholders’ money.

Second, the settlement decisions made by corporations are not, of course, made by the corporations themselves or by their shareholders, but rather by senior-level corporate executives. Because these corporations often have extremely deep pockets, and because the individuals making settlement decisions on behalf of corporations (who may be far more interested in deflecting blame from themselves than in conserving the corporation’s wealth) are not spending their own money, corporate defendants are more likely to agree to more generous settlements with the SEC than are individual defendants.

The recent controversy over a proposed settlement between the SEC and Bank of America provides a very useful window on this point. The proposed settlement was to end a lawsuit challenging misrepresentations made by Bank of America in connection with the Bank’s solicitation of shareholder support for its proposed merger with Merrill Lynch in late 2008.

In its complaint, the SEC alleged that Bank of America “made materially false and misleading statements” to its shareholders in the proxy statement of November 3, 2008, in which the bank solicited the approval of its shareholders to complete the bank’s proposed $50 billion acquisition of Merrill. According to the complaint, Bank of America represented that Merrill had agreed not to pay year-end performance bonuses or other discretionary incentive compensation to its executives prior to the closing of the merger without Bank of America’s consent (notwithstanding the fact that) contrary to the representation…. Bank of America had agreed that Merrill could pay up to $5.8 billion—nearly 12% of the total consideration to be exchanged in the merger—in discretionary year-end and other bonuses to Merrill executives for 2008.

35. Id. at 2.
The litigation was solely against Bank of America. No individual defendants were named. Under the terms of the settlement, Bank of America, without admitting or denying the accusations, agreed to be enjoined from making future false statements in proxy solicitations and agreed to pay the SEC a fine of $33 million. In rejecting the settlement, U.S. District Judge Jed Rakoff acknowledged the strong presumption in favor of settlements, observing that "an ordinary civil settlement that includes dismissal of the underlying action is close to unreviewable." 36

Nevertheless, Judge Rakoff, "even upon applying the most deferential standard of review for which the parties argue," was "forced to conclude that the proposed Consent Judgment [was] neither fair, nor reasonable, nor adequate." 37 Judge Rakoff described the proposed settlement as follows:

[T]he parties were proposing that the management of Bank of America—having allegedly hidden from the bank's shareholders that as much as $5.8 billion of their money would be given as bonuses to the executives of Merrill who had run that company nearly into bankruptcy—would now settle the legal consequences of their lying by paying the S.E.C. $33 million more of their shareholders' money. 38

Judge Rakoff's "first and foremost" grounds for rejecting the settlement were that forcing the shareholders who were the victims of the bank's alleged misconduct now to pay the penalty for that misconduct did "not comport with the most elementary notions of justice and morality." 39 In other words,

37. Id. at 3.
38. Id. at 2.
39. Id. at 4. The SEC defended making the shareholders pay for the company's fraud on the grounds that "[a] corporate penalty . . . sends a strong signal to shareholders that unsatisfactory corporate conduct has occurred and allows shareholders to better assess the quality and performance of management." Id. (alteration in original) (citation omitted). As Judge Rakoff noted, the SEC's justification makes no sense when applied to the facts here: for the notion that Bank of America shareholders, having been lied to blatantly in connection with the multi-billion-dollar purchase of a huge, nearly-bankrupt company, need to lose another $33 million of their money in order to 'better assess the quality and performance of management' is absurd.

Id.
Judge Rakoff could not “justify imposing penalties on the victims of [Bank of America’s] lie, the shareholders.”

In his opinion, Judge Rakoff was particularly cognizant of the conflict of interest whenever management settles an SEC action brought against the corporation for the management’s own conduct. Judge Rakoff intimated strongly that it might be beyond the purview of management, when it is “accused of having lied to its shareholders to determine how much of those victims’ money should be used to make the case against the management go away.”

Judge Rakoff left no ambiguity about the SEC’s self-interest in agreeing to settle with Bank of America. He opined that the parties’ proposed Consent Judgment “was a contrivance designed to provide the SEC with the facade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry—all at the expense of the sole alleged victims, the shareholders.” Moreover, according to the Judge,

[t]he proposed Consent Judgment in this case suggests a rather cynical relationship between the parties: the SEC gets to claim that it is exposing wrongdoing on the part of Bank of America in a high-profile merger; the Bank’s management gets to claim that they have been coerced into an onerous settlement by overzealous regulators. And all this is done at the expense, not only of the shareholders, but also of the truth.

B. In Pursuit of Low-Hanging Fruit

In testimony before the Senate Committee on Banking, Housing, and Urban Affairs, two top SEC officials attempted to explain the SEC’s failure to detect the massive fraud perpetrated by Bernard Madoff. The SEC’s failures were rigorously catalogued in a 477-page report by the SEC’s Office of Inspector General (OIG), a relatively independent office within the Commission. Although there are many candidates for the designation, the SEC’s failure to pursue Bernard Madoff’s Ponzi

40. Id. at 5.
41. Id. at 7 (noting that “even if this decision is arguably within [management’s] purview, it calls for greater scrutiny by the Court than would otherwise be the case”).
42. Id. at 8.
43. Id. at 11.
44. Khuzami & Walsh Hearing, supra note 13.
45. MADOFF INVESTIGATION, supra note 4, at 1–2.
scheme may well be the most flamboyant and salient series of missteps in the agency’s history. The SEC itself acknowledges that “no one can or should defend, excuse, or deflect responsibility for the SEC’s handling of the Madoff matter.”\textsuperscript{46}

The OIG investigation did not find evidence that any SEC personnel conducting the examination of Madoff had any inappropriate connection with Madoff that influenced their examination or investigatory work. Nonetheless, the OIG investigation revealed that the SEC had received an astonishing amount of incriminating information about Madoff and failed to follow up thoroughly on any of it:

[T]he SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS (Bernard Madoff Investment Securities) for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed. The OIG found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff’s hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. Finally, the SEC was also aware of two articles regarding Madoff’s investment operations that appeared in reputable publications in 2001 and questioned Madoff’s unusually consistent returns.\textsuperscript{47}

Stunningly, the reason that the SEC did not pursue these complaints against Madoff was because the Commission did not want to devote the necessary resources.\textsuperscript{48} In particular, an SEC official testified that there was no effort to obtain what is known as “audit trail data” because the SEC, as a general matter, believes that obtaining and analyzing this data is too expensive and time-consuming.\textsuperscript{49} Audit trail data provides information on individual trades and is the primary manner in which the SEC and the self-regulatory organizations (the Financial Industry Regulatory Authority and the New York Stock Exchange) obtain

\textsuperscript{46. Khuzami & Walsh Hearing, supra note 13.}
\textsuperscript{47. MADOFF INVESTIGATION, supra note 4, at 20–21 (emphasis added).}
\textsuperscript{48. Id. at 98.}
\textsuperscript{49. Id. at 108–09 (“I can tell you we were always hesitant to get audit trail data because it can be tremendously voluminous and difficult to deal with and is a huge resource issue for us. It takes us a ton of time.”).}
the detailed trading data necessary for the detection of fraud, manipulation, insider trading, and other securities law violations. If the SEC had pursued the audit trail data, it would have discovered that Madoff was not actually doing the trades he claimed to be doing and that his entire business enterprise was a sham. An SEC official observed that he “had no explanation for why the request for detailed audit trail data would be eliminated, stating, ‘I can’t account for this, but it would have been, frankly, asinine for us to not get the audit trail.’”

Another way that the SEC easily could have detected the Madoff fraud was by investigating Madoff’s counterparties, that is, the people with whom Madoff claimed to have been trading. Because Madoff falsely claimed to be profiting from trading activity, communicating with the companies that he claimed were his counterparties would have revealed the fraud.

The OIG investigated why the SEC did not attempt to obtain information about Madoff’s counterparties. In response, the SEC officials involved in the Madoff investigation noted that the entities that Madoff claimed were his counterparties were European banks, Royal Bank of Scotland (RBS) and the Swiss bank UBS. Because these banks were foreign, the SEC Division of Enforcement personnel investigating Madoff would have to consume time and resources either dealing with these companies’ U.S. affiliates or dealing with their colleagues at the SEC Office of International Affairs. Neither of these options was attractive to the SEC enforcement staff, apparently due to “the scarcity of resources and the difficulty of obtaining such records.”

In fact, even beyond the Madoff investigation, investigating Ponzi schemes in general seems to have been regarded as a “burning [of] resources.” Yet, the most striking thing about the SEC Division of Enforcement’s failure to conduct an adequate investigation into the Madoff scheme is that such an investigation would not have required much in the way of resources. If the SEC is not even willing to investigate a suspected massive fraud on the basis of tips from numerous credible informants, one wonders what the SEC does investigate.

50. Id. at 109.
51. Id. at 339. In all, the OIG investigation of Madoff cites the unwillingness or inability to devote resources to the investigation over thirty times.
52. MADOFF INVESTIGATION, supra note 4, at 244 n.167.
According to the SEC Division of Enforcement, the SEC opens a matter for inquiry (known in SEC parlance as a Matter under Inquiry or "MUI") when it receives information from a variety of sources that may warrant the opening of a new MUI, including newspaper articles, complaints from the public, whistleblowers, and referrals from other agencies or self-regulatory organizations. Assigned staffers are encouraged to use their discretion and judgment in making the preliminary determination of whether it is appropriate to open a MUI.  

Among these various sources of leads, the dominant one appears to be newspaper articles. An example of the significance of newspaper articles can be seen in research that has found that accounting fraud that occurs relatively far away from the SEC home office in Washington, D.C., or from one of the SEC regional offices is less likely to be investigated by the SEC. This is largely due to the reliance by SEC staffers on "stories in the regional press, which by its nature tends to focus on local events. This means that unless SEC staffers carefully monitor the newspapers of all cities in their regions (which typically span several states) this [type of] source [(newspapers)] is likely to bias investigations towards geographically proximate companies." This bias appears to be so significant that researchers have found that auditors located farther away from SEC Regional Offices perceive a lower risk of enforcement actions and thus are more likely to compromise their independence than auditors located close to SEC Regional Offices.  

Newspaper articles appear to be the preferred external source for leads for two reasons. First, when a newspaper ar-

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56. Id. at 4–5.
57. The primary internal source is referrals to the Division of Enforcement from the Division of Corporate Finance. See Michael J. Kigin, Assoc. Chief Accountant, Office of the Chief Accountant, Sec. & Exch. Comm’n, Remarks to Business Issues and Audit Conference, The Institute of Internal Auditors: The SEC’s View on
article is published, by definition a reporter already has investigated a matter, done sufficient research to write a story about it, had the story subjected to some measure of fact checking, and faced the obligation to print a retraction if the companies and individuals who are subjects of the article are able to refute its assertions. Thus, the SEC is able to free ride on the resources of newspapers and on the investigative talents of newspaper reporters. Second, because, like other agencies, the SEC is intensely concerned with public opinion, it has a strong independent motive to pursue allegations of securities fraud contained in newspaper stories, regardless of whether such stories are likely to be accurate.

C. Vagueness as a Bureaucratic Goal

The SEC likes to bring a large number of cases, and it likes to settle those cases promptly. Vague rules serve the interests of the SEC by making it less likely that the agency will invest substantial resources in conducting an investigation and then be unable to bring a case against the putative defendants. The SEC is likely to prefer vague rules to clear rules because vague rules expand the Commission’s discretion about what cases it can bring.

On the other hand, cases that invoke and rely on vague legal doctrine are more likely to be litigated than cases that rely on clear legal doctrine. The SEC does not like to litigate cases for a variety of reasons, not the least of which is resource constraints. The SEC wants to bring a large number of cases, and settling rather than litigating allows it to do so. The SEC actually litigates so few cases, however, that on balance vagueness serves the interests of the SEC by expanding its discretion to bring cases, which it can then settle. Moreover, because the SEC has no real clients who must pay the marginal costs of pursuing weak or nonexistent claims, the SEC can pursue cases

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based on vague or dubious legal theories. On the other hand, the SEC's counterparties must bear the high costs of litigating even dubious claims against the SEC, and if these litigation and transaction costs are sufficiently high, even the most innocent client will find it in its best interests to settle.

Current Supreme Court doctrine always encourages and sometimes actually requires lower federal courts to rely on the legal interpretations of administrative agencies when they are interpreting a statute, particularly when the statutes are those that the agencies are empowered by Congress to enforce.61 Thus, even the most vague or far-reaching SEC interpretation is entitled to deference, a factor that is bound to encourage defendants to settle.

An area clearly affected by this SEC penchant for promulgating vague rules is insider trading. The Division of Enforcement prefers bringing insider trading cases to bringing other sorts of cases. The SEC likes cases "with an attention-grabbing angle," and "many kinds of insider trading cases are particularly well suited for this."62 Thus, it is not surprising that the SEC consistently has pushed for vague interpretations of the rules against insider trading. It actually has refused, persistently and for decades, to promulgate a definition of what constitutes illegal insider trading because it prefers to keep the contours of the rule vague, and it does not want to provide too much guidance to market participants.

As a remedy, insider trading is not defined either by the SEC or by statute. To the extent that there is a definition, courts have created it and offered interpretations of insider trading doctrine incrementally, on a case-by-case basis. Studies of the SEC's enforcement effort acknowledge "[t]he reluctance of the SEC to use its rule-making authority and its tendency to regulate piecemeal through adjudication."63

62. Langevoort, supra note 60, at 8.
D. The SEC Prefers Rules that Are Not Only Vague, but Also Broad

To the extent that the securities laws are interpreted rather than left vague, the SEC prefers that such laws are interpreted as expansively as possible to maximize the Commission’s ability to bring cases. In fact, from the SEC’s perspective, the optimal insider trading rule would make insider trading a status offense. Under such a rule, officers, directors, large shareholders, professional investors, or anybody with an informational advantage of any kind over his trading partners would be forbidden to use that informational advantage when trading. Such a broad rule would enable the SEC to meet its quota for cases more easily and would give the SEC discretion to sue virtually anybody who was able to make money in securities trading.

The most recent example of the SEC’s efforts to expand the contours of the laws against insider trading concerns the insider trading action against Mark Cuban. This case involved Cuban’s trading in the stock of a public company called Mamma.com. The company was on the verge of entering into a financing transaction that would depress significantly the share price of the company’s outstanding stock. Mr. Cuban, although a major shareholder, was not a member of the Mamma.com board or an officer or employee of the company, and he learned of the impending transaction and sold his stock in advance to avoid the loss. The transaction in question was a so-called “PIPE” (“Private Investment in Public Equity”) deal in which a company makes money by making a private placement of stock to a small number of institutional investors when the company has previously made a public offering of the same class of identical stock. Where the PIPE private placement is made at a discount to the current market price of the outstanding publicly traded stock, the owners of the publicly traded stock suffer a dilution in the value of their investments. The SEC sued Cuban for illegally avoiding $750,000 in losses by selling his entire holding of

64. See SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009). The Author participated in writing and filing an amicus brief supporting the dismissal of the SEC’s complaint.
65. Id. at 717.
66. Id. at 717-18.
67. See id. at 717.
600,000 shares when he learned from the CEO of Mamma.com that the company was about to make its private PIPE sale.\textsuperscript{68}

One of the rules that the Supreme Court has promulgated for the specific purpose of curbing baseless insider trading cases is that a defendant must breach a duty of trust owed to the source of the information.\textsuperscript{69} In the Cuban case, Mamma.com, the issuer, was the source of the information. Cuban, however, had never signed an agreement not to use information that management might pass along to him, although he had signed an agreement in which he promised to keep information provided to him by the company confidential.\textsuperscript{70}

In dismissing the SEC’s complaint, the district court made the rather obvious point that a promise to keep information confidential is not the same as a promise to refrain from trading. In order to give rise to a legal duty to refrain from trading, a shareholder must have a “legal duty to refrain from trading on or otherwise using the information for personal gain.”\textsuperscript{71} Because the SEC’s complaint did not allege that Cuban agreed to refrain from trading while aware of the impending PIPE offering, the judge held that the confidentiality agreement that Cuban signed could not form the basis for an insider trading prosecution.\textsuperscript{72}

Significantly, the court ruled further that the SEC could not unilaterally make Cuban’s conduct illegal. Specifically, in 2000, the SEC promulgated Rule 10b5-2(b)(1), covering situations in which “a person agrees to maintain information in confidence.”\textsuperscript{73} As this rule bases misappropriation theory liability “on a mere confidentiality agreement lacking a non-use component,” the court ruled that the SEC could not rely on it to establish Cuban’s liability under the misappropriation theory.\textsuperscript{74} In other words, the SEC could not simply transform confidentiality agreements between private parties into agreements not to trade.

\textsuperscript{68} Id. at 717-18.  
\textsuperscript{70} Cuban, 634 F. Supp. 2d at 728.  
\textsuperscript{71} Id. at 725.  
\textsuperscript{72} Id. at 725-28.  
\textsuperscript{73} 17 C.F.R. § 270.10b5-2(b)(1) (2009).  
\textsuperscript{74} Cuban, 634 F. Supp. 2d at 730-31.
E. The More the Merrier

Because the SEC wants to maximize the number of cases it brings, it will try to develop theories of wrongdoing that can support litigation against multiple defendants for the same sort of conduct without the need for significant extra work. Examples of the phenomenon of suing entire industries are the SEC's campaigns against late trading and penny stocks.

1. Late Trading and Market Timing

The crusades against market timing and late trading began in 2003 when Eliot Spitzer, then New York Attorney General, began to develop and enforce law on these issues, deeply embarrassing the SEC. Market timing is "[a]n investment strategy based on the forecasting of changes in the direction of market prices," by which investors hope to make a profit by buying and selling at opportune moments.\(^{75}\)

Not only is market timing legal, but because virtually all unsophisticated traders (and many sophisticated traders) attempt, in some fashion, to "buy low and sell high," it would not seem to be practical or advisable to attempt to ban the practice. On the other hand, if the SEC wants to maximize its prosecutorial discretion to maximize its ability to bring cases, then being able to sue market timers would be a highly attractive option for the SEC.

Some market timers attempt to profit by exploiting stale prices. The model strategy is "time-zone arbitrage," which involves attempting to profit from differences between the net asset value, or "NAV,"\(^{76}\) and the actual current market value of the underlying securities in the mutual fund portfolio.

When a U.S. mutual fund holds shares in Asian or European markets, market timing arbitrage is possible. Suppose, for example that a U.S. mutual fund holds shares in German, French,

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75. *Market Timing*, in *A Dictionary of Business and Management* 355 (5th ed. 2009). The efficient markets hypothesis (also known as the Efficient Capital Markets Hypothesis, or ECMH) predicts, among other things, that share prices adjust very rapidly to new information and already reflect historical information. A basic implication of the efficient markets hypothesis is that most market timing strategies cannot possibly succeed because they attempt to predict future share prices on the basis of historical patterns of share prices. This is fundamentally incompatible with the efficient markets hypothesis.

76. The NAV is the value of the mutual fund shares as calculated by the Mutual Fund Company's adviser divided by the number of mutual fund shares outstanding.
and Italian companies that are traded in Frankfurt, Paris, and Milan. The U.S. mutual fund determines the NAV for its shares, which is the price at which investors can buy and sell the mutual fund’s shares in the late afternoon, usually not long after 4:00 p.m. when U.S. markets close. Markets close in Europe when it is only 11:00 a.m. in New York, however, so the price used to compute the prices of the German, French, and Italian stocks in the mutual fund portfolio will be several hours old and probably quite “stale” when the NAV of the U.S. mutual fund is calculated.

Suppose, for example, that there is some news released that is clearly going to lead to an increase in the value of the European stocks owned by the U.S. mutual fund.\textsuperscript{77} Suppose further that this news is released between 11:00 a.m. and 4:00 p.m., that is, between the time when the European markets close and when the NAV for the mutual fund is computed. When this sequence of events occurs—and it occurs frequently—a market timer can buy or sell at the old, stale price of the mutual fund by buying it soon after the news is released and before the NAV is calculated by the mutual fund. In the example here, this purchase enables the market timer (who in this case is acting as a time zone arbitrageur) to buy shares cheaply because the shares will be priced at the old 11:00 a.m. price even though they can be bought during the period after 11:00 a.m. when the news is released and before the fund sets its NAV much later in the day.

Once the mutual fund price has adjusted upward, the market timer generally will sell as quickly as possible in order to lock in the gain. It is for this reason that market timers sometimes engage in rather frequent trading.

Late trading is the term used to describe what happens when a mutual fund investor is permitted to receive the current day’s NAV for his purchase or sale of mutual fund shares despite submitting the order after the mutual fund has calculated its NAV for that day. Late trading is prohibited by SEC Rule 22c-1 (the “forward pricing rule”) which provides, in pertinent part, that

\begin{quote}
[n]o registered investment company issuing any redeemable security ... shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt
\end{quote}

\textsuperscript{77} The European Central Bank may announce, for example, that it will lower interest rates because manufacturing is up and employment is down.
of a tender of such security for redemption or of an order to purchase or sell such security ... 78

Thus, by its plain terms, Rule 22c-1 does not require that mutual funds calculate their NAVs at any particular time (although mutual funds are required to calculate their NAVs at least once a day). 79 Late trading occurs when mutual funds either accept orders from certain favored customers at the previously calculated NAV or permit such customers to cancel their orders after the mutual fund has calculated its NAV. The potential problem with late trading is that it allows traders to take advantage of information released late in the day, after the markets have closed, by trading at the old, stale price that existed earlier in the day, before the NAV was calculated.

For years it was widely accepted that the SEC had been captured by the mutual fund industry. 80 All of this changed in late 2003 when Eliot Spitzer began his crusade against the same industry.

On September 3, 2003 Spitzer announced the settlement of a complaint against Canary Capital Partners, a large hedge fund, for alleged actions involving a number of mutual fund companies with whom Canary traded. 81 Spitzer alleged that these mutual funds permitted Canary, a favored customer, to engage in late trading in violation of Rule 22c-1 and inappropriate market timing arrangements in violation of other SEC rules. 82 Spitzer's claim that he had identified abuses in the mutual fund industry, and his use of his office to enforce rules that the SEC had promulgated and was supposed to enforce, was deeply embarrassing to the SEC. In

78. 17 C.F.R. § 270.22c-1(a).
79. 17 C.F.R. § 270.22c-1(b).
80. See Edward Sherwin, The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort, 12 STAN. J.L. BUS. & FIN. 1, 19 (2006) (describing “[t]he SEC’s usually cooperative relationship with the mutual fund industry”); see also Paula Dwyer, Breach of Trust, BUS. WK., Dec. 15, 2003, at 98 (describing the close relationship between the SEC’s mutual fund regulators and the mutual funds they were supposed to regulate and explaining how this relationship led to a situation in which illegal activity was condoned).
82. Id. As noted above, market timing and frequent trading are not illegal. Of course, mutual funds may not violate the terms of their own prospectuses by permitting frequent trading to the extent that such trading violates their prospectuses. And, others may not actively conspire with a mutual fund to violate the terms of its prospectus. The SEC is, in theory, supposed to police prospectus disclosures.
fact, as with a number of other high profile "controversies roiling the securities and insurance industries, many of these [mutual fund] abuses were not discovered by the SEC, but by New York State Attorney General Eliot Spitzer, a fact that forced the SEC to play catch-up with state regulators."83

Soon thereafter, the SEC began investigating the entire mutual fund industry, sending a letter to the eighty largest fund complexes in which it requested information on "market timing, late trading, and other practices alleged of others in the New York Attorney General's complaint."84 In subsequent letters the SEC attempted to figure out what international mutual funds were doing to deal with market timing arbitrage.85

Despite the vagueness of the rules and the lack of harm to investors, the SEC found it politically expedient to pursue virtually an entire industry for alleged wrongdoing. This method is clearly an efficient way for the SEC to increase the number of cases it brings because the research and investigation necessary to bring a lawsuit against one defendant can be amortized over many defendants, thereby greatly reducing the costs of bringing lawsuits.

2. A Penny for Your Stock

The strategy of going after entire industries is not new. For years the SEC has taken the view that people who specialize in selling so-called penny stocks should be pursued. This strategy serves not only the interest that the SEC has in bringing cases, but also the interests of the established broker-dealer firms that compete with the upstart penny stock operations. This group of established broker-dealer firms is an important constituency of the SEC, not to mention an important source of employment for SEC alumni.86

Penny stocks are simply equity investment instruments that trade at low prices, usually less than one dollar. Penny stocks generally are high-risk, as they typically are issued by young, start-up or highly speculative ventures. The SEC imposes a

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83. Sherwin, supra note 80, at 19–20.
85. Id.
86. As noted above, recently SEC alumni from the Division of Enforcement have placed themselves in senior positions at Deutsche Bank, JPMorgan Chase, and Morgan Stanley. See supra text accompanying note 23.
substantially higher regulatory burden on penny stocks than on other stocks. The SEC has attempted to delegitimize all firms that issue low-price shares and all firms that deal in or broker such securities. Thus,

[t]he [SEC's] successful efforts to regulate penny stocks provide a classic example of an administrative agency seeking to create a demand for its own existence by turning an industry into a cartel, thereby establishing that industry as a major source of political support for the agency. The [SEC] provided a major service to the established firms and exchanges by eliminating their fastest growing competitors—start-up brokerage firms and market makers providing capital and liquidity to firms issuing penny stocks.

F. The Culture of the SEC

Because the SEC is dominated by lawyers, its culture is focused on process, and has become slow and exceedingly bureaucratic. The SEC appears to be at the outer-range of federal agencies both in terms of the extent to which it is dominated by lawyers and the extent to which its operation is paralyzed by bureaucracy. In general, it has been reported by the GAO that at the SEC,

[s]ome attorneys estimated that they spend as much as a third to 40 percent of their time on the internal review process, thus making it harder to meet the division’s emphasis on bringing cases on a timely basis. A number of attorneys told us that the effect of the intensive review process is to create a culture of risk aversion, an atmosphere of fear or insecurity, or incentives to drop cases or narrow their scope. . . . In one instance, an attorney closed a case rather than go through a review with another division. . . . In two other cases, charges were dropped or reduced because the matters had taken so long that people were unable to recall earlier considerations of evidence. In another situation, it took 2 1/2 months to prepare a paragraph requesting permission to send a Wells notice; in another case, staff prepared multiple drafts of a Wells memo over 3 years before finally closing the case because it was so old. Finally, one investigative attorney told us that a company under investigation offered to pay whatever penalty amount Enforcement

87. See Macey, supra note 1, at 946.
88. Id. at 948.
asked; 5 months later, the matter still remained open, with an action memorandum in its tenth draft. Some attorneys noted that such delays may encourage violators.89

In connection with the collapse of Madoff's financial empire, the SEC Inspector General allocated much of the blame for the SEC's failure to the crippling bureaucracy, noting that administrative burdens prevented the agency from effectively doing much real work:

You had to have people writing closing memos, which is of course, you should be shutting down your old cases, but that's what [one employee] spent a lot of her time doing, writing closing memos because she had inherited a branch where everybody had left and left these old cases in shambles, and you had to go back to the court records, pulling all these court files, and recreating files to close them. [This employee] had tons of this stuff, much more than [the other Branch Chief in Bachenheimer's group]. It was crazy. Then you had to have six month memos on cases, whether or not you should keep them open, memos to write. The joke that we had in the office was that you had to write a memorandum to get permission to write a memo. You know, a lot of this was to make the performance measurable, which is great, and it should be measurable, but you have to provide people the resources to do it.90

CONCLUSION

The SEC is the government agency that is supposed to ferret out securities fraud. Unfortunately, the SEC's excessive focus on bringing a large number of cases and collecting large fines has led it to abandon the critical "ferreting" aspect of its mission. Ferreting is time-consuming and expensive. From the SEC's perspective, it makes sense to bring cases that do not require costly, time-consuming, and risky investigations.

This Article has focused on the incentives facing the Enforcement Staff of the SEC and shown how, to a large extent, the decline of the SEC is not actually the SEC's fault. The SEC,

89. See GOV'T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT 28 (2009).
90. MADOFF INVESTIGATION, supra note 4, at 366 (identifying administrative burdens facing the SEC staff attorneys charged with investigating Madoff).
in pursuing large numbers of cases, was trying to meet the performance objectives generated by the simple evaluative heuristics that elected officials and bureaucrats used to evaluate the agency’s performance. In building a bureaucracy, the lawyers at the SEC were acting as lawyers are trained to act, which is to create elaborate administrative decision-making structures.

Unfortunately for the SEC, the environment in which it has been operating has led the agency to stumble repeatedly. Large scandals have erupted continuously over the past decade and few, if any, observers believe that the SEC is effective at fighting corporate fraud and abuses in U.S. capital markets. One would predict that the SEC would react decisively in response to the bad publicity it has been receiving, and it has. It appears that the SEC’s response to the current crisis is to attack the hedge fund industry just as it attacked the penny stock industry in 1990.

The SEC is in search of a scapegoat. It thinks that it has found one in the hedge fund industry. The tool it is using to pursue the hedge funds is its authority to regulate insider trading. If the SEC can convince the courts that most, if not all, of what the most successful hedge funds do is illegal insider trading then the agency will be able to run the hedge fund managers out of U.S. markets once and for all.

Thus, insider trading in general, and insider trading at hedge funds in particular, is at the top of the SEC’s agenda once again. Even the SEC’s staunchest defenders like SEC alumnus-turned-law-professor Norm Poser lament that the SEC “was known for years as one of the finest, if not the finest, of the federal regulatory agencies,” but is now “at a time when the reputation and effectiveness of the agency are at their lowest point in history.”

Bringing high-profile insider trading cases against prominent businessmen like Mark Cuban may be the SEC’s only shot at garnering some good press these days. For example, in what has been described as a “wake-up call” for hedge fund managers, on October 19, 2009 the SEC and the Department of Justice charged Mr. Raj Rajaratnam, along with a number of his colleagues and acquaintances, in the biggest insider trading scheme ever to involve a hedge fund.

This lawsuit is not merely an attack on insider trading. It is an attack on the way that hedge funds do business. It is extremely common for hedge fund managers to share information with other hedge fund managers. The SEC believes that the world of hedge funds is a corrupt world of "you scratch my back and I'll scratch yours," which is precisely the way Preet Bharara, the U.S. Attorney for the Southern District of New York, describes the Rajaratnam case. But since when has trading of any kind, whether such trading involves cars, or turnips, or information, been illegal in this country? Hedge funds often hire experts to analyze companies and new legislation to look for a trading edge. As long as no ethical line is crossed in obtaining such information, the hedge funds should be free to use it as they wish. They should be free to trade on it, and they should be free to share the information with their industry colleagues.

On the other hand, if Rajaratnam obtained his information by subterfuge or by brokering pilfered information among corporate insiders who stole it from their employers, then he crossed a line and should be punished. Among the accusations against Rajaratnam is that he received an inside tip from one of his hedge fund colleagues who was also a member of the board of directors of an outsourcing company called PeopleSupport about ongoing merger negotiations between PeopleSupport and a subsidiary of the Indian company Essar Group. If the tipper revealed information to Rajaratnam that his employer did not want to be used, then Rajaratnam broke the law if he traded on it while knowing that the source of his information had violated a duty to his employer.

The SEC is taking a big risk in embarking on its latest crusade against insider trading in hedge funds, particularly given the still fragile condition of U.S. equity markets. Too little regulation of insider trading means the markets begin to look rigged. If insider trading is not regulated at all, smart, honest players will be discouraged from participating because nobody wants to play against a rigged deck. But clamping down on insider trading too hard may even be worse. If trading on the basis of superior in-

sight or information is illegal, then smart, honest players will shy away from trading even more because they risk getting sued, or even thrown in jail, merely for being too smart, too well-informed, or too critical of the companies whose shares they trade.

If insider trading is going to be regulated effectively, the evil insider trading that should be punished should be distinguished from the benign trading that should be rewarded. Unfortunately, making these fine distinctions does not serve the SEC’s need for better press clippings. The SEC is suspicious of any and every sort of trading by suspect groups like hedge funds, particularly when such traders have an informational advantage over their counterparties, regardless of whether the methods used to get such information were fair or foul.

The SEC’s chronic inability—or unwillingness—to distinguish between the good guys, who help ferret out fraud at companies like Enron, from the bad guys who steal information and use it for selfish purposes is quite unfortunate. It has transformed what should be a simple and easy moral issue into a morass of confusion and wasteful litigation.

Insider trading is bad when, and only when, it involves theft. When people steal and trade on information that rightfully belongs to somebody else, they should be punished. When people use their own resources and imaginations to obtain information honestly, they should be able to use that information in any way they please without fear of civil or criminal sanction. This approach to insider trading is consistent not only with our interest in having efficient capital markets, but also with our basic moral intuitions about right and wrong.

The SEC’s strategy of pursuing Rajaratnam supports the analysis of the SEC’s behavior offered in this Article. The case involves a complicated legal theory that will, if accepted, expand the scope of the SEC’s power and authority. As such, the case will not only benefit the SEC as an institution, but it will also advance the careers of the individual attorneys at the SEC who are associated with the case. Further, the SEC has chosen as its target an entire industry, that is, the hedge fund industry. This strategy permits the SEC to maximize the number of cases it brings, because the Commission can sue a large number of defendants on the same set of legal theories and factual premises. Finally, the strategy permits the SEC to expand its regulatory authority over hedge funds, an industry that politicians have conveniently demonized in recent years.
THE REDUCTION OF SYSTEMIC RISK IN THE UNITED STATES FINANCIAL SYSTEM

HAL S. SCOTT*

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This Article concentrates on the central problem for financial regulation that has emerged from the 2007-2009 financial crisis—the prevention of systemic risk. The discussion largely focuses on the relevant recommendations of the Committee on Capital Markets Regulation (CCMR) in its May 2009 report.¹ Where appropriate, the Article compares the CCMR recommendations to those of the United States Treasury in its June 2009 report² and its suggested implementing legislation, and also to pending congressional legislation.³

The CCMR is an independent, nonpartisan research organization founded in 2005 to improve the regulation of United States capital markets.⁴ “Thirty leaders from the investor community, business, finance, law, accounting, and academia comprise the CCMR's membership.”⁵ Its “co-chairs are Glenn Hubbard, Dean of Columbia Business School, and John Thornton, Chairman of the Brookings Institution.”⁶ The Author of this Article is the Director.

3. H.R. 4173, 111th Cong. (as passed by House, Dec. 11, 2009); STAFF OF S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, 111TH CONG., RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010 (Comm. Print 2010) [hereinafter SENATE PROPOSAL].
5. Id.
6. Id.
I. SYSTEMIC RISK REDUCTION: THE CENTRAL PROBLEM

Going forward, the central problem for financial regulation (defined as the prescription of rules, as distinct from supervision or risk assessment) is to reduce systemic risk. Systemic risk is the risk that the failure of one significant financial institution can cause or significantly contribute to the failure of other significant financial institutions as a result of their linkages to each other. Systemic risk can also be defined to include the possibility that one exogenous shock may simultaneously cause or contribute to the failure of multiple significant financial institutions. This Article focuses on the former definition because proper regulation could have the greatest potential to reduce systemic risk in this area.\(^7\)

There are four principal linkages that can result in a chain reaction of failures. First, there are interbank deposits, whether from loans or from correspondent accounts used to process payments. These accounts were the major concern when Continental Illinois Bank almost failed in the mid-1980s.\(^8\) Continental held sizable deposits of other banks; in many cases, the amount of the deposits substantially exceeded the capital of the depositor banks. These banks generally held such sizable deposits because they cleared payments, such as checks or wire transfers, through Continental. If Continental had failed, those banks would have failed as well. Section 308 of the FDIC Improvement Act of 1991 gives the Federal Reserve Board powers to deal with this problem.\(^9\) The Act permits the Board to limit the credit extended by an insured depository institution to another depository institution.\(^10\) Limitation of interbank deposits may be feasible with respect to placements by one bank with

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7. A recently released report by the Financial Stability Board, International Monetary Fund, and Bank for International Settlement suggests that “systemic risk” could also be defined as the risk of a “disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy.” INT’L MONETARY FUND ET AL., REPORT TO G20 FINANCE MINISTERS AND GOVERNORS: GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: INITIAL CONSIDERATIONS 5-6 (2009).


10. Id.
another because the amount of credit extended is fixed for a
given term. Indeed, it appears that the chain-reaction risk aris-
ing from bilateral credit exposures from overnight Federal Re-
serve funds transactions is quite low: Losses would not exceed
one percent of total commercial banking assets as long as loss
rates are kept to historically observed levels.\textsuperscript{11}

Exposures are more difficult to identify with respect to inter-
bank clearing accounts where the amount of credit extended is
a function of payment traffic. For example, Bank A may be
credited by its correspondent Bank B for an incoming wire
transfer of $10 million. Bank A is thus a creditor of Bank B for
this amount. If Bank B were to fail, Bank A is seriously ex-
posed.\textsuperscript{12} Without material changes in the payment system, such
as forcing banks to make and receive all payments through
Federal Reserve rather than correspondent accounts, it would
be quite difficult to limit these types of exposures.

Second, a chain reaction of bank failures can occur through
net settlement payment systems. If one bank fails to settle its
position in a net settlement system for large value payments,
such as the Clearing House Interbank Payments System
(CHIPS) in the United States, other banks that do not get paid
may, in turn, fail.\textsuperscript{13} This risk was the major systemic risk con-
cern of the Federal Reserve until CHIPS changed its settlement
procedures in 2001 to essentially eliminate this risk.\textsuperscript{14}

Third, a chain reaction of bank failures can occur through
imitative runs. When one bank fails, depositors in other banks,
particularly those whose deposits are uninsured, may assume
that their banks may also fail and so withdraw their funds, ex-
posing these banks to a liquidity crisis and ultimately to failure.
This result comes from a lack of information in the market
about what specifically caused the first bank to fail.\textsuperscript{15} The Fed-

\begin{itemize}
  \item \textsuperscript{11} Craig H. Furfine, \textit{Interbank Exposures: Quantifying the Risk of Contagion}, 35 \textit{J. MONEY CREDIT & BANKING} 111, 125 (2003); see also Simon Wells, \textit{Financial Interlinkages in the United Kingdom’s Interbank Market and the Risk of Contagion} 5–7 (Bank of Eng., Working Paper No. 230, 2004) (looking at exposures in the U.K. interbank market and finding that although a single bank failure is rarely sufficient to cause other banks to fail, it does have the potential to weaken their capital substantially).
  \item \textsuperscript{12} \textit{Scott}, supra note 8, at 174.
  \item \textsuperscript{13} \textit{Id.}
  \item \textsuperscript{14} \textit{Id.} at 471.
  \item \textsuperscript{15} \textit{Id.} at 174.
\end{itemize}
eral Reserve plays the classic role of lender of last resort to stem irrational imitative runs in situations such as this one.

Lastly, and especially prominent in the current crisis, a chain reaction of bank failures can occur as a result of counterparty risk on derivative transactions, such as credit default swaps (CDSs). Here the concern is that if institution X fails to settle its derivative position with institution Y, both X and Y will fail. If Y in turn cannot settle its positions, other institutions will also fail. This risk proved potentially significant in the failure of the hedge fund Long-Term Capital Management in 1998. Concerns of this type also underlay JPMorgan Chase’s assisted acquisition of Bear Stearns and the injection of federal funds into AIG. This is one area in which the failure of non-banks is a major concern, but the severity of this form of systemic risk and the degree of interconnectedness among financial institutions is currently unknown. A report by the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) on the government’s investments in AIG indicated that Goldman Sachs, a major counterparty, would have been made whole in the event of an AIG default. The report further indicated that the Treasury and Federal Reserve were primarily concerned with losses that would be incurred by investors in AIG in the event of a default, including $10 billion of state and local government money, $40 billion in 401(k) plans, and $38 billion in retirement plans. The report’s explanation of the government’s action also mentioned concern over stemming runs on money market funds, which held $20 billion in AIG commercial paper. Similarly, in their recent testimony on the “Federal Bailout of AIG,” Treasury Secretary Timothy Geithner and

18. Robin Sidel, Dennis K. Berman & Kate Kelly, J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis, WALL ST. J., Mar. 17, 2008, at A1; see also Scott supra note 16.
19. See OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSETS RELIEF PROGRAM, FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES 29 (2009), [hereinafter SIGTARP]; see also Scott, supra note 16.
20. SIGTARP, supra note 19, at 16-17.
21. Id. at 9-10.
22. Id. at 10-11.
New York Federal Reserve General Counsel Thomas Baxter also emphasized factors other than derivatives counterparty risk, including the impact that the failure of AIG would have on money market funds, personal savings and retirement plans, and insurance policyholders. If prospective investor losses, rather than the fallout of interconnectedness, were the true basis for the government policy with respect to AIG, it may be that the concern with systemic risk is overstated. Further study and better disclosure from the Treasury and Federal Reserve is needed to support informed estimates of the magnitude of the problem. In any event, gauging the impact of systemic risk is difficult to determine and beyond the scope of this Article.

The threat of systemic risk (whether real or imagined) results in both the need for government bailouts at taxpayer expense and in an increase in moral hazard. These results occur because both equity and debt holders, as well as counterparties, may be protected against losses. Of course, the government could decide not to intervene, but this laissez-faire approach could put the entire global economy at risk, an even worse outcome. As the financial crisis has illustrated, banks cannot always count on the government to cut off systemic risk when it occurs. The politics of supplying money to banks are unpopular and unsustainable by the Federal Reserve over the long term without intense public scrutiny and loss of independence.

At the outset, it is also worth noting that the "Volcker Rules" and related limitations on bank size announced by the Obama Administration on January 21, 2009 do not have much if any

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23. The Federal Bailout of AIG: Hearing Before the H. Comm. on Oversight and Gov't Reform, 111th Cong. (2010) (statements of Timothy F. Geithner, Sec'y, U.S. Treasury Dep't & Thomas C. Baxter, Exec. Vice President and General Counsel, Fed. Reserve Bank of N.Y.). But see Eric Dinallo, What I Learned at the AIG Meltdown, WALL ST. J., Feb. 3, 2010, at A17 (arguing that "insurance policyholders at AIG were protected by reserves that each of the insurance companies are required to hold by state regulation").


potential to reduce systemic risk. The Volcker Rules would prohibit bank holding companies and all of their subsidiaries from engaging in proprietary trading, as well as from investing in or sponsoring hedge fund and private equity operations. Although President Obama has characterized proprietary trading as trading “unrelated to serving customers,” a precise legal standard has not been given. The related size limitations were initially described as straightforward caps on each bank’s market share of non-deposit liabilities. As Deputy Treasury Secretary Neal Wolin describes, however, the size limits would not require banks to divest existing operations or restrict organic growth, but would instead limit banks’ ability to gain market share through mergers and acquisitions.

The Volcker Rules are unlikely to reduce systemic risk for several reasons. First, banks generally engage in relatively little proprietary trading. For example, Wells Fargo and Bank of America, two of the largest deposit-funded banks, are estimated to earn less than 1% of revenues from proprietary trading. Second, activities that threaten the financial system do not occur only in banks. In fact, none of the most prominent failures of the financial crisis—Fannie Mae, Freddie Mac, AIG, Bear Stearns, or Lehman—was a deposit-taking bank. And third, focusing on proprietary trading ignores the real cause of the financial crisis: losses from lending and securitization. Goldman Sachs has estimated that losses from lending and securitization accounted for approximately 80% of overall credit losses incurred by U.S. banks.

Nor should we expect reductions in systemic risk to result from the size limitations. An institution does not pose systemic risk because of its absolute size, but rather because of its debt, its derivatives positions, and the scope and complexity of its other financial relationships. Because the problem is not size but interconnectedness, reform should focus on reducing the interconnections so that firms can fail safely. Furthermore, even

if size were the right issue, Mr. Wolin's testimony implies that the size limitations would not require any existing bank to shrink. If size is the source of systemic risk, presumably we should be concerned about it whether it is the result of acquisition, organic growth, or otherwise.

The draft legislation introduced by Senator Dodd on March 15, 2010 (the Senate draft) contained a modified version of the Volcker Rules and size limitations.\textsuperscript{29} Though the Senate draft calls on the Financial Stability Oversight Council to conduct studies of whether these reforms will reduce systemic risk before they are implemented,\textsuperscript{30} studies are not needed to confirm that benefits from these reforms will be negligible. Outright restrictions on proprietary trading proposed in the Senate draft would apply to insured depository institutions, companies that control insured depository institutions, bank holding companies, and all subsidiaries of the foregoing.\textsuperscript{31} The Dodd proposal is even more strict than Chairman Volcker recommended. According to Chairman Volcker it would be acceptable for Goldman Sachs to drop its bank charter and continue to engage in proprietary trading.\textsuperscript{32} However, under the Senate draft, Goldman would almost certainly be a systematically important non-bank financial company when it dropped its bank charter,\textsuperscript{33} and thus would continue to be supervised by the Federal Reserve. While Goldman could, as a non-bank, continue to engage in proprietary trading, it would be subject to Federal Re-

\begin{footnotesize}
\textsuperscript{29} Senate Proposal, supra note 3, §§ 619-620; see also Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs, 111th Cong. (2010) (statement of Paul A. Volcker, Chairman, President's Econ. Recovery Advisory Bd.) [hereinafter Volcker Testimony].

\textsuperscript{30} Senate Proposal, supra note 3, §§ 619(g), 620.

\textsuperscript{31} Id. § 619(b)(1).

\textsuperscript{32} Volcker Testimony, supra note 29 ("The basic point is that there has been, and remains, a strong public interest in providing a 'safety net'—in particular, deposit insurance and the provision of liquidity in emergencies—for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds—taxpayer funds—protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions.").

\textsuperscript{33} Under Section 113, the Financial Stability Oversight Council "may determine that a U.S. nonbank financial company shall be supervised by the [Federal Reserve] if the Council determines that material financial distress at the U.S. nonbank financial company would pose a threat to the financial stability of the United States." Senate Proposal, supra note 3, § 113(a)(1).
\end{footnotesize}
serve controls, including "additional capital requirements" and "additional quantitative limits." 34

Thus, even if Goldman Sachs were to give up its bank charter, it would be required to hold additional capital against its proprietary trading positions. Because institutions that are systemically important are likely to be more thoroughly regulated than those that are not, this could encourage proprietary trading to shift to less carefully monitored firms, thereby increasing systemic risk. Saddling non-bank financial companies engaged in proprietary trading with additional capital requirements is thus problematic.

This Article addresses what I regard as the five most important policies for dealing with systemic risk: the imposition of capital requirements (or limits on leverage), the use of clearinghouses and exchanges for over-the-counter derivatives, the resolution of insolvent institutions, the emergency lending by the Federal Reserve, and the structure of the regulatory system as it affects the control of systemic risk.

II. CAPITAL REQUIREMENTS

Ex ante, regulatory capital requirements have been the chief measure to reduce systemic risk. Capital requirements, which have focused principally on banks, are designed to decrease the likelihood of financial institution failure. If institutions do not fail, the problem of systemic risk largely disappears. Capital requirements have been highly regulated for a long time. Since 1988, the requirements have been standardized worldwide by the Basel Committee on Bank Supervision. 35 The United States implemented Basel I and is in the process of implementing Basel II for banks and their holding companies. 36 The SEC had already implemented Pillar I of Basel II for securities firms' holding companies before the onslaught of the credit crisis. 37 These capital requirements proved highly inadequate. The

34. Id. § 619(f)(1).
35. See BASEL COMM., INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS 3 (1988), http://www.bis.org/publ/bcbsc111.pdf?
37. See 17 C.F.R. §§ 200.30-3, 240.3a4-2 to -6, 240.3a5-1, 240.3b-17 to -18, 240.15a-7 to -9 (2004).
SEC's Basel II-based rules permitted the top five major investment banks to achieve leverage of over thirty to one. Insufficient capital was a significant cause of the failure of Lehman Brothers and Bear Stearns. Insufficient capital also played a major role in forcing Merrill Lynch to sell itself to Bank of America. Indeed, the most intensive and detailed area of regulation, capital, has proven ineffective. This failure demonstrates that more regulation does not necessarily translate into less systemic risk.

One of the interesting features of capital regulation is that depository banks turned out to be much less leveraged than investment banks—those banks that do not take deposits. The top five depository banks were leveraged at thirteen to one compared to the over thirty to one leverage of the investment banks. Whereas Basel imposed a minimum 8% capital requirement on risk-weighted assets, the United States requires 10% for well-capitalized banks. The United States also imposed its own leverage requirement of 5% on all assets, without risk weighting, again for well-capitalized banks. The leverage ratio, which was not applied to investment banks, turned out to be a more binding restraint on banks than the more "sophisticated" Basel approach.

A. CCMR Recommendations Aligned with the White Paper

The CCMR, like the Treasury, believes that institutions with the ability to borrow from the Federal Reserve in its capacity as lender of last resort should be subject to some form of federal capital regulation. It also believes, however, that these requirements should not necessarily take the form of bank capital rules. For example, insurance companies should have differ-

38. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 60.
40. Id.
41. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 60.
42. BASEL COMM., supra note 35, at 13.
44. 12 C.F.R. § 208.43(b)(1)(ii).
45. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 80; see also TREASURY WHITE PAPER, supra note 2, at 11 (recommending strengthening capital requirements at all banks).
46. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 80–81.
ent rules than banks that are appropriate to the different business risks of insurance companies. 47

The CCMR and the Treasury also recommended the adoption of techniques to ensure that capital ratios are countercyclical, with ratios higher in good times (characterized by rising markets) than in bad times with falling valuation and liquidity. 48 Countercyclical ratios could be implemented through dynamic provisioning, as in Spain, 49 to permit reserves to cover estimated future losses rather than only known losses. The CCMR has suggested that the imposition of countercyclical ratios could be accomplished without violating current accounting and securities regulation rules by providing that estimated losses not run through the income statement. 50 Under current accounting rules, premised on the incurred loss model, only known impairments, but not expected future losses, are provisioned for and reflected in an institution's financial reporting. 51 In addition, financial institutions should be required to main-

47. Id.
48. Id. at 81; TREASURY WHITE PAPER, supra note 2, at 80.
51. Both U.S. GAAP and IFRS accounting rules operate according to an incurred loss model under which a financial institution records an impairment only after the associated financial asset is known to have incurred a loss. This principle governs even when the exact loss amount is not known with specificity and must be estimated based on past experience (for example, in the case of receivables, losses on which may be known to have been incurred but not identified specifically). Expected future losses, by contrast, are not reserved against under the incurred loss model and thus are not deducted from income. CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES §§ 5, 114 (Am. Inst. of Certified Pub. Accountants 2009). The incurred loss model is a staple of both U.S. GAAP and IFRS accounting, but has been subject to recent criticism and challenge, for example in the International Accounting Standards Board's November 2009 exposure draft outlining a proposed expected loss model to replace the incurred loss model in connection with financial asset reporting. Press Release, Int'l Accounting Standards Bd., IASB publishers proposal on the impairment of financial assets (Nov. 5, 2009), available at http://www.iasb.org/News/PressReleases/IASB+publishes+proposals+on+the+impairment+of+financial+assets.htm.
tain some form of contingent capital to address the cyclicality that is characteristic of existing requirements.\textsuperscript{52}

The CCMR and the Treasury also recommended that large institutions hold proportionately more capital because they are more likely to require taxpayer funds if they fail (even if debt and equity are wiped out).\textsuperscript{53} Both of them also recommended maintaining and strengthening the leverage ratio—the best performing measure in the crisis.\textsuperscript{54} The Basel committee is currently pursuing policies that are responsive to these recommendations.\textsuperscript{55}

B. CCMR Recommendations That Differ from the White Paper and Pending Legislation: How Much and What Type of Capital

1. How Much Capital: Regulation and Markets

The most fundamental issue—how much capital banks or other financial institutions should be required to maintain—has gone largely unaddressed. Basel I “back-solved” into an 8% requirement in 1988 to prevent an increase in bank capital as a result of implementing its new regime.\textsuperscript{56} Basel II basically adopted the same approach following several quantitative impact studies.\textsuperscript{57} Although the House bill and Senate draft do not mandate particular capital levels, they would both require more stringent capital requirements for firms that are systemi-


\textsuperscript{53} CCMMR PLAN FOR REGULATORY REFORM, supra note 1, at 81; TREASURY WHITE PAPER, supra note 2, at 80–81.

\textsuperscript{54} CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 81; TREASURY WHITE PAPER, supra note 2, at 80–81.

\textsuperscript{55} BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT, STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR 60 (2009), http://www.bis.org/publ/bcbs164.pdf.

\textsuperscript{56} BASEL COMM., supra note 35, at 13; CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 62.

\textsuperscript{57} Jacob Gyntelberg et al., Overview: cautious optimism on gradual recovery, BIS Q. REV., Sept. 2009, at 1, 2. The quantitative impact studies are available at http://www.bis.org/bcbs/qis/index.htm.
cally significant. But basic questions remain unanswered: Regardless of how capital is measured, how much capital should be required? How much more capital do systemically important firms require? And most fundamentally, can regulation really determine what the right amount of capital is? Probably not, based on the failure of somewhat analogous endeavors to regulate prices of goods and services in the United States and elsewhere. Even more daunting is the determination of the correct capital “price” on risk.

Not surprisingly, regulatory capital requirements have not acted as a binding constraint on the amount of capital banks actually hold, given the lack of a solid foundation. In 2007, before the crisis, the regulatory capital ratio for the top twenty United States banks (accounting for almost two-thirds of the nation’s banking assets) averaged 11.7%. This figure was nearly 50% above the minimum regulatory requirement of 8% and 17% above the “well capitalized” standard of 10%. As a result, banks held more capital than regulation required due to the constraints of their own internal economic models and market demands.

In light of the difficult challenges facing regulators that attempt to specify the appropriate amount of capital for a given quantum of risk, the CCMR believes the government should explore expanded use of market forces as a complement to regulation to address the capital problem for publicly traded financial institutions. Market forces could impose greater discipline and give regulators a market-based warning for bank difficulties (signaled by the spread from a Treasury benchmark on the sub-

61. Id.
62. Id.
63. Id.
64. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 27.
ordinated debt yield) on two conditions: if the market had better information about the institutions’ riskiness, and if investors in institutions were forced to bear some risk for their failure due to holding an “unbailable” credit instrument such as subordinated debt. The Shadow Financial Regulatory Committee recommended this approach in 2000, although some have criticized this proposal as impractical given the poorly developed market in the United States for subordinated debt. Hart and Zingales have proposed that market signals could alternatively be provided by the spreads on credit default swaps referencing banks, instruments where payment is triggered when banks default on their debt. This proposal would sidestep the practicalities of banks issuing subordinated debt. If creditors of failing or failed banks do not experience losses, however, credit-default-swap (CDS) spreads will not be accurate. Losses for writers of CDSs depend on an event of default and on the value of auctioned debt under International Swaps and Derivatives Association protocols if there is a default because the more the debt is worth, the lower the CDS payoffs. If debt is bailed out, the exposures of CDS writers will be distorted. Thus, it is imperative to design a resolution system, as discussed later in this Article, that imposes losses on debtholders.

66. See, e.g., Bert Ely, Sub debt - silver bullet or big dud?, FIN. REG., Sept. 2000, at 32.
Market signaling through benchmark spreads is only as useful as the information on which the signals are based. There are critical deficiencies in the adequacy of information presently disclosed by banks. The results of supervisory examinations are generally not revealed to the market, and bank disclosures are quite difficult to compare from bank to bank. The 2009 Federal Reserve-conducted stress tests, however, were able to overcome these deficiencies. The stress tests compared bank capital levels using a common methodology and disclosed the results of the tests to the public (after much debate internally and with the affected banks). Rather than spooking the market and triggering bank runs—a common reason for not revealing the result of examination reports—the disclosure had a calming effect. This effect may have arisen because the market abhors uncertainty even more than poor results, or the stress test results may have been generally positive. Periodic stress test results, revealed to the market, may significantly improve the reliability of CDS pricing and, in turn, market discipline.

2. What Counts as Capital?

A second fundamental question is how to define capital and for what purpose. Basel defines Tier I capital, which must be at least 50% of total capital, differently than tangible common equity, the capital measure investors seem to be most focused on today (and differently from Basel common equity used in the stress tests). The main difference between tangible equity and the Basel measures is that Basel ignores equity losses or gains attributable to marking-to-market accounting rules. The difference is also based on the theory that mark-to-market changes do not fairly portray bank capital. This theory is highly debatable, but it also raises the key issue of whether there should be differences between regulatory and accounting measures of capital, and if so, what they should be. Since the thrift crisis, regulatory accounting principles (RAP) have generally had to conform to general accounting principles—the 1991 FDICIA legislation requires that RAP cannot be “less stringent” than

GAAP. But this requirement has placed enormous regulatory and political pressure on accounting standards to accommodate regulatory and political concerns that stem from banks not having adequate capital, and therefore needing public money. Bifurcation of these two standards may be a better solution, while also ensuring that regulators cannot invoke this authority as an excuse for forbearance. A neutral third party—whose identity would have to be decided—would have to determine that a regulatory approach different from GAAP was reasonable.

III. CLEARINGHOUSES AND EXCHANGES FOR DERIVATIVES

Overall, the CCMR strongly believes that CDSs are an important tool for measuring and diversifying credit risk and counsels against efforts to prohibit CDS contracts. CDSs allow lenders to hedge or diversify their exposures. CDSs also generally allow participants to take positive or negative credit views on specific reference entities. CDSs written on financial institutions send important signals to the market and regulators about the strength of financial institutions. The goal of regulation should be to ensure that CDSs can be traded without creating undue systemic risk.

In considering the role of clearinghouses, bear in mind that they have been historically used to clear exchange-traded instruments, such as securities, options, and futures markets. Thus, the identities of the instruments being cleared were not in doubt—they were the instruments traded on an exchange. In the context of derivatives, however, clearinghouses are being used to clear instruments that are not traded on an exchange, which poses special challenges for defining what instruments will be cleared and how their settlement risk will be controlled. One of the first clearinghouses for non-exchange-traded derivatives was LCH Clearnet’s SwapClear. In 1999, SwapClear began clearing plain vanilla interest rate swaps of up to ten years maturity in dollars, euros, yen, and British pounds, recently expanding to encompass clearing a broad range of currencies.
Reduction of Systemic Risk and major indices. SwapClear attempts to reduce credit risk posed by these over-the-counter (OTC) derivatives through multilateral netting and daily margining.

Clearinghouses for derivatives can play a valuable role in reducing systemic risk as a break on interconnectedness. If a financial institution fails, it may result in losses for counterparties to derivatives contracts. If these counterparties do not have adequate collateral, they may also fail, and others may later fail as well. Even if counterparties appear to have adequate collateral, a simultaneous sale of collateral could drive down collateral prices low enough to make the counterparties' collateral insufficient. Bank positions are not fully collateralized. A recent Options Clearing Corporation (OCC) survey shows banks' collateral only covers 30 to 40% of their exposures, a Basel Supervisors Committee survey shows 44%, and an International Swaps and Derivatives Association (ISDA) survey shows 66%. And collateral cannot cover all risk—price movements may occur on an intraday basis before more additions to collateral can be provided. In addition, those posting collateral may be entitled to take back all or some of their collateral as prices move in their favor, but the holder of collateral may fail before returning excess collateral.

A. The Ability of the Clearinghouse to Reduce Counterparty Risk

A clearinghouse reduces counterparty risk, fundamentally, by collectivizing losses by becoming the counterparty to each contract. Thus, the impact of the failure of one institution is borne by all the members of the clearinghouse, not just by in-

75. Id.
76. The counterparty would not fail, of course, if it had cash collateral (apparently the case of Goldman Sachs with AIG). Failure would be highly unlikely if the collateral were treasury notes due to the depth of liquidity in that market. See Telephone Conference Call with David Viniar, CFO of Goldman Sachs, Goldman Sachs Business Update (Mar. 20, 2009), transcript available at http://www.scribd.com/doc/13465855/Preliminary-GS-Conference-Call-Transcript. In the case of AIG, Goldman Sachs had enough collateral to protect itself against an AIG default. Because the collateral was cash the value would not have been decreased by a “rush to the exits” as could occur if all counterparties simultaneously sold their non-cash collateral. Scott, supra note 16.
77. EUR. CENT. BANK, CREDIT DEFAULT SWAPS AND COUNTERPARTY RISK 48-49 (2009).
dividual counterparties. Of course, this pooling of risk will result in risk to the clearinghouse—if the clearinghouse were to fail central clearing would amplify, not reduce, systemic risk. Thus, the clearinghouse needs to take measures to reduce its own risk—including membership and capital adequacy requirements, and a backup clearing fund—and regulators must ensure that these measures are adequate.\textsuperscript{78} The first line of defense, however, is margining requirements for out-of-the-money participants—those owing money on their contracts. Every day (and sometimes intraday), the clearinghouse must mark participants’ contracts to current market prices, and participants whose contracts have declined in value must post collateral. This practice is common for derivatives that already trade on exchanges: futures and options. Currently, dealers in OTC derivatives, particularly CDSs, have formed and are clearing certain contracts through clearinghouses, both in the United States and in Europe.\textsuperscript{79}

Clearinghouses can reduce but not eliminate systemic risk. A clearinghouse itself could fail despite its own risk prevention measures, and there is little doubt that the government would bail out a clearinghouse if it is already willing to bail out systemically important institutions. Once created, these clearinghouses need to be carefully regulated because of possible public exposure. In general, a clearing requirement makes sense only if the reduction in systemic risk resulting from mutualizing losses is greater than the increase in systemic risk posed by the prospect of insolvent clearinghouses that clear large portions of the derivatives market.

1. Customized or Illiquid Contracts

Contracts that are customized are poor candidates for central clearing due to the difficulty in pricing and setting margin requirements for such contracts.\textsuperscript{80} If excluding a substantial number

\textsuperscript{78} See CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 42; SCOTT, supra note 8, at 507–08.


Reduction of Systemic Risk

of nonstandardized contracts from the clearinghouse poses significant systemic risk, the question then arises whether standardization should be mandated or measures taken to prevent the design of contracts as nonstandard to escape the clearinghouse regime (with its tough regulation and margin requirements).\footnote{81} Although OTC derivatives contracts are becoming more standardized, there are still significant differences between contracts. For example, on CDSs, parties can choose how they define the “Credit Events” that trigger a settlement obligation. So, for example, one contract referencing XYZ Corporation may define a restructuring short of bankruptcy as a “Credit Event,” while another contract written on the same reference entity may require an actual bankruptcy.\footnote{82} Although ISDA’s recent “hardwiring” creates a mechanism to assure more certainty as to whether a Credit Event has occurred through the use of so-called Credit Derivatives Determination Committees,\footnote{83} there is no data on the percentage of standardized contracts, due in major part to the lack of a uniformly accepted standard as to what constitutes a standard contract. What is more, despite standard terms, a standardized CDS may not be liquid in the sense that there is very little transaction volume. These possible exclusions, for CDSs alone, are significant. Some sources estimate that 20 to 40% of CDSs are insufficiently liquid to be suitable for clearing, although industry practitioners have indicated that the percentage of currently traded CDSs sufficiently liquid for clearing is likely to be higher.\footnote{84} The overall value of the CDS market is $36 trillion.\footnote{85}

The CCMR has recommended that centralized clearing be increased, but it has not gone so far as to call for all “standard-

\footnote{81. Over-The-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Hous. & Urban Affairs, 111th Cong. 6-7 (2009) (statement of Gary Gensler, Chairman, Commodity Futures Trading Comm’n).}


\footnote{83. See INT’L SWAPS & DERIVATIVES ASS’N, 2009 ISDA CREDIT DERIVATIVES DETERMINATIONS COMMITTEES AND AUCTION SETTLEMENT SUPPLEMENT TO THE 2003 ISDA CREDIT DERIVATIVES DEFINITIONS 5-7 (2009); Client Alert, White & Case, ISDA Announces Changes to Credit Default Swaps Due to Take Effect in March 2009 (Mar. 3, 2009), available at www.whitecase.com/alert_securities_derivatives_isda.030309.}


ized" contracts to be centrally cleared, which the Treasury's proposed legislation seemed to require.\textsuperscript{86} The CCMR recognizes that centralized clearing requires the clearinghouse to set margin requirements on positions, which in turn requires reliable prices. Reliable pricing depends not only on standardized contracts but also on a base level of liquidity—a significant volume in the contract.

Thus, the central clearing requirement should be limited to contracts that are both standardized and liquid. Subject to this principle, the CCMR believes that the Federal Reserve, rather than the SEC or CFTC, on the one hand, or market participants or clearinghouses, on the other, should ultimately determine what types of contracts are centrally cleared.\textsuperscript{87} It would be inappropriate to leave the decision to clearinghouses, because clearinghouses are largely controlled by dealers and dealers may have too little incentive to opt for central clearing if it results in a narrowing of their spreads. On the other hand, the Federal Reserve should undertake a cost-benefit analysis before deciding to require clearing of a new category of contracts beyond what clearinghouses are themselves offering to clear. Any such action should be subject to the same standards of review and challenge as any other similar regulatory action under existing law.

As a general matter, the Federal Reserve should have exclusive authority to regulate clearing due to its centrality to systemic risk,\textsuperscript{88} and, therefore, the House bill errs by giving the CFTC and SEC discretion to determine which types of contracts are subject to clearing requirements.\textsuperscript{89} The Senate draft is less clear on this point. Although Title VII of the Senate draft suggests that the CFTC's and SEC's authority over clearing would be similar to what it is in the House bill,\textsuperscript{90} Title VIII gives the

\textsuperscript{86} CCMR \textit{Plan for Regulatory Reform}, supra note 1, at 46; \textit{Treasury White Paper}, supra note 2, at 7; CCMR Derivatives Letter, supra note 80, at 10.

\textsuperscript{87} CCMR Derivatives Letter, \textit{supra} note 80, at 11–12.

\textsuperscript{88} Id. at 11.

\textsuperscript{89} See, e.g., H.R. 4173, 111th Cong. §§ 3102(a)(3), 3203(a).

\textsuperscript{90} For example, Sections 713(a)(3) and 753(a) of the Senate draft provide for a clearinghouse to submit to the CFTC or SEC for pre-approval any "group, category, type, or class" of swaps that the clearinghouse seeks to clear. These sections would also give the CFTC or SEC, in consultation with the Financial Stability Oversight Council, power to exempt from clearing requirements any swap where one of the counterparties (a) is not a swap or dealer or major swap participant and (b) is ineligible for membership in
Federal Reserve responsibility for “clearing activities” determined by the Financial Stability Oversight Council to be systemically important. Jurisdictional lines may be clearer after the Senate Banking Committee completes its markup.

2. **Contracts Involving Nonparticipants in the Clearinghouse**

OTC derivative contracts (assuming they are standard and liquid) that only involve clearinghouse members should be centrally cleared. Difficulties arise, however, when one of the parties to the contract is not a clearinghouse member. The number and value of these contracts may be significant. Estimates of the extent of dealer-to-dealer contracts vary (a very high percentage of dealer-to-dealer contracts would involve clearinghouse members). CCMR research indicates that 50 to 65% of CDS contracts and approximately 40% of foreign exchange and interest rate derivatives contracts are between dealers. Suffice it to say that a significant percentage of contracts may involve a counterparty that is not a clearinghouse participant.

The key issue is whether contracts involving a nonparticipant counterparty should be required to be centrally cleared with a guarantee by a clearinghouse member. The two leading

any clearing organization that clears the swap. **SENATE PROPOSAL, supra note 3, §§ 713(a)(3), 753(a).**

91. Id. §§ 804(a)(1), 805.

92. Both the House and Senate proposals require contracts between “swap dealers” to be centrally cleared. See H.R. 4173, 111th Cong. § 3103(a)(4) (2009) (amending the Commodity Exchange Act by inserting § 2(j)(8)(A)); **SENATE PROPOSAL, supra note 3, § 713(a)(3).** Although clearinghouses are composed mainly of dealers, not all dealers who enter into swaps may be members and not all participants in a clearinghouse may be dealers. I focus on requiring participant rather than dealer contracts to be centrally cleared because a requirement that all dealer contracts be centrally cleared exposes the clearinghouse to potential risk from poorly capitalized dealers.

93. Discussions with industry sources indicate that the higher figure (65%) results from the classification of certain hedge-fund-to-prime-broker trades, as in effect, dealer-to-dealer. The Bank for International Settlements reports that in the first half of 2009 dealer-dealer CDS contracts were approximately 53% of outstanding CDS contracts by notional value. **BANK FOR INT’L SETTLEMENTS, OTC DERIVATIVES MARKET ACTIVITY IN THE FIRST HALF OF 2009, at 8 (2009).** The Depository Trust and Clearing Corporation (DTCC) reports that as of December 11, 2009, approximately 80% of the total notional value of CDSs in its Deriv/SERV Trade Information Warehouse are dealer-to-dealer swaps. The DTCC reports that approximately 90% of CDSs traded throughout the world are cleared through the Deriv/SERV Trade Information Warehouse. See DTCC, Deriv/SERV Trade Information Warehouse Reports, http://www.dtcc.com/products/derivserv/data (last visited Mar. 1, 2010).

94. **BANK FOR INT’L SETTLEMENTS, supra note 93, at 6–7.**
congressional approaches would require central clearing. The House bill would require all contracts between dealers (anyone in the business of trading in such contracts)\textsuperscript{95} to be centrally cleared even if one or both of the dealers were not members of a clearinghouse.\textsuperscript{96} The House bill would also require central clearing of any contract involving a “major swap participant,” defined as a person, other than a swap dealer\textsuperscript{97} that maintains a substantial net position or whose positions could create substantial net exposure for its counterparties.\textsuperscript{98} Finally, the House bill would require all other persons (even if not a dealer or swap participant) to centrally clear a contract unless the person was using swaps to hedge or mitigate commercial risks, such as when corporations use swaps to hedge business risk (the “corporate exemption”).\textsuperscript{99}

The Senate draft follows a similar approach. Like the House bill, it requires central clearing of contracts where both counterparties are either dealers or major swap participants.\textsuperscript{100} It then permits (but does not require) the regulators to exempt contracts where one of the counterparties is not a dealer or major swap participant and “does not meet the eligibility requirements of any derivatives clearing organization that clears the swap.”\textsuperscript{101} Its definition of “major swap participant” focuses

\textsuperscript{95} H.R. 4173, 111th Cong. § 3101(a)(3) (2009) (amending the Commodity Exchange Act by inserting § 1a(38)(A)).

\textsuperscript{96} Id. § 3103(a)(4) (amending the Commodity Exchange Act by inserting § 2(j)(8)(A)), § 3203(a) (amending the Securities Exchange Act by inserting § 3B(h)(1)).

\textsuperscript{97} A “swap dealer” means any person who—(i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly engages in the purchase of swaps and their resale to customers in the ordinary course of business; or (iv) engages in any activity that causes the person to be commonly known as a dealer or market maker in swaps. A person may be designated a swap dealer for a single type or single class of or category of swap and considered not a swap dealer for other types, classes or categories of swaps.” Id. § 3101(a)(3) (amending the Commodity Exchange Act by inserting § 1a(38)(A)).

\textsuperscript{98} See id. § 3101(a)(3) (amending the Commodity Exchange Act by inserting § 1a(39)(A)); see also SENATE PROPOSAL, supra note 3, § 711(a)(7).

\textsuperscript{99} The clearing requirement does not apply only if one of the counterparties is not a swap dealer or major swap participant and able to demonstrate the use of such swaps for mitigating business, operating, or commercial risk in a manner that accounts for the financial obligations associated with non-cleared swaps. H.R. 4173 § 3103(a)(4) (amending the Commodity Exchange Act by inserting § 2(j)(8)(A)); id. § 3203(a) (amending the Securities Exchange Act by inserting § 3B(h)(1)).

\textsuperscript{100} SENATE PROPOSAL, supra note 3, § 713(a)(3) (amending the Commodity Exchange Act by inserting § 2(j)).

\textsuperscript{101} Id. (amending the Commodity Exchange Act by inserting § (9)(B)).
solely on persons, other than swap dealers, whose positions could create substantial net exposure for their counterparties. Additionally, the Senate draft does not establish a special “corporate exemption” like the House bill does.

The primary functions of a clearinghouse are to monitor the exposures of clearinghouse members and to allocate losses in the event a member defaults. Contracts involving nonmembers, whether “dealers,” “major swap participants,” or others, may only be cleared through clearinghouse members. Because the clearinghouse has limited information about and cannot control the risk of default of nonmembers, it will insist that a member guarantee any contract submitted by a nonmember. This arrangement reduces the risk for the counterparty member by replacing that member’s exposure to the nonmember with exposure to the clearinghouse. That same counterparty risk to the nonmember is then transferred to the guarantor member. Take an example: Corporation XYZ enters into an OTC derivatives contract with Dealer A, a clearinghouse member. The clearinghouse becomes a counterparty to A’s obligation to XYZ and also becomes a counterparty to XYZ’s obligation to A as guaranteed by Dealer B. Although the risk of A’s default is reduced because its counterparty is now the clearinghouse, Dealer B is now exposed to the risk of default of XYZ through its guarantee.

Because the losses arising from the default of a nonmember of a clearinghouse are borne entirely by the member guarantor, clearing contracts of nonmembers does not facilitate loss spreading. Therefore, proposed legislation could be simplified by generally requiring that only contracts between members of a clearinghouse be centrally cleared. One would want to make sure, however, that institutions with substantial trading activity in derivatives be members of a clearinghouse to assure maximum collectivization of failure risk.

102. A “swap dealer” is “any person engaged in the business of buying and selling swaps for such person’s own account, through a broker or otherwise. . . . The term ‘swap dealer’ does not include a person that buys or sells swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.” Id. § 711(a)(5).
103. See id. § 711(a)(7).
104. See id. § 713(a)(3) (amending the Commodity Exchange Act by inserting § 2(j)).
How would one determine who should belong? One way is to assess the size of the net exposures created by counterparties to derivatives contracts. This assessment could be implemented by requiring clearinghouses to establish net counterparty exposure thresholds (positions in each swap category would be netted for each counterparty and then aggregated) for all swap categories in which they were active. Any counterparty that generated a net exposure above the relevant threshold would be eligible for, and could be required to obtain, membership in the relevant clearinghouse. Membership would also be subject to reasonable standards of solvency to ensure that the clearinghouse and its membership were adequately capitalized. Finally, regulators and antitrust officials should retain responsibility for monitoring membership criteria to ensure that existing clearinghouse members do not establish thresholds which unreasonably exclude systemically important nondealer counterparties.

Although many firms whose exposures exceed the defined net exposure thresholds could be admitted as clearinghouse members, some—including some dealers that have lower capital, some hedge funds, as well as most (if not all) mutual and pension funds—may not meet reasonable membership qualifications. When such firms do not qualify for clearinghouse membership, they should be required to clear their trades even if it means obtaining a member guarantee. Although the guarantee may increase the risk of the guarantor member, clearinghouse members will generally be subject to higher levels of supervision than the firms whose positions they are guaranteeing (such as highly leveraged hedge funds) and are, therefore, less likely to fail and set off a chain reaction of failures.

Apart from systemic risk concerns, there are efficiency gains from clearing, but only systemic risk concerns should warrant mandatory clearing. First, a clearinghouse facilitates dynamic readjustment of the initial margin attached to a contract in response to changes in the credit quality of the nonmember counterparty. Under current bilateral practice, a significant credit event that impairs the counterparty’s solvency or jeopardizes its ability to perform, or a significant change in a contract’s volatility, does not necessarily trigger readjustment of initial margin levels. But this lack of readjustment is a result of industry practice and perhaps better knowledge of counterparty individual risks for margin than is available through the homogenous margin practices of clearinghouses.
Second, a clearinghouse could alleviate the competitive pressure dealers face to attract business by reducing the amount of collateral they require from customers, whether in the form of initial or mark-to-market margins, eliminating a possible "race to the bottom" in collateral in the bilateral context. But requiring dealers to establish prudent collateral levels can be accomplished through regulation and supervision without requiring a clearinghouse.\textsuperscript{105}

Third, clearinghouses could achieve economies of scale in providing trade processing services, such as segregation systems, the management of the provision of transfer of collateral, or dispute resolution procedures. These efficiencies may reduce operational risk. Both the House bill and Senate draft call for dealers to segregate funds or property associated with a non-cleared swap at their counterparties' request.\textsuperscript{106} The House bill cannot assure that pricing for segregation will be deemed competitive with the non-segregated—and arguably systemically riskier—holding of collateral directly by the dealers.\textsuperscript{107} If counterparties are indeed interested in the use of segregation systems or any of the other services that clearinghouses can offer more cheaply than other providers, however, one can assume that, provided viable buy-side clearing options are available, these counterparties will insist on central clearing rather than resist it. These efficiencies do not per se provide a reason for imposing a clearing requirement on non-dealer counterparties.

Fourth, there are cases in which the use of clearinghouses can facilitate netting of derivatives trades, because cleared contracts are fully fungible within a clearing framework. They therefore continuously and automatically net down, whereas bilateral contracts require consent of all parties to novate or net. Some believe that the reduction of systematic risk by greater netting alone justifies a clearing requirement. But as Professors Duffie and Zhu observe, the use of a clearinghouse does not necessarily increase netting.\textsuperscript{108} For example, a clearinghouse that clears

\textsuperscript{105} See infra Part VI.

\textsuperscript{106} H.R. 4173, 111th Cong. § 3122 (2009) (amending the Commodity Exchange Act by inserting § 4u), § 3203(e) (amending the Securities Exchange Act by inserting § 3D); SENATE PROPOSAL, supra note 3, § 718 (amending the Commodity Exchange Act by inserting § 4t).

\textsuperscript{107} H.R. 4173 § 3122.

one type of asset creates opportunities for multilateral netting in that asset class. Whether this results in an overall increase in netting turns on whether these gains are offset by the lost opportunities to net among different asset classes that might exist in the bilateral setting. Thus, whether the use of a clearinghouse increases netting depends on multiple factors, including the range of assets that clearinghouses clear, and the agreements among clearing members and their nonmember customers to net among cleared and uncleared contracts.

On the other hand, it is important to recognize that bilateral clearing may itself offer efficiency advantages, primarily by allowing more counterparty-specific margining that legitimately takes into account the underlying credit risk of the counterparty, something a clearinghouse cannot do. If the efficiencies of using a clearinghouse outweigh the costs, nonparticipants will volunteer to have their contracts centrally cleared without being mandated to do so. This statement assumes, however, that clearinghouses do not unreasonably exclude firms from using their facilities, so regulators and antitrust officials should monitor clearinghouses to make sure unreasonable exclusion does not occur.

To repeat, the basic reason to mandate central clearing is to reduce systemic risk, not to increase the efficiency of the OTC market. If central clearing is more efficient, it may be important to encourage it, but without mandating it, and market participants will eventually demand it themselves, absent restraints of trade.

What should be done with respect to uncleared positions? Despite the recommendations above, there will still be a substantial number of nonstandardized or illiquid positions or positions held by nonparticipants of a clearinghouse. The Treasury White Paper suggests higher capital and margin requirements for such positions, but the effectiveness of higher capital requirements is contingent on the regulator's ability to determine the amount of capital required. If the regulator's amount proves incorrect, we will either not eliminate the risk of failure or we will discourage valuable risk-reducing contracts. This problem is also present in the congressional calls for higher capital.

The House bill requires swap dealers and major swap participants to maintain capital and meet margin requirements set by prudential regulators (for banks) or the CFTC or SEC (for non-banks). In the case of non-cleared swaps, regulators are directed to set capital and margin requirements that are appropriate to the risk associated with the non-cleared swaps. Additionally, prudential regulators can set collateral and margin requirements for swaps where banks or bank holding companies are end users—with the CFTC and SEC doing the same where non-bank swap dealers or major swap participants, for which there is no prudential regulator, are end users.

The Senate draft differs in its approach by imposing a capital requirement greater than zero for cleared swaps and substantially higher capital requirements for non-cleared swaps to offset the greater risks to dealers and major swap participants and to the financial system. Capital requirements for non-bank holding companies, or entities within the jurisdiction of the CFTC or SEC, are prescribed to be as strict as those set for banks.

Similarly, under the Senate draft, margin requirements are to be set by “primary financial regulatory agencies” for bank swap dealers and major swap participants—with the CFTC and SEC imposing as strict or stricter margin requirements on non-bank dealers and major swap participants. The Senate draft provides for an exemption to the margin requirement for persons who are not a swap dealer nor major swap participant, are using swaps as an effective hedge under GAAP, and are predomi-

110. H.R. 4173, §3107 (amending the Commodity Exchange Act by inserting §4s(d)); §3204 (amending the Securities Exchange Act by inserting §15F(d)).
111. Id. Prudential regulators will set collateral and margin requirements for swaps where banks or bank holding companies are end users, and the CFTC and SEC will do the same where non-bank swap dealers or major swap participants, for which there is no prudential regulator, are end users. Id. The Senate draft, in contrast, envisions that capital requirements will be set by “primary financial regulatory agencies,” with the CFTC and SEC doing so for all non-bank dealers and major swap participants. SENATE PROPOSAL, supra note 3, §717 (amending the Commodity Exchange Act by inserting §4s(e)(1)).
112. H.R. 4173, §3107 (amending the Commodity Exchange Act by inserting §4s(d)(1)(A)–(B)); id. §3204 (amending the Securities Exchange Act by inserting §15F(d)(1)(A)–(B)).
113. SENATE PROPOSAL, supra note 3, §717 (amending the Commodity Exchange Act by inserting §4s(e)(3)(A)).
114. Id. (amending the Commodity Exchange Act by inserting §4s(e)(3)(B) & (C)).
115. Id. (amending the Commodity Exchange Act by inserting §4s(e)(4)(A)(i)–(B)(i)).
nantly engaged in activities that are not financial in nature.\textsuperscript{116} Noncash collateral may meet margin requirements to the extent it is consistent with preserving the financial integrity of the particular derivatives market and preventing systemic risk.\textsuperscript{117}

B. The Optimal Number and Scope of Clearinghouses

Another issue connected to clearinghouses is the question of how many there should be and which derivatives contracts they should clear. Duffie and Zhu have pointed out that more risk reduction is possible through bilateral counterparty netting and collateral for all derivative contracts than from centralized clearing of just CDSs.\textsuperscript{118} Yet the new clearinghouses under way, such as IntercontinentalExchange Inc. (ICE), are focused only on CDSs.\textsuperscript{119} With respect to quantity of clearinghouses, one is more efficient than many, but its failure would pose more systemic risk. This issue is further complicated by the European Union’s insistence that CDS contracts on European reference entities be cleared through a European clearinghouse.\textsuperscript{120}

Although the CCMR has previously recommended that clearing occur through one or two facilities to take maximum advantage of netting, if clearing is to be spread into several facilities, the CCMR’s current view is that there are benefits from having multiple clearinghouses organized by asset class.\textsuperscript{121} First, a lower number of clearinghouses would imply a greater concentration of risk. To the extent feasible, it would be better to avoid having clearinghouses that are “Too Big to Fail.” Second, having multiple clearinghouses would preserve competition that is potentially important, at the current early stage of

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\textsuperscript{116} Id. (amending the Commodity Exchange Act by inserting § 4s(e)(4)(A)(ii)).
\textsuperscript{117} Id. (amending the Commodity Exchange Act by inserting § 4s(e)(5)).
\textsuperscript{119} CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 43; CCMR Derivatives Letter, supra note 80, at 20.
\textsuperscript{121} CCMR Derivatives Letter, supra note 80, at 21.
\end{flushleft}
development, for evolving the best frameworks for clearing OTC derivatives.\textsuperscript{122} And third, the Committee believes different asset classes have different risk profiles and are better handled by different risk management techniques. Assuming that it is more difficult for one clearinghouse to manage risk across multiple asset classes than it is for multiple clearinghouses to handle risk from one asset class each, having multiple clearinghouses organized by asset class could be the safer option.\textsuperscript{123}

Of course, these points do not negate Duffie and Zhu's observation that a more limited number of clearinghouses leads to more efficient margining. However, less efficient margining will not lead to increased systemic risk as long as margining arrangements in each clearinghouse are adequate to protect against failure. The existence of multiple clearinghouses therefore does not contradict the goal of reducing systemic risk as long as regulators carefully scrutinize clearinghouse margin requirements. It is also worth noting that the efficiency gains from a reduced number of clearinghouses described by Duffie and Zhu will gradually create market pressure for clearinghouses to consolidate. Over time, the market will ensure that the number of clearinghouses is not excessive.

It may also be possible, in theory, to achieve the systemic risk reductions of multiple clearinghouses at the same time as the margining efficiency of a more limited number of clearinghouses. Insisting on interoperability between clearinghouses would allow a net position in one clearinghouse to be netted against a position in another. This interoperability, however, could be very costly; thus, the CCMR exercised caution with this recommendation because of the difficulties of establishing inter-clearinghouse accounts if the risk profiles and regulatory standards differ among interlinked clearinghouses.

\textsuperscript{122} At the same time, the basic models should be consistent in terms of operational functionality. For example, clearing should be available on a same day basis given timely submission, clients should be able to engage multiple Futures Commission Merchants, and there should be options to the client in failure to clear situations.

\textsuperscript{123} The CCMR "acknowledges that some of its members do not believe there are risk management benefits to be gained by limiting clearinghouses to one asset class, and they are concerned that organizing [clearinghouses] by asset class will substantially increase the cost of clearing since there will be less risk diversification and netting, and because it will not be possible to spread the cost of capitalizing [clearinghouses]." CCMR Derivatives Letter, \textit{supra} note 80, at 22.
Several studies have examined the risks that arise from linkages between clearinghouses. The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissioners have developed recommendations for the evaluation and management of risks that arise from clearinghouse linkages. The Joint Regulatory Authorities of LCH.Clearnet prepared a more detailed analysis of the risks from linkages between clearinghouses. Their analysis highlights operational, legal, liquidity, and settlement risks that arise from linkages between clearinghouses. They caution that linkages between clearinghouses may lead to an increase in systemic risks in the financial system. Actual experience with links between clearinghouses is limited. To date, several linkages have been established among European clearinghouses, although the overall level of integration remains low.

C. Ownership of Clearinghouses

The House bill would limit the combined control share of all restricted owners in a clearinghouse—swap dealers and major swap participants—to 20% of the votes to be cast on any matter. Thus, all restricted owners combined cannot control a majority of board seats. These restrictions are intended to reduce conflicts among members, or reduce the risk that mem-

124. Interoperability, flowing from a requirement that clearinghouses allow participants to move open positions from one clearinghouse to another, could bring benefits to the market. “In practice, however, operational, legal, and risk-management issues make interoperability difficult and costly for the foreseeable future. Interoperability should be a design element for [clearinghouses] for future consideration.” FED. RESERVE BANK OF N.Y., POLICY PERSPECTIVES ON OTC DERIVATIVES MARKET INFRASTRUCTURE 14 (2010).


126. JOINT REGULATORY AUTHS. OF LCH.CLEARNET GROUP, INVESTIGATION OF RISKS ARISING FROM THE EMERGENCE OF MULTI-CLEARED TRADING PLATFORMS (2008). The Joint Regulatory Authorities include regulators in Belgium, France, the Netherlands, Portugal, and the UK that have supervisory authority over LCH.Clearnet Group.


bers will act in their own self-interest rather than the interest of the clearinghouse. However, the limitation in the control rights of restricted owners means that the members that are restricted owners would be contributing capital and bearing risk but without exercising rights relevant to managing risks to which their capital is exposed. This disjunction of risk and control creates an incentive not to create clearinghouses in the first place. The Senate draft does not impose this limitation.\footnote{See \textit{SENATE PROPOSAL}, supra note 3, § 719.}

This control restriction may also give rise to poor governance. A primary function of a clearinghouse is the management of the risks from derivatives transactions. These transactions are activities in which swap dealers and major swap participants have particular expertise. The control restrictions in the House bill, however, would limit the ability of swap dealers and major swap participants, who are the parties with the greatest expertise in risk management, to exercise influence over the policies and operations of a clearinghouse.

On the other hand, the restrictions could be ineffective at limiting "restricted owners" from controlling a clearinghouse since one can exercise control without ownership if one is the major value-added source for running a business. A better approach would be for regulators to review clearinghouse rules and practices to ensure that membership and access policies are not discriminatory.

\textbf{D. Collection and Publication of Data}

In the interest of having better price information, the CCMR has further recommended that certain volume and position data be made publicly available to reduce risk for traders and clearinghouses. To achieve that objective, the CCMR has recommended that within the CDS market, regulators should facilitate the adoption of a transaction reporting system similar to the Financial Industry Regulatory Authority’s TRACE system for corporate bonds.\footnote{CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 48–49; CCMR Derivatives Letter, supra note 80, at 24. TRACE stands for "Trade Reporting and Compliance Engine."} The CCMR also supports measures in the proposed legislation that mandate the reporting of derivatives transactions to data repositories and for clearinghouses and data repositories to disseminate aggregate data on trading
volume, transaction prices, quotations, and open interest to the public. However, due to the high costs of implementing a TRACE-like system, the CCMR believes a reasonable tradeoff between transparency and cost would be to allow regulators to permit block reporting of transactions on a modestly delayed basis as an acceptable means of implementing the transaction reporting requirement and to generally allow some bunching of normal trades to reduce cost.

The CCMR is also aware of the potential damage from applying continuous reporting requirements to large derivatives trades. The issues are analogous to those involved in reporting “block trades” in the equity context. If traders know someone is shopping or seeking to acquire a large position, traders will take advantage of this knowledge. This, in turn, will make block sales or purchases less likely and reduce liquidity. The CCMR thus recommends that the Federal Reserve permit delayed reporting for transactions that are large compared to average volume or that involve contracts that infrequently trade.

The House bill and the Senate draft both provide for public reporting of aggregate data on swap trading volumes and positions from clearinghouses, swap repositories, and—for non-cleared swaps whose data was not accepted by a swap repository—submitted transaction reports. The Senate draft goes further by calling for the terms and conditions of contracts, agreements, and transactions cleared and settled by the organization, including daily settlement prices, to be made publicly available by clearing organizations.

E. Exchange Trading

A highly contested issue among dealers and exchanges is whether there is a need for derivatives, particularly CDSs, to be exchange-traded over and above the need for clearinghouses.

131. H.R. 4173 §§ 3103(a)(3), 3103(b)(3), 3109, 3203(a); SENATE PROPOSAL, supra note 3, §§ 713(a)(3), 713(b)(4), 753(a).
132. H.R. 4173 § 3104 (amending the Commodity Exchange Act by inserting § 8(j)), § 3203(a) (amending the Securities Exchange Act by inserting § 3B(j)(2)); SENATE PROPOSAL, supra note 3, § 713(a)(2) (amending the Commodity Exchange Act by inserting § 3(j)(6)).
133. SENATE PROPOSAL, supra note 3, § 713(b)(3) (amending the Commodity Exchange Act by inserting § 5b(c)(2)(L)).
Although dealers are generally opposed to exchange-trading because it would narrow their spreads, dealers' interest in maintaining spreads cannot be a basis for policy. There is, however, a legitimate issue as to whether exchange-trading is desirable or feasible. The argument for exchange-trading is that it would further improve the ability to price derivatives, which is important not only to traders but to the clearinghouses as well to settle margin requirements. Currently, pricing information with respect to quotes is available from vendors like Markit on both an end-of-day and intraday basis. Although the clearinghouses already utilize this information, no current intraday collection of pricing data is based on actual transactions. Although only an estimated 60% of trades are reported to the Depository Trust and Clearing Corporation warehouse by the end of the day, this percentage is rapidly increasing. An exchange would provide continuous data on the prices of transactions.  

The exchange trading provisions in the House bill and the Senate draft are closely related to the requirements on clearing. In the House bill, derivatives contracts that are required to be cleared would need to be traded on a regulated exchange or "registered swap execution facility."  

While the Senate draft also requires derivatives contracts that are required to be cleared to be traded on a regulated exchange or registered "alternative swap execution facility," the Senate draft's definition of "alternative swap execution facility" is more restrictive than the definition of "registered swap execution facility" in the House bill.  

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135. See CCMR Plan for Regulatory Reform, supra note 1, at 50; CCMR Derivatives letter, supra note 80, at 26.

136. H.R. 4173 § 3103(a)(4) (amending the Commodity Exchange Act by inserting § 2(k)(1)), § 3203(c) (amending the Securities Exchange Act by inserting § 5A(a)(1)). The House bill defines a "swap execution facility" as a "person or entity that facilitates the execution or trading of swaps between two persons through any means of interstate commerce, but which is not a designated contract market, including any electronic trade execution or voice brokerage facility." Id. § 3101(a)(3) (amending the Commodity Exchange Act by inserting § 1a(49)), § 3201(a)(6) (amending the Securities Exchange Act by inserting § 3(a)(77)). To be registered, such a swap execution facility would need to comply with certain requirements, including a requirement to maintain rules designed to prevent market manipulation. Id. § 3109 (amending the Commodity Exchange Act by inserting § 5h(d)), § 3203(d) (amending the Securities Exchange Act by inserting § 3C(d)).

137. Senate Proposal, supra note 3, §§ 713(a)(3), 753(a). The Senate draft defines an "alternative swap execution facility" as an "electronic trading system with pre-trade and post-trade transparency in which multiple participants have
sons would likely satisfy the House bill’s exchange trading requirement but not the exchange trading requirement in the Senate. The requirements in both approaches apply only when an exchange-traded contract is available. One cannot force people to trade contracts that exchanges do not want to trade.

Pricing of CDSs in which a credit event has occurred raises further problems. The ISDA has an auction procedure to determine the cash settlement price of these contracts, essentially what the seller is required to pay, but these auctions only occur thirty days after the determination that a credit event has occurred. Recent market events bear witness that thirty days is entirely too long to wait for price determination in the fast-paced CDS market. Exchanges could improve the ability to price these contracts.

Exchanges may also improve liquidity, which is not only important to traders but also to clearinghouses seeking to close out the position of a defaulting member. An exchange would likely add liquidity to what is presently achievable in the OTC market.\(^{138}\) Bear in mind that the class of derivatives that would be exchange-traded, however, is a subset of those that would be cleared through a clearinghouse due to lack of trading interest. In addition, even contracts normally required to be exchange-traded would require exceptions for “block trades” to avoid the usual block trade problem resulting from a dealer disclosing its entire trading position.

The current view of the CCMR is that exchange trading should not be required, but encouraged where appropriate. To the extent that legislation includes an exchange-trading requirement, the House bill and Senate draft properly give regulators authority to determine which contracts would be subject

\(^{138}\) In the case of CDSs, for example, exchange-trading would increase liquidity in the CDS market and would allow small investors to trade credit risk more easily. Mike Jakola, Credit Default Swap Index Options: Evaluating the Viability of a New Product for the CBOE 8 (June 2, 2006) (unpublished manuscript), available at http://www.kellogg.northwestern.edu/research/fimrc/papers/jakola.pdf.
Reduction of Systemic Risk to exchange-trading requirements. Further, to the extent that legislation involves an exchange-trading requirement, the only alternative to trading on an organized exchange should be trading on a platform along the lines of an "alternative trading system"—which the SEC defines as an organization, association, person, or system that provides a marketplace or facilities for bringing together buyers and sellers—or another venue that is appropriately regulated in light of the transparency objectives of the legislation.

F. The International Dimension

There is a challenging international dimension to this problem. First, uncoordinated international action could lead to suboptimal clearing arrangements, as previously discussed in the case of the European Union. Second, traders may seek out less regulated clearinghouses or exchanges because no one country can ensure that derivatives will be cleared under the rules it devises.

Perhaps the United States should penalize or restrict its own financial institutions from seeking more friendly climes, but it seems extreme to penalize foreign institutions and foreign countries for having what the United States deems to be lower standards or reckless markets. Under the House bill, the Federal Reserve (in deciding whether to allow a foreign bank to establish a branch in the United States), and the SEC (in deciding whether to allow a foreign broker-dealer to register as a broker-dealer in the United States) would consider whether the home country of the bank or broker-dealer has adopted, or is progressing toward, "an appropriate system of financial regulation" to mitigate sys-


140. The SEC's formal definition of an "alternative trading system" is any organization, association, person, group of persons, or system: (1) [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Rule 3b-16 under the Securities Exchange Act of 1934; and (2) [t]hat does not: (i) [s]et rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or (ii) [d]iscipline subscribers other than by exclusion from trading.

Moreover, the Federal Reserve and the SEC may decide to terminate the activities of a bank or broker-dealer based on their judgment that the home country has not adopted, or made demonstrable progress toward adopting, such a system of financial regulation. But why should a British bank or broker-dealer be excluded from the United States financial system (including access to United States payment systems) because an American or even an Italian hedge fund sought to clear or trade derivatives in a less regulated United Kingdom market? Such unilateral action by the United States might result in resentment and ultimately retaliation. A better approach involves more coordinated international action, the approach we have already followed for capital regulation.

IV. RESOLUTION PROCEDURES

A. The Importance of Resolution Procedures

Sound resolution procedures are necessary for two principal reasons. First, poor procedures may increase systemic risk. Some believe this economic crisis was a result of using the poor procedures of general bankruptcy law for resolving Lehman Brothers. Second, the lack of adequate procedures may preserve institutions that should otherwise be restructured, sold, or liquidated. Preservation of such institutions is undesirable because it may increase taxpayer cost and moral hazard by failing to impose costs on investors or counterparties. The institutions that received TARP funds may fall into this category. Thus, the inability to inject public funds as part of the bankruptcy process and the placement of crucial decisions of administration in the hands of courts rather than regulators appear to be primary reasons why authorities sought to avoid bankruptcy for systemically important institutions, including bank holding companies, particularly after the Lehman experience.

There is also concern about how derivatives are handled by the Bankruptcy Code. The Code permits counterparties to liq-

142. Id. § 1951(b)(3) (amending the International Banking Act of 1978 by inserting § 7(e)(1)(C)), § 1951(c) (amending the Securities Exchange Act by inserting § 15(l)).
reduce collateral on in-the-money contracts, which can drive collateral prices sufficiently downward for collateral to become inadequate, triggering a chain reaction of possible failures of counterparties. In an FDIC conservatorship, the derivatives book can be (and routinely is) held by the government as conservator or transferred within one business day to third parties without triggering the right of counterparties to liquidate collateral. Concerns with AIG’s derivatives book were critical to placing the company into an ad hoc receivership rather than bankruptcy, even though AIG’s failure came only two days after Lehman’s.

The avoidance of bankruptcy for insolvent institutions—even for banks whose holding companies are not subject to the Federal Deposit Insurance Act (FDIA) receivership provisions—has the potential to create a zombie financial system at the taxpayers’ expense. Placing insolvent banks and their holding companies into an FDIA receivership to be restructured (while being kept open if necessary) would impose losses on equity and debt holders instead of the taxpayer, as was done in the cases of Washington Mutual and IndyMac through the FDIA Act. This is not to say we have not imposed losses on equity and debtholders through TARP. In the case of TARP infusions, equity was substantially diluted and debtholders were subordinated to the new government preferred investment. In

146. See Carol J. Loomis, Derivatives: The Risk that Still Won’t Go Away, Fortune, July 6, 2009, at 55, 57–58 (describing the handling of Lehman’s derivatives book as it neared bankruptcy); Scott, supra note 16.
addition to equity dilution, TARP recipients including Goldman Sachs and Morgan Stanley were subject to multiyear limitations on common dividend and stock repurchase policies, and significant restrictions were imposed on executive compensation. Nonetheless, more substantial losses could be imposed through the use of resolution procedures. As observed earlier, the imposition of such losses is particularly important for achieving more market discipline with respect to required levels of capital.

B. What Institutions Should be Subject to Special Resolution Procedures?

The CCMR has recommended that the FDIA be expanded to provide comprehensive and unified resolution procedures for all financial institutions. The Treasury White Paper falls short in achieving this goal. It would create a new procedure for only some financial institutions—"systemically important" holding companies of regulated entities and their subsidiaries. Hedge funds and insurance companies are not covered, and broker-dealers remain covered by the Securities Investor Protection Act of 1970 (SIPA).

The House bill and the Senate draft are similar to the Treasury proposal in the following respect: Subject to exceptions, the resolution procedures in both the House bill and the Senate draft are potentially applicable to bank holding companies, companies that have been made subject to stricter prudential regulation, companies predominantly engaged in activities that are financial in nature or incidental thereto for purposes of the Bank Holding Company Act, and any subsidiaries of the foregoing. The resolution procedures in the Senate draft would also be applicable to brokers-dealers. Before applying the

152. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 113.
153. See TREASURY WHITE PAPER, supra note 2, at 76–78.
155. See H.R. 4173, 111th Cong. § 1602(9) (2009); SENATE PROPOSAL, supra note 3, § 201(7), (8), (11). For an explanation of which companies are subject to stricter prudential regulation, see infra notes 241–47 and accompanying text.
156. See SENATE PROPOSAL, supra note 3, § 201(6). However, the bill also provides that the FDIC will appoint the SIPC to act as a trustee for any covered broker or dealer that has entered into receivership. Thus, subject to certain limitations, broker-dealers
resolution procedures, however, the Secretary of the Treasury must make a series of determinations, including the determination that the failure of any such company would have "serious adverse effects on financial stability or economic conditions in the United States."\textsuperscript{157}

In the Senate draft, the Secretary of the Treasury must petition the "Orderly Liquidation Panel" for an order authorizing receivership under the draft's provisions, and it is only in receivership that public money can be used to support an institution.\textsuperscript{158} Although the Panel, composed of three judges from the United States Bankruptcy Court for the District of Delaware,\textsuperscript{159} has twenty-four hours to determine whether the company is in default or in danger of default,\textsuperscript{160} its judgment can be appealed to the United States Court of Appeals, which need not reach a decision for another thirty days.\textsuperscript{161} The appeals court decision can then be appealed to the Supreme Court, which has an additional thirty days to consider the matter.\textsuperscript{162}

Thus, the Treasury, House, and Senate approaches only apply to institutions whose failure is determined to have important systemic effects at that time.\textsuperscript{163} Although avoidance of advance branding of institutions as systemically important does sidestep an increase of moral hazard and cost-of-funds advantage for such institutions arising out of the implicit government guarantee that goes with the brand,\textsuperscript{164} it also makes it difficult for investors or counterparties to know in advance which regime will apply to its positions. Furthermore, it may be very difficult to determine whether an institution is systemically important in a timely manner. The Senate draft's multistep judicial review process raises issues of this kind in a particularly pointed form.
The resolution procedures in the House bill and Senate draft also leave out certain types of financial institutions. Under the House bill, insured depository institutions,\textsuperscript{165} certain insurance companies,\textsuperscript{166} and certain government-sponsored entities, including Fannie Mae and Freddie Mac,\textsuperscript{167} would be excluded. The House bill would also exclude hedge funds and broker-dealers, even when broker-dealers are the subsidiaries of firms that are otherwise within the scope of the resolution procedures.\textsuperscript{168} The Senate draft would exclude insured depository institutions\textsuperscript{169} as well as insurance companies that are regulated by a state insurance regulator and covered by a state law that is designed to deal with the rehabilitation, liquidation, or insolvency of an insurance company.\textsuperscript{170}

The CCMR recommended a very different approach—the creation of a comprehensive Financial Company Resolution Act applicable to all financial companies, not just those whose failure was determined to be systemically important,\textsuperscript{171} which is the same approach we take today with banks. This approach allows more certainty of outcome. It makes sense to handle all banks under special procedures, regardless of systemic importance, and the CCMR believes the same is true for all financial companies. Flexible procedures deployed by knowledgeable regulators ensure the proper functioning of the financial system better than the litigation- and rules-based approach of the Bankruptcy Code.

Not every financial company subject to this Act would be eligible for public support;\textsuperscript{172} as with banks, support would require a special determination. Without such a determination, normal least-cost procedures would be used. In the case of failed banks, the basic expense is paying off insured depositors (normally funded by industry from the deposit insurance fund). Of course,

\textsuperscript{165} H.R. 4173 § 1602(9)(F).
\textsuperscript{166} Id. § 1604(e).
\textsuperscript{167} See id. § 1602(9)(D).
\textsuperscript{168} See id. § 1602(9)(B)(v).
\textsuperscript{169} SENATE PROPOSAL, supra note 3, § 201(7)(b).
\textsuperscript{170} Id. § 203(e).
\textsuperscript{171} CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 124.
\textsuperscript{172} Peter J. Wallison, Reinventing GSEs: Treasury’s Plan for Financial Restructuring, AEI FIN. SERVICES OUTLOOK, Mar./Apr. 2009, at 3, 5. This might be true for the Treasury proposal, which would only be used for “systemically important” institutions, but not under the CCMR’s proposed regime for handling failed financial companies that do not pose a systemic risk.
Reduction of Systemic Risk

for non-banks, this insurance cost would be absent. Public expense would be limited to the administrative cost of liquidating or selling the failed institution, with the exception of institutions requiring assistance to continue functioning.

The CCMR would also permit financial companies now eligible for resolution under the Bankruptcy Code to petition for reorganization under Chapter 11 of the Code, provided that the regulator would be empowered to convert such a proceeding into a disposition under the CCMR’s proposed Financial Company Resolution Act.173 Thus, the regulators could decide when and if it would be preferable to use the Bankruptcy Code to handle a particular resolution.

Instead, the Senate draft would expand the scope of the Bankruptcy Code to include many small banks that are not systemically important.174 In addition to the drawbacks discussed in the preceding paragraph regarding the general shortcomings of the bankruptcy process, the expansion of the Bankruptcy Code’s scope raises some key questions about the authority of the FDIC. For example, the FDIC currently has the ability to take “prompt corrective action” when it believes that a bank is in danger of failing. Will the FDIC continue to have this authority if the resolution of small banks is handled under the Bankruptcy Code? Also, consistent with its mandate to employ a “least cost resolution approach,”175 the FDIC can now use its funds to assist with the resolution of insolvent banks. For example, where it is cheaper to subsidize the purchase of an insolvent bank than to liquidate and pay off depositors, the FDIC can use its funds to provide such a subsidy. Will the FDIC continue to do so once small banks are subject to the bankruptcy process? It is unclear what the answers to these questions might be under the Senate draft.

C. Imposition of Losses under Special Resolution Procedures

A pivotal issue that legislation needs to address is how to impose costs on counterparties to derivatives contracts within the special resolution procedures. Although the Bankruptcy Code faces the systemic disadvantage of potentially triggering unde-
sirable fire sales of collateral, it does expose counterparties to losses on uncollateralized positions, which is beneficial to the reduction of moral hazard. The FDIA, on the other hand, makes counterparties whole, regardless of collateral, by transferring positions to solvent third parties, which increases moral hazard. A mechanism needs to be found to impose some losses on counterparties without unduly creating systemic risk, particularly for non-banks. The Treasury, House, and Senate approaches fall short on this issue. The House bill mandates involuntary bankruptcy for defaulting on an FDIC-guaranteed obligation, but the FDIC’s new resolution authority for systemically important firms applies different rules governing creditors’ rights, borrowed from bank resolution provisions rather than from the Bankruptcy Code, including rules regarding treatment of contingent claims, avoidance of security interests, repudiation of contracts, and damages determinations. Since the Senate draft provides that the resolution of non-systemically-important firms is handled under the Bankruptcy Code, derivatives counterparties of small banks will face the possibility of loss if they do not have sufficient collateral. However, the same incentive will not exist for counterparties of systemically important firms because the Senate draft provides, as under current law governing FDIC-insured banks, for the transfer of the derivatives book of systemically important firms to healthy companies, extending the time period from one to five days.

The pending legislation does, however, address losses for shareholders and creditors (a matter not addressed by the Treasury). The House bill permits the FDIC to make loans to a company in receivership, purchase debt securities or assets from such a company, and assume or guarantee such company’s obligations only if it ensures that shareholders do not receive payments until all other claims are fully paid, all taxpayer funds are repaid before payments are made to creditors, and unsecured creditors bear losses. Second, consistent with

177. SENATE PROPOSAL, supra note 3, § 202(d)(1).
179. SENATE PROPOSAL, supra note 3, § 210(c)(9).
180. Id. § 210(c)(10)(B)(i).
181. H.R. 4173 §§ 1604(d)(1)-(4), 1604(f)(2)-(4); see also H.R. 4173 § 1609(b)(1) (establishing a priority of claims whereby unsecured claims would be paid only after “ad-
Reduction of Systemic Risk

commercial bankruptcy practices, creditors whose claims are partially secured would be treated as unsecured creditors with respect to the portion of their claim that exceeds the fair market value of their collateral.\textsuperscript{182} Third, and more controversially, the House bill provides that up to 10% of a secured creditor's claim may be treated as unsecured if amounts realized from the dissolution are insufficient to repay any amounts owed to the United States or the systemic dissolution fund; if a secured creditor has a claim arising under a "qualified financial contract"—which includes certain securities contracts, forward contracts, repurchase agreements, and swap agreements—with a term of one calendar month or less; and if the collateral that secures the claim is not a security issued by the U.S. government.\textsuperscript{183}

The Senate draft follows the House bill in permitting the FDIC to take action to stabilize a financial company only if shareholders do not receive payments until all other claims are satisfied and unsecured creditors bear losses.\textsuperscript{184} Also like the House bill, the Senate draft empowers the receiver to treat a partially secured creditor as unsecured with respect to the portion of the claim that exceeds the value of the creditor's collateral.\textsuperscript{185} But the current Senate draft does not incorporate a provision like the one in the House bill that would subject secured creditors to the possibility of a haircut.

Although it is crucial to reduce moral hazard, legislation must also ensure that the resolution procedures do not exacerbate the problem they were designed to address by excessively burdening creditors. By imposing a haircut of up to 10% on certain secured creditors, which would essentially deprive them of the value of their security, the House bill commits a serious error. If lenders know they will have to take a haircut, they will be less likely to extend credit to the institutions that are most in need. This could increase the risk of a chain reaction of failures among financial institutions.\textsuperscript{186}

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\textsuperscript{182} H.R. 4173 § 1609(a)(4)(D)(ii)(I).
\textsuperscript{183} H.R. 4173 § 1609(a)(4)(D)(iv), (v).
\textsuperscript{184} SENATE PROPOSAL, supra note 3, § 206.
\textsuperscript{185} Id. § 210(a)(3)(D).
\textsuperscript{186} See Scott, supra note 16.
In light of the losses that would be imposed on shareholders and creditors under both the House bill and Senate draft, some objections to the new resolution procedures appear overstated. For example, Peter Wallison has argued that the resolution procedures would weaken market discipline:

Given that bailouts are going to be much more likely than liquidations, especially for systemically important firms, a special government resolution or rescue process will also undermine market discipline and promote more risk-taking in the financial sector. In bailouts, the creditors will be saved in order to prevent a purported systemic breakdown, reducing the risks that creditors believe they will be taking in lending to systemically important firms. Over time, the process of saving some firms from failure will weaken all firms in the financial sector.  

Although the CCMR agrees that it is crucial to preserve market discipline, Wallison’s view that the resolution procedures would undermine market discipline is mistaken. A significant motivating factor for introducing the resolution procedures is to increase the losses that could be imposed on shareholders and creditors by allowing firms to fail. As we have seen, the House bill provides that neither shareholders nor creditors receive payments until taxpayer funds have been repaid; under the Senate draft, shareholders would not receive payments until taxpayers have been repaid, while unsecured creditors would be required to bear losses.

It is true, however, that the special resolution procedures envision the possible public injection of funds in an institution, a possibility not available in bankruptcy. But the pending legislation envisions such bailouts as a possibility only for systemically important firms whose failure would have "serious adverse effects on financial stability or economic conditions." This determination would be made by the Secretary of the Treasury, upon the recommendation of the Federal Reserve Board and the FDIC that the resolution would avoid or mitigate such adverse effects, taking into account, among other things, the potential to increase moral hazard or excessive risk taking on the part of creditors, counterparties, and shareholders.

187. Wallison, supra note 172, at 5.
188. H.R. 4173 § 1603(b)(2); SENATE PROPOSAL, supra note 3, § 202(a)(2)(B).
ers in the financial company. Even if all financial companies were covered by special resolution procedures, as advocated by the CCMR, legislation could provide that no institution receive public support unless it was determined to be systemically important and only after a full measure of losses was imposed on investors and counterparties.

D. Funding the Cost of New Procedures

How should the cost of the new procedures for non-banks be funded given that the regularly imposed deposit insurance premiums that normally fund bank resolutions would not exist? Under the Treasury proposal, the FDIC would borrow funds from the Treasury, which would later be repaid through an assessment on certain bank holding companies. The Senate draft and the House bill, on the other hand, each provide for a resolution fund that would be capitalized primarily through assessments on qualifying financial institutions. The Senate draft mandates the establishment of an “Orderly Liquidation Fund” with a target size of $50 billion. Although the Senate draft also authorizes the FDIC to borrow from the Treasury, during the Fund’s initial capitalization period the FDIC is required to impose risk-based assessments on “eligible financial companies,” defined as bank holding companies with assets greater than or equal to $50 billion and non-bank financial companies supervised by the Federal Reserve Board. Similarly, while also enabling the FDIC to borrow from the Treasury, the House bill would establish a systemic resolution fund of up to $150 billion that would be pre-funded through assessments on non-hedge-fund financial companies with at least $50 billion and hedge funds with at least $10 billion of assets.
Under all three proposals, large bank holding companies could be required to pay for resolutions of systemically important non-bank institutions that are subject to the resolution procedures, which include systemically important hedge funds under the Treasury proposal, House bill, and Senate draft, as well as systemically important insurance companies under the Treasury proposal and the Senate draft.

While recognizing the need for further study of these issues, the CCMR believes that the pre-funded approach embraced by the House bill and the Senate draft is misguided in at least two respects. First, ex ante, it is not clear how much any resolution procedure will cost, so a pre-raised $50 or $150 billion fund may prove to be insufficient or excessive. It would thus be preferable to adopt an as-needed approach, whereby resolution assessments are levied in an amount equal to what is then required to resolve an institution. Second, whether or not the total magnitude of pre-raised assessments is appropriate, the amount imposed on a particular company may not be. The Senate draft provides that financial companies with greater assets will be assessed at a higher rate, but also empowers the FDIC to take into account several other factors when imposing assessments on a specific company, including the risk posed by the company and the extent to which the company might benefit from the proposed liquidation. The House bill lists a similar set of factors and requires "that the assessments charged equitably reflect the risk posed to the Fund by particular classes of financial companies." Notwithstanding the importance of such a provision, the CCMR fears that companies may still end up bearing burdens that they should not have to bear.

For example, under the Senate draft and likely the House bill as well, even if only large banks fail, systemically important hedge funds with negligible ties to these institutions will not be entitled to a refund of their assessments but instead must bear...
the costs of resolving these entities. Alternatively, heavily regulated banks could end up paying for the resolution of less regulated, but systemically important, hedge funds. Although analogous problems arise in the context of FDIC insurance, they are much less severe because banks are more evenly regulated than the range of institutions within the scope of the new resolution authority.

As an alternative, legislators should consider having the creditors and counterparties of particular failed institutions fund the cost of resolution. This approach has the advantages of encouraging market discipline and avoiding the cross-subsidization problems discussed in the preceding paragraph. Although some worry that creditors and counterparties of failed institutions may not be able to bear potentially high resolution costs, this concern can be reduced by allowing such costs to be amortized over an appropriate period of time.

**E. The International Dimension**

Finally, there is an important international dimension to resolution, as many of the most important financial institutions operate in multiple jurisdictions. Coordination of outcomes among these jurisdictions has proven difficult and time consuming in the court-based resolution of Lehman. International coordination would probably be easier, albeit still difficult, in an administrative system. In any event, the CCMR report, Treasury proposal, House bill, and Senate draft support increased international coordination for resolving multinational financial institutions.201

**V. EMERGENCY FEDERAL RESERVE LENDING**

The first responder to the financial crisis in the United States was the Federal Reserve.202 As matters worsened during 2007,
the Federal Reserve reduced interest rates generally and reduced the penalty rate for borrowing at the discount window from fifty to twenty-five basis points.

The Federal Reserve also created a number of new liquidity facilities: (1) In December 2007, the term auction facility (TAF) in which the Federal Reserve auctioned off Federal Reserve funds for twenty-eight days; (2) on March 11, 2008, the term securities lending facility (TSLF) under which the Federal Reserve offered to loan primary dealers (dealers qualified to bid on treasury securities including investment banks) Treasury securities for twenty-eight days; (3) on March 16, 2008, concomitantly with the provision of assistance to JPMorgan Chase to acquire Bear Stearns, the extension of the discount window to primary dealers; (4) on September 19, 2008, the asset-backed commercial paper (ABCP) money market fund liquidity facility (AMLF), to allow banks to purchase ABCP, providing assistance to money market funds seeking to sell their ABCP assets to fund accelerated redemptions; (5) on October 7, 2008, the commercial paper funding facility (CPFF) under which the Federal Reserve began to buy corporate commercial paper after the private market had all but seized up; (6) on October 21, 2008, the money market investor funding facility (MMIFF) under which the Federal Reserve provided senior secured financing to a series of special purpose vehicles (SPVs) to finance the purchase of certain assets from money market funds.
Reduction of Systemic Risk in addition to ABCP;\(^209\) (7) on November 25, 2008, the asset-backed securities loan facility (TALF) (which became operational in March 2009) under which the Federal Reserve would lend on a non-recourse basis to investors in highly rated newly issued asset-backed securities;\(^210\) and (8) on November 25, 2008, a program to purchase the direct mortgage-backed obligations (MBS) of government sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.\(^211\)

In addition to these facilities, the Federal Reserve extended aid in connection with the failure of Bear Stearns and AIG. It assisted the JPMorgan Chase (JPM) acquisition of Bear Stearns on March 16, 2008, by providing JPM with a non-recourse loan of $30 billion, subject to absorption by JPM of the first $1 billion of losses.\(^212\) On September 17, 2008, just two days after Lehman Brothers declared bankruptcy, the Federal Reserve loaned $85 billion to AIG through a two-year credit facility. The Federal Reserve’s exposure was subsequently restructured on November 10, 2008, after the Treasury used its TARP fund to purchase $25 billion of the Federal Reserve’s debt, reducing its debt to $60 billion, and then once again on March 2, 2009, when the Federal Reserve’s exposure was reduced to about $33 billion after the Treasury assumed more of the Federal Reserve’s debt.\(^213\) In addition, on November 23, 2008, the Federal Reserve,


\(^{212}\) As of September 2009, the Federal Reserve marked down this loan to $4 billion. Henry Sender, Fed carrying losses from Bear portfolio, FIN. TIMES, Feb. 16, 2010, at 8.

in partnership with the Treasury and FDIC, guaranteed $306 billion of losses on a pool of Citigroup's bad assets, and on January 16, 2009, $118 billion on a pool of Bank of America's bad assets (mostly accumulated in the acquisition of Merrill Lynch).  

These facilities and transactions had a significant impact on the Federal Reserve's balance sheet as set forth below:

Table 1: Federal Reserve Balance Sheet: $2.0 trillion (June 3, 2009) (billions of dollars)  

<table>
<thead>
<tr>
<th>Treasury securities</th>
<th>606,168</th>
<th>29% of total (2006: 91% of $852B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GSE securities</td>
<td>81,971</td>
<td></td>
</tr>
<tr>
<td>MBS securities</td>
<td>427,633</td>
<td>February 2010: $970,327B</td>
</tr>
<tr>
<td>Discount Window</td>
<td>124,239</td>
<td>Including loans to primary dealers</td>
</tr>
<tr>
<td>TAF</td>
<td>372,540</td>
<td></td>
</tr>
<tr>
<td>CPFF</td>
<td>142,635</td>
<td></td>
</tr>
<tr>
<td>Maiden Lanes (Bear/AIG)</td>
<td>72,560</td>
<td></td>
</tr>
<tr>
<td>Central Bank $ Swaps</td>
<td>175,712</td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>85,772</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>2,079,241</td>
<td></td>
</tr>
</tbody>
</table>

Total Federal Reserve assets have more than doubled to over $2 trillion as compared with $852 billion in 2006. Although Treasury securities were over 90% of Federal Reserve assets in 2006, they were only 29% in June 2009, reflecting the extraordinary


nary funding of the financial system. Traditional loans by a lender of last resort are adequately collateralized to prevent moral hazard and to reduce risk to the central bank. However, the adequacy of the collateralization of these positions (the CPFF is entirely unsecured) is unclear due to the lack of transparency on this issue.217 Needless to say, the potential risk to the Federal Reserve from these positions is substantial.218

Given the expansion of the money supply, driven by lending through the new programs, the Federal Reserve took steps to limit the potential inflationary impact by selling Treasury bills to the banking system as a whole to absorb the expanded liquidity. This policy faced increasing resistance because of insufficient Treasury bills held on the Federal Reserve’s books as a percentage of total assets. This issue was addressed in two ways. First, the Treasury, at the Federal Reserve’s request, sold special issues of Treasuries and deposited the proceeds with the Federal Reserve, under the Supplementary Financing Program.219 The issue of these Treasuries drained reserves from the banking system;220 in effect, the Treasury was selling Treasuries not to raise revenue but as part of the conduct of monetary policy. As of June 3, 2009, the Supplementary Financing Account of the Treasury was about $200 billion compared to Treasuries of about $475 billion, indicating that the Treasury had become a significant player in monetary policy.221 In addition, the Federal Reserve began paying interest on bank reserves. It had acquired the power to do so under the Financial Services Regulatory Relief Act of 2006,222 originally to be effective beginning October 1, 2011. The Treasury had traditionally opposed granting this power to the Federal Reserve as its use would decrease the size-

217. In March 2009, the Senate twice voted to require the Federal Reserve to release more details of its lending program, including collateral. Steven Sloan, With Senate Demands, Fed’s Role in Jeopardy, AM. BANKER, Apr. 6, 2009, at 1, 5.


able contributions the remittance of Federal Reserve profits makes to government revenue—about $46.1 billion in 2009. The Emergency Economic Stabilization Act of 2008 had accelerated the effective date to October 1, 2008. Again, however, the Federal Reserve had to seek new authority from Congress to conduct monetary policy, further jeopardizing its independence.

Much of the emergency Federal Reserve lending was based on Section 13(3) of the Federal Reserve Act. This Section allows the Federal Reserve in "unusual and exigent circumstances" to lend to "any individual, partnership or corporation," against "notes" that are "secured to the satisfaction of the Federal Reserve Bank." This provision does not restrict who can borrow or specify particular levels of collateral; instead, judgment of the adequacy of collateral is left entirely to the Federal Reserve. However, former Federal Reserve Chairman Paul Volcker—as well as many members of Congress who are dissatisfied with bailing out the banks—questioned the Federal Reserve's authority to engage in much of the emergency lending. Former Chairman Volcker voiced his concerns to the Eco-

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225. Id. § 129, 122 Stat. at 1396-97.

226. The full section, entitled, "Discounts for Individuals, Partnerships and Corporations," provides:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve Bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are endorsed or otherwise secured to the satisfaction of the Federal Reserve Bank: Provided, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal Reserve Bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

Simply stated, the bright new financial system—for all its talented participants, for all its rich rewards—has failed the test of the market place. To meet the challenge, the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending certain long embedded central banking principles and practices. The extension of lending directly to non-banking financial institutions—while under the authority of nominally "temporary" emergency powers—will surely be interpreted as an implied promise of similar action in times of future turmoil. What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time honored central bank mantra in time of crisis—"lend freely at high rates against good collateral"—to the point of no return.227

Quite apart from the legal issue, the Federal Reserve’s assumption of credit risk by lending against insufficient collateral may compromise its independence by making the Federal Reserve more dependent on the Treasury for support in carrying out its core functions including the conduct of monetary policy (see the example of the Supplemental Finance Facility discussed above), jeopardizing its ability of the Federal Reserve to finance its own operations and thus increasing the need to look for budgetary support from the government, tarnishing its image and financial credibility in the event that the Federal Reserve ends up with minimal or negative capital, and making it more subject to political pressures.

It is because of these concerns that the CCMR recommended that any existing Federal Reserve loans to the private sector that are uncollateralized or insufficiently collateralized should be transferred in an orderly fashion to the balance sheet of the federal government through asset purchases by the Treasury from the Federal Reserve.228


228. COMM. ON CAPITAL MKTS. REGULATION, RECOMMENDATIONS FOR REORGANIZING THE U.S. FINANCIAL REGULATORY STRUCTURE 4 (2009); see also KUTNER, supra note 218, at 12; WILLEM BUTER, CTR. FOR ECON. POL'Y RESEARCH, CAN CENTRAL BANKS GO BROKE? 11 (2008).
rupt because it can always discharge its liabilities by creating money; however, any losses of the Federal Reserve are ultimately losses for United States taxpayers. The Federal Reserve regularly remits billions in profits to the Treasury, and without this revenue, taxpayers would have to make further contributions to the general revenue if spending cuts were not forthcoming.

With respect to requiring collateral for emergency loans, the House bill would amend Section 13(3) to prevent the Federal Reserve from extending credit based on low-quality assets. Similarly, the Senate draft requires the Federal Reserve, in consultation with the Secretary of the Treasury, to establish policies to ensure that “the collateral for emergency loans is of sufficient quality to protect taxpayers from loss.” The CCMR agrees with Senator Dodd that taxpayers should be protected from loss by requiring the Federal Reserve to make adequately collateralized loans. Indeed, the Senate draft could be improved through the addition of even stronger language requiring Section 13(3) loans to be fully collateralized. However, the focus in both the House bill and Senate draft on the “quality” of collateral received is misplaced. For example, a junk bond with a par value of one hundred might be adequate collateral if only valued at twenty for such purpose.

The Treasury, House, and Senate approaches would also place substantial procedural hurdles in the way of the Federal Reserve’s exercise of its lender-of-last-resort functions. The Treasury White Paper recommends legislation to amend Section 13(3) of the Federal Reserve Act to require the written ap-

(A) [Assets] that would be classified as "substandard," "doubtful," or "loss," or treated as "special mention" or "other transfer risk problems," in a [bank examination or in an internal classification system]. (B) An asset in a nonaccrual status. (C) An asset on which principal or interest payments are more than 30 days past due. (D) An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor unless such asset has been performing for at least 6 months since the renegotiation.
Id.
231. Senate Proposal, supra note 3, § 1151(6).
proval of the Secretary of the Treasury for any extension of credit under that Section.\textsuperscript{232} The House bill would amend Section 13(3) so that extensions of credit would require a two-thirds vote of the Financial Stability Oversight Council, written consent of the Secretary of the Treasury, and certification by the President that an emergency exists.\textsuperscript{233} In addition, the House bill would prohibit the Federal Reserve from authorizing, and the Secretary of the Treasury from approving, any Section 13(3) extension of credit without the belief that there is a “99 percent likelihood that all funds disbursed or put at risk,” together with “all interest due on any funds,” will be repaid to the Federal Reserve System.\textsuperscript{234} The Senate draft would require the Federal Reserve to obtain the approval of the Secretary of the Treasury before establishing new liquidity facilities.\textsuperscript{235} To the extent that the Federal Reserve is loaning against adequate high quality collateral, these procedural safeguards are overkill and unnecessarily limit the independence and flexibility of the Fed to respond to crisis.

Finally, the House bill and Senate draft appropriately seek to prevent the Fed from making bailout loans to single institutions. Under the House bill, the Federal Reserve would only be able to extend credit under Section 13(3) as “part of a broadly available credit or other facility and may not authorize a Federal Reserve bank to discount notes, drafts, or bills of exchange for only a single and specific individual, partnership, or corporation.”\textsuperscript{236} The Senate draft would amend Section 13(3) such that extensions of credit thereunder would be available to “financial market utilit\[ies\] that the Financial Stability Oversight Council determines [are], or [are] likely to become, systemically important, or any program or facility with broad-based eligibility.”\textsuperscript{237} The Senate draft would also require the Federal Reserve, in consultation with the Secretary of the Treasury, to implement policies to ensure that emergency lending authority is

\begin{itemize}
\item \textsuperscript{232} \textit{TREASURY WHITE PAPER, supra note 2, at 16.}
\item \textsuperscript{233} H.R. 4173 § 1701 (amending the Federal Reserve Act by inserting § 13(c)(1)).
\item \textsuperscript{234} Id. (amending the Federal Reserve Act by inserting § 13(c)(2)(A)-(B)).
\item \textsuperscript{235} SENATE PROPOSAL, supra note 3, § 1151(6).
\item \textsuperscript{236} H.R. 4173 § 1701 (amending the Federal Reserve Act by inserting § 13(c)(4)).
\item \textsuperscript{237} SENATE PROPOSAL, supra note 3, § 1151(2)-(5).
\end{itemize}
used "for the purpose of providing liquidity to the financial system, and not to aid a failing financial company." 238

In short, the Federal Reserve needs authority to lend in a crisis to avoid systemic risk arising through the chain reaction of financial institution failures that could result in a complete economic collapse. On the other hand, the Federal Reserve’s own credibility and independence should not be jeopardized. These objectives can be achieved by giving the Federal Reserve full authority to lend against good collateral—a traditional power of a central bank—while requiring the government to give support where there is a bailout or good collateral is not available.

VI. REGULATORY REORGANIZATION

There are two key questions with respect to regulatory reorganization that affect systemic risk: who should be responsible for systemic risk regulation, and who should supervise various financial institutions?

A. Regulation of Systemic Risk

Under the Treasury proposal, the Federal Reserve would generally keep all of its current regulatory powers and would be granted additional authority to regulate all systemically important payment, clearing, and settlement systems and activities. 239 Additionally, Federal Reserve Discount Window access for payment, clearing, and settlements systems would exist for emergency purposes, with systemically important systems "expected to meet applicable standards for liquidity risk management." 240

The House bill and Senate draft follow a similar approach, generally preserving the Fed’s existing regulatory powers and increasing some as well. Under the House bill, the Federal Reserve, acting on behalf of the Financial Services Oversight Council, is authorized to impose stricter prudential standards on any firm if the Council deems it necessary after considering certain criteria. 241 Such additional standards include stress testing. 242

238. Id. § 1151(6).
239. TREASURY WHITE PAPER, supra note 2, at 51-52.
240. Id. at 54.
241. H.R. 4173 § 1104(b)(1).
242. Id. § 1104(g)(1).
imposing and defining higher capital standards, dismissing executive officers and board members, and restricting compensation. Likewise, the Financial Stability Oversight Council established in the Senate draft could require the Federal Reserve to impose stricter prudential standards on non-bank financial firms the Oversight Council deems systemically significant. Stricter prudential standards contemplated by the Senate draft include more rigorous capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, and concentration limits, as well as contingent capital requirements, enhanced public disclosure, and overall risk management requirements.

Nonetheless, there are differences between the Oversight Councils called for in the House bill and Senate draft. One concern is that the Financial Stability Oversight Council created by the Senate draft would give too little authority to bank regulators. First, although a simple majority is the default rule for decisions made by the Council, some decisions require a two-thirds majority. For example, two-thirds of the Council is needed to determine that a liquidity event exists such that the FDIC would be permitted to create a "widely available program to guarantee obligations of solvent [banks and bank holding companies] during times of severe economic distress." In addition, when the Federal Reserve determines that a bank holding company with $50 billion or more in assets poses a "grave threat to the financial stability of the United States," a two-thirds majority of the Council is required to approve a Federal Reserve decision to require that bank holding company to terminate certain activities or sell assets or off-balance-sheet items. These decisions should be left to bank regulators alone. Moreover, unlike the House bill, the Senate draft would not include the head of the National Credit Union Administration on the Oversight Council, but it

244. Id. § 1104(e)(7)(B)(v)(II).
245. Id. § 1104(e)(7)(D).
246. SENATE PROPOSAL, supra note 3, § 113.
247. Id. § 115(b)(1).
248. Id. § 111(f).
249. Id. §§ 1154(b), 1155(a).
250. Id. § 121(a).
would include an independent member with insurance expertise. Given the two-thirds majority voting requirements and composition of the Council’s membership—four of the nine members of the Council would be the Chairman of the Bureau of Consumer Financial Protection, the Chairman of the Securities and Exchange Commission, the Chairperson of the Commodity Futures Trading Commission, and the independent member with insurance expertise—non-bank regulators could prevent the Council from acting properly on issues that pertain mainly to banks.

Because the CCMR believes the Federal Reserve should have an enhanced role in regulating systemic risk generally, it has proposed that the Federal Reserve have exclusive control over capital requirements for all financial institutions and margin requirements for clearing. This proposal differs from the Administration’s, which would leave capital requirements to the multiple bank regulators and envisions the Federal Reserve as only having overlapping authority with the SEC and CFTC over clearing arrangements. Similarly, a range of “prudential regulators,” in the case of the House bill, and “primary financial regulatory agencies,” in the case of the Senate draft, are directed to set capital requirements for banks, with the CFTC and SEC doing so for non-banks. In both approaches to regulatory structure, regulatory power remains dispersed and fragmented. To its credit, however, the Senate draft would give

251. Id. § 111(b)(1).
252. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 204.
253. See TREASURY WHITE PAPER, supra note 2, at 4.
254. H.R. 4173, 111th Cong. § 3107 (2009) (amending the Commodity Exchange Act by inserting § 4s(d)), § 3204 (amending the Securities Exchange Act inserting § 15F(d)); SENATE PROPOSAL, supra note 3, § 717 (amending the Commodity Exchange Act by inserting § 4s(e)(1)).
255. The Treasury, House, and Senate approaches all advocate the creation of a Consumer Financial Protection Agency (CFPA) with broad and sweeping powers to regulate and enforce substantive standards for financial activities involving consumer financial products or services. H.R. 4173 § 4201; SENATE PROPOSAL, supra note 3, § 1021; TREASURY WHITE PAPER, supra note 2, at 57–58. The Treasury proposal places a greater emphasis on control by a Board of Directors, whereas the House bill and Senate draft concentrate greater authority in the agency’s director. H.R. 4173, §§ 4201–4202; SENATE PROPOSAL, supra note 3, § 1011(b); TREASURY WHITE PAPER, supra note 2, at 58. The House bill also exempts small financial institutions (insured depository institutions with total assets of $10 billion or less and all insured credit unions with total assets of $1.5 billion or less) from CFPA examination and enforcement. H.R. 4173 § 4203(a)(1)(B). The Senate draft, instead, vests the CFPA with the authority to exempt
the Federal Reserve the authority to set margin and collateral requirements, as well as capital requirements, for financial market utilities, such as clearinghouses, that are designated systemically important by the Financial Stability Oversight Council.256

The CCMR did not recommend, as the Treasury does, the creation of a systemic risk council (the Financial Services Oversight Council, in the House bill, or the Financial Stability Oversight Council, in the Senate draft) to monitor systemic risk,257 but it is unlikely that the CCMR would oppose this idea, as long as the Council had no operational role. Here the CCMR would agree with the Treasury (and Ben Bernanke, the Chairman of the Federal Reserve),258 but not Sheila Bair, the Chairman of the FDIC, who favors the Council.259 The CCMR would also probably not object to the approaches in the House bill and Senate draft, which would also create Oversight Councils that do not have responsibility for day-to-day management of the financial system.

Generally, regulatory agencies, trade groups other than those representing the largest banks (like the American Bankers Association or Community Bankers Associations), and many in Congress have opposed this systemic risk role for the Federal Reserve. Regulators do not want to lose jurisdiction.260 Many

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256. SENATE PROPOSAL, supra note 3, § 1022(b)(3).
257. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 20.
banks prefer their own choice of regulator (currently they can choose to be regulated at the federal level by the Federal Reserve, the Office of the Comptroller of the Currency (OCC), or the FDIC), and Congress is responding to its political advantage by criticizing the Federal Reserve as the agency that gave money to the “bad” banks.

B. Supervisory Authority

The House bill basically leaves the fragmented regulatory structure entirely in place. Fragmentation hinders the ability to prevent systemic risk by permitting matters to fall through the cracks and allowing regulatory arbitrage (institutions changing their legal form to choose their preferred regulators). On the other hand, the House bill preserves the Federal Reserve’s current supervisory authority over bank holding companies and substantially expands its authority by giving the Federal Reserve supervisory authority over so-called Tier I financial services holding companies, financial firms that are systemically important. This proposal was in line with the Treasury’s proposals and an option that the CCMR thought should be considered.

The initial Senate draft released by Senator Dodd in November took a very different approach, creating a new Financial Institutions Regulatory Administration (FIRA) as an independent consolidated banking supervisor. This agency would have taken over the powers of the Federal Reserve with respect to the supervision of bank holding companies and member banks, the OCC with respect to national banks, the Office of Thrift Su-


263. There is one minor consolidation. Under the House bill all Office of Thrift Supervision powers will be transferred to either the OCC or the FDIC after first consul-

264. TREASURY WHITE PAPER, supra note 2, at 22.

265. CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 203-05.
pervision (OTS) with respect to federal thrifts, and the FDIC with respect to nonmember banks.\textsuperscript{266} FIRA would have been the supervisor of any branch, agency, representative office, or commercial lending company of a foreign bank. The Federal Reserve was to be left with monetary policy and the role of lender of last resort, while the FDIC was to be left with the deposit insurance fund.\textsuperscript{267} This approach had the virtue of addressing fragmentation in a significant way. The more recently released Senate draft authored by Senator Dodd represents a step backward, however. The new draft would essentially reallocate banking supervision among the existing hodgepodge of bank regulators.\textsuperscript{268}

In terms of the Federal Reserve's supervisory authority, the current Senate draft would give the Federal Reserve supervisory authority over banks with more than $50 billion in assets.\textsuperscript{269} Because it is implausible to suppose that all such banks are systemically significant, this approach has the advantage of avoiding the implication that all firms supervised by the Federal Reserve can rely on bailouts.\textsuperscript{270} On the other hand, the current Senate draft also gives the Federal Reserve supervisory authority over any firm that the Financial Services Oversight Council, by a two-thirds vote, deems systemically important.\textsuperscript{271} This approach would create an unfair funding advantage for some firms. For instance, a hedge fund regulated by the Federal Reserve (and thus more likely to be bailed out) will likely be able to borrow more cheaply than an unregulated hedge fund.

The CCMR has proposed that a new U.S. Financial Services Authority (USFSA), modeled on the U.K.'s Financial Services Authority (FSA), be created to regulate in areas not considered to be systemically important. The CCMR also thought that it was a serious option to charge the USFSA with the supervision of all financial institutions (as compared to the option of letting the Federal Reserve supervise systemically important ones).\textsuperscript{272} The consolidated option is better because it avoids the thorny

\textsuperscript{266} STAFF OF S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, 111TH CONG., RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2009 §§ 311, 322, 331 (2009).
\textsuperscript{267} Id. § 322.
\textsuperscript{268} SENATE PROPOSAL, supra note 3, § 312.
\textsuperscript{269} Id. § 312(b)(1)(A).
\textsuperscript{270} One drawback of this approach, however, is that it could encourage banks to manage their asset levels just below the $50 billion threshold.
\textsuperscript{271}SENATE PROPOSAL, supra note 3, § 113(a)(1).
\textsuperscript{272} See CCMR PLAN FOR REGULATORY REFORM, supra note 1, at 203–05.
problem of identifying, initially and over time, systemically important institutions. As suggested in the previous paragraph, it also avoids the moral hazard problems and unfair cost-of-funds advantages that exist when certain firms are branded "systemically important." Of course, this problem would be much less significant if investors and counterparties to systemically important failing and failed institutions experienced the same losses as those with relationships with less important institutions, a recommendation discussed above.\footnote{273} This USFSA supervisory proposal has the additional advantage of keeping the Federal Reserve focused on monetary policy and regulation of systemic risk. While the Federal Reserve and the Treasury have argued for a supervisory role on the grounds that they need to supervise institutions to which they may have to lend,\footnote{274} this goal could be accomplished by giving the Federal Reserve the right to obtain all supervisory information obtained by the USFSA and the power to design examinations of large institutions to the required extent for improvements.

C. International Developments

One must note, however, that two major markets are moving in the opposite direction. The new Merkel coalition government in Germany has indicated that it will transfer the bank supervisory powers of BaFin to the Bundesbank,\footnote{275} and a similar plan has been put forward for dismantling the supervisory power of the U.K. FSA by the opposition party, the Tories, who currently hold a substantial lead over Labour in the polls.\footnote{276} Both of these recommendations seem largely motivated by the advantages politicians can acquire by blaming those in charge during the crisis for the supervisory failures.\footnote{273. See supra Part IV.} This blame shifting has a particularly ironic twist in the United Kingdom be-

\footnote{275. Beate Preuschoff & Andrea Thomas, Bigger Role Eyed for Bundesbank, WALL ST. J., Oct. 9, 2009, at A26.}
\footnote{276. Alistair MacDonald & Laurence Norman, Tory Plan Would Nix U.K. Market Regulator, WALL ST. J., July 20, 2009, at C4. The next election must be held on or before June 3, 2010. Id.}
cause the FSA itself was born out of the supervisory failures of the Bank of England, Barings, and BCCI, as well as the election of the new Labour Blair government in 1997. These developments do not have any bearing on the desirability of creating a United States FSA.

CONCLUSION

Many seem to believe regulatory reform has been stalled because of the stabilization of the financial system and what appears to be the beginning of an economic recovery. I think they are right, but I do not think this stalling is necessarily a bad thing.

All of the possible reforms can do little to deal with the crisis or insure a faster economic recovery; they are forward-looking. One can argue that the salience of future reform will diminish as we distance ourselves from the crisis, but I doubt it. The economic crisis severely affected the American people with unforgettable consequences. The Administration and Congress will be at political risk unless they can convincingly claim that they have taken measures to avoid or at least greatly decrease the chances of repeating such crises.

Nonetheless, at the moment, there is an increased risk of inaction. The bipartisan approach reflected in the negotiations between Senators Dodd and Shelby fell apart. On March 22, the Senate Banking Committee voted along party lines to approve Senator Dodd’s “Manager’s Amendment” and reported the Dodd draft to the Senate floor. The politicization of the process may result in no legislation at all. Such an outcome would be very undesirable. The financial system needs new rules and we need to avoid the continued uncertainty produced by needless delays and squabbles.

Unfortunately the main point of contention between the two political parties is the creation of a new consumer regulator. While important, consumer protection was not the central issue of the financial crisis—systemic risk was. We should not allow disagreement on consumer protection to block reforms needed to decrease systemic risk. In any event, a reasonable resolution

of the consumer protection issue should be found. The second major dividing point is the possibility of future bailouts. Many Senators (including some Democrats) want to say that we will never again need to "bail out" financial institutions. But this position is irresponsible as long as interconnectedness can lead to a chain reaction of financial institution failures. Using the congressional jargon, we must be able to put "foam on the runway." The Dodd draft and House bill provide for this protection, as they must. What we need to do is to minimize the need for foam through better regulation and insist that losses be fully imposed on holders of equity and unsecured debt, as well as counterparties, before public funds are used. The counterparties are the crux of the interconnectedness problem, and while counterparties are connected, many have controlled exposures and collateral sufficient to avoid chain reaction effects. We should do everything we can to increase the use of these safeguards.
THE SCANDAL BENEATH THE FINANCIAL CRISIS:
GETTING A VIEW FROM A MORAL-CULTURAL
MENTAL MODEL

KEVIN T. JACKSON*

“We have met the enemy, and he is us.”

—Walt Kelly

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INTRODUCTION

When diagnosing the financial crisis one should take care in framing the terms of discourse. Ever since the signs of economic collapse began appearing, it has been commonplace for pundits as well as the general public to call the fiscal meltdown a "crisis," a term that conveniently carries no ascription of moral disapprobation. Yet after one has reckoned the extensive list of both personal and corporate malfeasances that have played a significant role in precipitating the financial turmoil and paid heed to the underlying moral-cultural factors accompanying the wrongdoing, a more apt description would be "scandal," a term that implies some degree of moral-cultural failure.

This is not idle quibbling over terminology. Most people would agree that it is of critical importance whether an economic downturn is branded a "recession" or a "depression." There are significant political consequences of using one term or the other. Similarly, it matters whether we characterize the global financial imbroglio in amoral (scientific) or moral (human-oriented) terms. It matters whether we approach the crisis with the attitude that we can understand it simply by looking at economists' equations and statistical analyses, annexed to business managers' technocratic jargon, or, instead, we decide that by looking beyond these mental models to the broader realm of moral and intellectual culture we can achieve a more satisfactory understanding.

Looking at the financial scandal from a moral-cultural frame of reference reveals a moral-cultural malaise, and it matters how we respond to this condition.¹ Do we acquiesce to legisla-
tors' attempts to promulgate new laws and regulations? This response is common, but it ultimately cedes responsibility for solving the dysfunctions behind the crisis to legal authorities. This Article argues that this approach is inadequate. We would do better to act as if the crumbling of the current economic edifice is a massive chastening, with a call for deepened moral reflection and reform. We ultimately have no one but ourselves to blame for this economic collapse, and there is no one else to whom we can look to chart a new course to prosperity.

The use of the amoral word "crisis" to characterize the meltdown likely flows from an ingrained habit of viewing the world of business in general, and financial markets in particular, as if they operated according to the same kind of mechanistic, determined, and repeatable behavior, like the chemical reactions that scientists study in the laboratory. Those disposed to explain market phenomena with a positivist mindset, who see the business of business as business, in some cases reduce both the symptoms of and the cure for today's credit malaise to mathematical equations.

Sometimes they diagnose the problem in squarely scientific, even medical terms, as evidenced by appear absurd. There is no conclusive argument to support the basic contention that a broader mindset offers greater insight into both understanding the phenomenon and developing practical responses that are likely to enhance business success in the broad sense. It is likely that other attempts at analyzing, and proposing solutions to, the financial crisis are even less satisfactory.

2. Although written in the midst of the rise of totalitarian regimes posing a threat to free institutions, the following words sound equally germane to the present global financial crisis: "We are ready to accept almost any explanation of the present crisis of our civilization except one: that the present state of the world may be the result of genuine error on our own part and that the pursuit of some of our most cherished ideals has apparently produced results utterly different from those which we expected." F.A. HAYEK, THE ROAD TO SERFDOM: TEXTS AND DOCUMENTS, 65-66 (Bruce Caldwell ed., Univ. of Chi. Press 2007) (1944).

3. Dependence modeling with the use of copula functions is commonly used in financial risk assessment and actuarial analysis—for instance, in the pricing of collateralized debt obligations (CDOs). A methodology of applying the Gaussian copula to credit derivatives, as formulated by David X. Li, has been cited among factors contributing to the financial crisis. See Felix Salmon, A Formula for Disaster, WIRED, Mar. 2009, at 74, 74–75.

4. For instance, consider the term "global contagion." In the context of economic analysis, the word "contagion" expresses the effect of financial calamities spreading from one institution to another. For example, a run on a bank can expand from a few banks to many others. Similarly, a financial crisis can spread from one country to another, as in the case of currency crises, sovereign defaults, or stock market crashes advancing across borders. Another example of medical jargon is "transfusion." In an online commentary, Boston University's School of Manage-
the quick $700 billion and $2.3 trillion prescriptions of government leaders in the United States and Europe respectively. In line with such viewpoints, we have heard many talk of how the economic meltdown was precipitated by a falling real estate market, the product of recurring bubbles that appear every ten or twenty years. According to this account, fundamental dynamics in housing and property markets lead to speculative bubbles that inevitably bring financial systems down with them—no matter what kinds of systems they are—because financial systems are heavily involved in mortgage lending. Even those systems that do not have substantial securitization and are not dominated by private banks are susceptible to those trends. But using the reductive mathematical and scientific explanations of some economists and business theorists to account for the present financial crisis may turn out to be as serious a delusion as the false belief peddled by the current administration that government bailouts, coupled with the geyser of regulations that has been gushing from congressional committees, can fix it.

This Article argues that, although it is necessary to ground any meaningful discussion of the financial crisis in the received views of economists, business managers, and legal experts, gaining a deeper understanding of the current financial predicament requires that one advance beyond the mental models upon which such viewpoints are based and adopt the perspective of a moral-cultural mental model (MCMM) as well. Indeed, such a vantage point is essential for discerning the lessons for enlightened business leadership going forward. From an MCMM point of view, several causes of the present economic crisis, particu-

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larly financial innovation and complexity, excessive executive compensation, and neglect of moral hazard, are seen to be rooted in deep-seated moral-cultural tendencies. Most notable among these are technocratic and dehumanized economic thinking, egoistic individualism, greed, short-termism, rejection of objective moral values, and a highly speculative culture.

These underlying moral-cultural trends cannot be resisted or reversed simply by increased law and regulation. Instead, they must be addressed by more nuanced ethical thinking and collective activity grounded in virtue, regard for the common good, and respect for the long-term preservation of market ecology, as well as by paying greater attention to the cultivation of intangible capital assets such as reputational and social capital. Our thinking needs to be more sensitive to the complexity of the relationship between ethics and economics and more attuned to the importance of trust, truth, and transparency. We must also establish localized and spontaneous social structures that are better equipped to foster such elements in business conduct than stepped-up regulation ever could.

Part I presents a brief account of the emergence of the financial crisis, drawing upon the received views of leading economists, businesspersons, and legal experts. Part II first offers a critical exegesis of the three chief conceptual models that have framed these received reactions to the calamity: the paradigms of economics, business management, and legal regulation. Second, it argues that in light of the limitations of these three mental models, an alternative moral mental model is of particular importance. Third, it distinguishes a natural law oriented moral framework, based on virtue, dignity, and the common good, from mainstream “business ethics” frameworks. Current business ethics models are deficient for these reasons. First, they tend to be based on the idea that if it is not illegal, it is acceptable. Second, they fail to seriously engage moral right and wrong because of their immersion in moral relativism. Third, they are dominated by window dressing, political-correctness, and anti-business agendas. Part III identifies the existence of a moral-cultural malaise lurking beneath the financial crisis. This general condition is characterized by a postmodern moral relativism and rejection of traditional values (both economic and moral), a rise in speculative culture, and egoistic individualism. Moral reform focused on virtue, dignity, and the common good, rather than legal regulation, is the appropriate response to these factors. Part IV introduces the concept of
"market ecology," and relates it to the idea of the common good. I highlight a number of key moral malfeasances connected to the financial crisis to illustrate the harm such practices inflict on the ecology of the market so conceived. This Article concludes that, instead of looking only to the adoption of new legal regulations, visionary corporate governance ought to take greater cognizance of cultivating virtuous, dignity-respecting behavior directed at the common good, which will create favorable background moral conditions for sustaining the ecology of the market.

I. RECEIVED VIEW OF THE FINANCIAL CRISIS

Looking at the economic crisis prompts some important questions: What happened? Why did it happen? What sorts of regulatory responses are called for? This Part will provide a brief sketch of widely recognized responses to these questions and will proceed in the terms of the conventional discourse of economists and legal experts.

We live in a world of mental models. To oversimplify for the sake of illustration, we could say that the mental model of the economist inclines him to look for mathematical formulas. Similarly, the mental model of the business management theorist leads him to seek causal scientific explanations. The mental model of the legal expert inclines him to suggest new laws and policies to "fix" the problem at hand. We have heard a lot of discussion about the financial crisis from each of these respective models. This Part will briefly summarize the distinctive ways in which these mental models have framed the financial crisis.


9. Of course, many other mental models exist and represent important perspectives from which to address the financial crisis. For instance, the mental model of the politician looks for the most expeditious way of getting through public matters. Consider the account of Federal Reserve Chairman Ben Bernanke (both an economist and a politician) in February, 2008: "I expect there will be some failures," but "[a]mong the largest banks, ratios are solid." Fed Chairman: Some Small US Banks May Go Under, CNBC, Feb. 28, 2008, http://www.cnbc.com/id/23390252/. Seven months later, in a dramatic meeting in September, 2008, Bernanke, along with Treasury Secretary Henry Paulson, met with key legislators. In Bernanke’s alarming words, "[i]f we don’t do this, we may not have an economy on Monday." Joe Nocera, 36 Hours of Alarm and Action as Crisis Spiraled, N.Y. TIMES, Oct. 2, 2008, at A1. The purpose of this depiction was political expediency—to pressure Congress into approving a $700
A. What Happened and Why?

Leading economists and business writers have asserted that the recent financial meltdown represents the most severe economic downturn since the Great Depression. The crisis has had global consequences: collapses of major businesses, sizeable reductions in personal wealth, extensive financial commitments taken on by governments, and a substantial downturn in economic activity. Economists and business experts have offered an array of explanations concerning the origins of the crisis.

For many economists, the proximate trigger of the financial turmoil was when the United States housing bubble popped after reaching its apex in 2005 and 2006. Soon after the bubble burst, the default rates on subprime and adjustable rate mortgages began to mount. Enlargements of loan incentives, particularly favorable initial terms, and a long history of rising housing prices had prompted borrowers to take on burdensome mortgages in the hope that they could readily refinance at more affordable rates. Yet when interest rates started rising and housing prices began dropping across the United States during 2006 and 2007, refinancing proved harder. Defaults, followed by foreclosure actions, increased appreciably as comfortable initial terms ended, house billion emergency bailout. The rhetoric worked. Within a month, on October 3, 2008, the Emergency Economic Stabilization Act created the Troubled Asset Relief Program (TARP). Pub. L. No. 110-343, 122 Stat. 3765 (2008).

The fatal limitation of the politician’s mental model is that it is ill-equipped to capture any sense of the common good. Narrow special interests are stronger and more vocal, and there is a paralyzing lack of consensus regarding national priorities. Politicians normally operate on a confrontational basis, as reflected in the opposition of labor versus management, business versus government, and environmentalism versus economic growth. Political rhetoric is characteristically framed in terms of “battles” and “wins or loses,” as if a win for one group is always a loss for another. Special interest groups, such as the American Medical Association, the National Rifle Association, the National Education Association, feminists, pro-choice groups, and pro-life groups, gather to push for their narrow objectives. The problem, then, in the context of the financial crisis, is that the discourse of contemporary politicians based on expediency and confrontation tends to foster poor communication, distrust, and cynicism at a time when listening, cooperation, and compromise would be more conducive to moral leadership.

values did not increase as expected, and rates on adjustable rate mortgages were recalibrated at higher rates.\footnote{11}

Before the crisis, substantial sums of money had been pouring into the United States from rapidly growing foreign economies. The heavy influx of funds, coupled with low rates of interest in the United States from 2002 to 2004, tended to ease credit conditions. The easing of credit, in turn, led to the inflation of housing bubbles and credit bubbles alike. Because of the ease with which a variety of loans could be obtained, especially those for automobiles, mortgages, and credit cards, consumers built up an unparalleled debt burden.\footnote{12} The magnitude of mortgage-backed securities, which acquire their value from mortgage payments and home prices, also intensified. These forms of financial innovation permitted investors and institutions across the globe to invest in the United States housing market. When housing prices fell, large global financial institutions that had borrowed and invested heavily in subprime mortgage-backed securities started reporting major losses.\footnote{13} In addition, declining prices caused houses to become valued below the amount of their mortgage loans. Owners then had a financial incentive to abandon the houses, leading to foreclosures. The rash of foreclosures that began in the United States at the end of 2006 depleted consumer wealth and abraded the power of financial institutions. In addition, defaults and losses on other types of loans escalated as the upheaval spread from the housing market to other sectors of the economy.\footnote{14}

As the credit and housing bubbles grew, a dynamic took hold whereby the financial system was expanding while simultaneously becoming more and more fragile. In the main, policymakers did not perceive the significant role of the financial institutions that made up the so-called shadow banking system, especially hedge funds and investment banks.\footnote{15} In the eyes of some experts, such institutions became as significant as retail depository banks

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\begin{enumerate}
\item See Kevin G. Hall, Not another real-estate crisis: Commercial mortgages next?, \textsc{McClatchy}, Apr. 30, 2009.
\item The intersection of Main and Wall, \textsc{Globe & Mail} (Canada), Oct. 1, 2008, at A20.
\item See Nick Onnenbo, U.S. financial system: Can it collapse?, \textsc{Telegram & Gazette} (Mass.), June 13, 2008, at 8.
\end{enumerate}
in supplying credit for the United States economy. Not only were such institutions exempt from the regulations that applied to depository banks, but, together with some regulated banks, they had taken on substantial debt loads while making loans. Yet they lacked financial cushions adequate to withstand large loan defaults or mortgage-backed securities losses. Such losses dampened the capacity of financial bodies to extend loans, which consequently tended to slow economic activity. Doubts surrounding the solidity of key financial organizations led central banks to extend funds to stimulate lending and shore up confidence in commercial paper markets, which are vital to supporting business operations. The government has intervened to bail out major financial establishments and has rolled out economic stimulus initiatives, taking on enormous financial obligations ranging from asset purchases, guarantees, and loans, to direct spending.

B. What Regulatory Responses Are Called For?

Beyond the government bailouts, and in line with the picture of the crisis presented by leading economists, influential legal experts have proposed a wide array of market-based and regulatory solutions, a number of which have either been put into action or are still being contemplated. What follows is a short, non-exhaustive summary of the regulatory proposals.

Generally, the regulatory proposals have been aimed at reducing the impact of the current crisis and preventing recurrences. The proposals have targeted a host of issues, including executive pay, financial cushions, consumer protection, the regulation of derivatives and the so-called shadow banking system, and the power of the Federal Reserve to wind-down systemically significant financial institutions. In particular, some of the more prominent regulatory proposals have included allowing debt-for-equity swaps to reduce mortgage balances for struggling homeowners, requiring minimum down payments together with income verifi-

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17. Alan Greenspan, We need a better cushion against risk, FIN. TIMES, Mar. 27, 2009, at 11.
cation to inhibit the proliferation of "liar loans," nationalizing major banks, establishing rules to insulate investors and financial institutions from systemic risk, imposing constraints on executive compensation so as to reward long-term performance rather than excessive risk-taking, regulating institutions that "act like banks" in ways similar to how banks are regulated, breaking up financial institutions that are "too big to fail" to mitigate systemic risk, returning to the separation of retail depository banking and investment banking established by the Glass-Steagall Act of 1933, establishing resolution or wind-down procedures to sort out liabilities of failed investment banks and hedge funds, requiring banks to maintain a stronger capital cushion with graduated regulatory capital requirements, and requiring that standardized derivative contracts be traded on regulated exchanges.

C. Taking Another Perspective, and Posing a Further Question

A vital question remains. It is a question that economists, management theorists, and legal experts are not well suited to tackle. This intractable question is: What are the implications of the crisis for business leadership? For reasons laid out in the next Part, addressing this question requires us to probe deeper than the received views of economists and legal authorities by

21. Peter S. Goodman, Taking the pulse of an America that has always Felt Lucky: Populist anger amid crisis may sharpen appetite for more regulatory oversight, INT’L HERALD TRIB., Sept. 21, 2009, at 18.
24. Richard Northedge, Make banking boring to avoid boom and bust, INDEP. ON SUNDAY (London), Mar. 15, 2009, at 82; see also, KRUGMAN, supra note 15, at 163.
25. Irwin Stelzer, If a bank is too big to fail, it must be broken up: None of the planned banking reforms protects the financial system, DAILY TELEGRAPH (London), July 29, 2009, at 19.
28. Boyd Erman, Europe, U.S. at odds over bank capital ratios; Split emerges over how much more is needed; European banks could be less competitive, GLOBE & MAIL (Canada), Sept. 24, 2009, at B4.
adopting the MCMM. First, however, this Article provides a
critical exegesis of prevailing mental models of economists,
management theorists, and legal experts.30

II. CRITICAL EXEGESIS OF MENTAL MODELS

Mental models provide the conceptual lenses through which
we see the world.31 Accordingly, depending on how they are
put to use, such lenses serve either to clarify or to distort our
view. The mental models of economics, business management,
and law have equipped us with knowledge to comprehend and
to manage, albeit in an imperfect and limited way, complex
financial systems and institutions. But are they adequate? Have
they warped our vision in some important way?

A. Mental Model of the Economist

Although economists have the most to say about the causes
of the financial crisis, they have been squarely faulted for the
inability of their econometric models to predict the crisis.32 The

30. Of course, not all economists, management theorists, and legal experts oper-
ate with the mental models herein diagnosed.

31. See THOMAS S. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS 175 (2d ed.
1970). Professor Kuhn uses the term “paradigm” to explain how fields of knowledge
are based upon shared systems of belief that are defined by a common vocabulary
and a set of accepted problems and agreed-upon solutions. Thus, on the one hand, a
paradigm defines a community of belief; on the other hand, communities of belief
do not exist but for the shared beliefs, acknowledged problems, and recognized
solutions that constitute a paradigm. Although Professor Kuhn’s book was aimed at
the history of changes in the physical or “hard” sciences, John Kenneth Galbraith
articulated a similar idea that is closer to the context of the present discussion: “The
first requirement for an understanding of contemporary economic and social life is a
clear view of the relation between events and the ideas which interpret them.” JOHN

32. Interestingly, Wilhelm Röpke makes a similar observation: “A few months
before the beginning of the greatest economic crisis in history, in the spring of
1929, the most distinguished American economists were talking about the happily
secure equilibrium of an economy running in top gear.” WILHELM RÖPKE, A HU-
MANE ECONOMY 250–51 (1960). One magazine article stated that economist
Nouriel Roubini had presaged the economic downturn as far back as September
of 2006, but added that the field of economics is not well equipped to foretell a
recession. Stephen Mihm, Dr. Doom, N.Y. TIMES, Aug. 17, 2008 (Magazine), at 26;
see also, Emma Brockes, He Told Us So, GUARDIAN (London), Jan. 24, 2009, at 24.
For other accounts of experts providing signals of an impending crisis, see Reces-
sion in America, ECONOMIST, Nov. 17, 2007, at 385, and Kabir Chibber, Goldman Sees
economics profession has also been criticized on the ground that the financial modeling it has used since the mid-1990s may have led a substantial number of banks and financial institutions to commit improprieties.  

Whatever the merits of such accusations, the key explanatory limitation of the economist's mental model is this: Economics is becoming so excessively mathematical that its human element is being eclipsed. Yet the human dimension is precisely where we must look to achieve moral and cultural reform. In the wake of the financial crisis, the mental model of the economist, when directed toward the world of business, is deficient to the extent that it overlooks the fundamental complexity of human nature that is at the core of economics and business, properly understood.

In a trend that originated during the time of John Maynard Keynes, ordinary economic theorizing has gradually become oriented towards mathematics and quantification. The evidence supporting this claim is readily available from a random walk through the stacks of any library to inspect leading journals of economics. Even a cursory examination reveals the superfluity of quantitative formulas, statistical analyses, and algebraic equations that typify the thought processes of conventional economics. The profusion of quantitative detritus seems to issue forth whether its instigators are neo-Keynesian disciples or adherents of the efficient markets hypothesis. Yet a major deficiency of this intellectual trend is

34. This critique of the mathematization of economics has been advanced by such thinkers as Friedrich Hayek, Robert Heilbroner, and John Maynard Keynes.
36. See, e.g., PAUL ANTHONY SAMUELSON, FOUNDATIONS OF ECONOMIC ANALYSIS 5–6 (1947).
37. As Röpke puts it: "When one tries to read an economic journal nowadays, often enough one wonders whether one has not inadvertently picked up a journal of chemistry or hydraulics." RÖPKE, supra note 32, at 247.
38. As Nobel Prize economist Myron Scholes stated, "[t]here are models, and there are those who use the models," referring to the distinction between "ivory tower" economists who concoct models and financial engineers who apply the models to the actual business world. Efficiency and beyond, ECONOMIST, July 18, 2009, at 368. Of course, a number of economists who embrace the efficient markets hypothesis posit some modifications to it as a consequence of their readiness to
that it effectively conflates the study of economics with but one instrument of economic examination. As Albert Einstein is supposed to have put it: "Not everything that can be counted counts, and not everything that counts can be counted."

As symbolic language that originally developed as a method for examining natural science, mathematics is well suited to the study of the natural world. It is also an effective means of representing comparatively steady and straightforward economic patterns. But mathematics is not as suitable for examining a broad range of phenomena—such as institutions, values, culture, and traditions—that clearly have an enormous bearing on economic life. In other words, it is highly dubious that the mental model of quantitatively oriented economics is an adequate intellectual framework for understanding the entire range of economic life, given all of its instabilities, complexities, and uncertainties.

Granted, economics can achieve sound results by deploying mathematics when explaining relationships that have distinctively quantitative features. But as economics continues to examine the world in almost purely quantitative terms, it tends to neglect the human side of things, which is to say, the part that is non-mathematical and that does not behave according to fixed laws. In the words of Wilhelm Röpke: "Economics is no natural science; it is a moral science and as such has to do with man as a spiritual and moral being." Röpke's insights point directly to a fundamental limitation of the mental model of the contemporary economist. In its quest for formulas, the "new economics," especially as it is enshrined in "financial engineering," is gradually eroding our comprehension of economics as a "moral science."

B. Business Management Mental Model

The rise of a narrow positivism or scientism in theories of business management has accompanied the mathematization of economics. Like the economists, business researchers have typically misdirected scientific methods by incorrectly assuming that the subject of their investigations—the world of business—closely resembles the physical sciences. They thus accept findings from other fields of study, such as psychology, in an effort to account for seemingly irrational economic behavior on the part of both individuals and institutions. See id.

39. RÖPKE, supra note 32, at 247.
40. Id.
wrongly believe that business unveils itself as an objective phenomenon governed by repeatable and predictable processes. Associated with this positivistic outlook is the further assumption that the only legitimate objective of business is maximization of shareholder value. How did such a restrictive narrative about business come about in the first place?

In answering this question, it is helpful to consider some points that emerged from a recent, penetrating study of business education by Rakesh Khurana. He maintains that the need to “professionalize” business schools was connected, as in the disciplines of engineering and medicine, with a need to convey knowledge that would function as a wall around the profession and thus keep the amateurs out of the picture. Yet unlike fields such as engineering or medicine, the exact content of that specialized knowledge remained obscure until 1959, when the Rockefeller, Carnegie, and Ford Foundations began to devote extensive resources to the development of technical subjects at business schools such as linear programming and statistical quality control. Underpinning this project was the assumption that introducing mathematics-infused social science into the curriculum would accord an aura of academic respectability to business schools. Thus, for instance, business faculty would be recruited, hired, and tenured according to their production of scientific publications. Khurana points out the irony that, from the 1970s on, this scientific turn led innovative business schools to embrace the agency theory that was itself an outgrowth of neoclassical economics. The widespread acceptance of agency theory’s seductive language, which was seen as useful for understanding a world in which business organizations, ownership, markets, and technologies are constantly in flux, served to dissolve traditional ideas of responsibility. According to this academic paradigm, managers are agents whose interests are not necessarily aligned with those of the principals, meaning the owners of a firm, the shareholders. The company is seen as a mere

41. See Freeman & Newkirk, supra note 35, at 138.
43. Id. at 176–92.
legal fiction, a "nexus of contracts." Within the nexus-of-contracts theory, however, there is no place for a corporate ethos or corporate responsibility. Managers pursue their own advantage rather than the good of the company, much less the community's welfare. For instance, managers have incentives to magnify their compensation by increasing the size of the enterprise and expanding the reach of their responsibility, even when there is no profit to be gained from this kind of arrangement.

Agency theory emphasized monitoring management performance and providing incentives for managers to improve business performance. Various financial innovations that emerged in the 1970s and 1980s, such as the deployment of leveraging and debt in restructuring business organizations, accordingly enjoyed a compelling justification in terms of heightened efficiency.

As a legacy of this approach, the dominant focus of business management today is on the model of large, publicly traded corporations that present a complex agency problem in which managers occupy the role of shareholders' agents. Within the field of business management, theories of social science take center stage, while business people act as if corporations and agency problems are virtually immune from any consideration other than shareholder value. According to Sumantra Ghoshal:

In courses on corporate governance grounded in agency theory, we have taught our students that managers cannot be trusted to do their job[—which, of course, is to maximize shareholder value . . . . In courses on organization design, grounded in transaction-cost economics, we have preached the need for tight monitoring and control of people to prevent "opportunistic behavior." Thus, underpinning a great deal of the management discussion is a positivistic and deterministic outlook on business. This interpretive mindset is persuasive in consulting, securities trad-

For investors and consultants alike, their tasks involve diagnostics and analysis. So there is a tendency in both of these lines of work for practitioners to adopt a reductionist mindset, regarding the businesses under observation purely as independent, determined phenomena. In the ordinary curriculum of a business school, the primary components of analysis are products and services, cash flows, processes, brands, and other stylized ideas that have taken on their own metaphysical stature. The narrow, functionalist thinking that produced the orthodoxy surrounding the notion of agency, the restrictive view that value can only mean economic value to shareholders, and the myopic perspective that regards the purpose of the firm as shareholder-centered, all constitute the dominant narrative in business education.

George Anders explains Khurana’s assessment of the situation as follows: “M.B.A. training has deteriorated into a race to steer students into high-paying finance and consulting jobs without caring about the graduates’ broader roles in society.” According to Khurana, the “logic of stewardship has disappeared” from business education. “Panoramic, long-term thinking,” Anders contends, “has given way to an almost grotesque obsession with maximizing shareholder value over increasingly brief spans.”

According to this received view of business management, what counts above all is “winning the war” against competitors and maximizing the bottom line. From this viewpoint, the idea of applying moral principles to business conduct is inconceivable, or as the cliché goes, business ethics is an oxymoron. Such a mental model rejects the notion that economic value is in any way related to moral conduct in business. Economics and morality are viewed as wholly dissimilar forms of discourse for managerial decision making and business practices. According to this view, the expectation that corporations exercise moral behavior beyond the requirements of law betrays a fundamental misconception about the nature of a free economy, unnecessarily imposes restraints on corporate activity, and squanders corporate

value on social initiatives of unsubstantiated value. The only plausible case for obeying legal and ethical standards, under this position, is to avoid the monetary cost of noncompliance.

Not only has business management theory been misdirected by positivist and scientist assumptions, it has also failed to provide any satisfactory understanding of what business actually is. For all of the technocratic blatherskite it generates, business theory gives little attention to the basic human interactions that make business a profoundly human enterprise. Yet business, in its most essential form, is a way that we create value for each other by cooperating and specializing our labor. Business is fundamentally about human relationships addressed to the proximate objectives of creating wealth and fostering trade, and to the broader objective of human fulfillment. In reality, business is utterly incapable of even occurring, much less flourishing, outside of interpersonal moral-social matrices. It is astounding that most theories of business—for instance, those premised upon shareholder theory—divorce business decisions from this human sphere.

The point is this: Not only have the mental models of economics and business management likely played a significant role in bringing about the financial crisis, but to the extent they neglect the moral and human dimensions of business, they are ill-equipped to provide any meaningful guidance for business leadership in the future. Providing such guidance will require a fundamental reframing of management practices to be more concordant with human nature and enduring moral values.

What is not ordinarily acknowledged is that classical economic theorists such as Adam Smith espoused principles that are in line with a robust pursuit of the common good in business. Barely one hundred years have passed since economic theory changed tracks and began developing an individualistic mindset grounded in the notion of scarcity and the view that people participate in the market purely as self-regarding profit-maximizers.53

53. Edward J. O’Boyle, Person: An Economic Agent for the Electronic Age, 34 INT’L J. SOC. ECON. 472, 478 (2007). Throughout the history of Western civilization, one repeatedly finds business ventures embodying humanitarian endeavors. Monasteries dating back to the Middle Ages were, in effect, incipient institutions of economic activity, in which ora (culture) and labora (work) were coupled. Likewise, as far back as the fifteenth century, the Franciscans had established the Montes Pietat-
Notwithstanding this relatively recent transition in economic thought, three key ideas upon which a human focus and classical economic theory come into agreement are the concepts of virtue, human dignity, and public happiness or the common good. The term "public" underscores the reciprocal character of happiness, as opposed to affluence. That is, one can be affluent alone, but to be happy requires others. Public happiness is diagnosed in a stream of economics literature stressing the concept that commodities and profits engender prosperity only when situated within a broader context of meaningful interpersonal relationships within which human dignity is accorded proper respect. Moreover, in the eyes of many classical economists, the market did not contravene civil society but was in fact the embodiment of it. Proper functioning of the market depended on contracts, cooperation, institutions, and trust. These in turn promoted reciprocity. Economic activity thus provided a setting where humans manifest their social being and reveal their desire for camaraderie in relationships of equality and civility.

Given contemporary technocratic understandings of the market, such characterizations no doubt appear strange, perhaps almost incomprehensible. Nevertheless, the crucial insight is this: The market reveals itself as a manifestation of social life when we can discern its strong dependence on the exercise of virtue, respect for dignity, and a shared sense of the common good. Logically, these moral elements must exist before bargaining. By building good and just institutions, and by forming agreements grounded in authentic trust rather than on the basis of deceptive

tis, precursors of modern banks, which grew up not directly seeking profit, but instead trying to battle usury and provide the impoverished with new beginnings in the wake of economic hardship. The nineteenth century also provided for a merging of economic and humanitarian objectives as the bulk of European welfare establishments and hospitals emerged out of spiritual associations. Luigino Bruni & Amelia J. Uelmen, Religious Values and Corporate Decision Making: The Economy of Communion Project, 11 FORDHAM J. CORP. & FIN. L. 645, 657–58 (2006).

54. A good deal of emerging research indicates that donors themselves experience a tremendous amount of benefit from giving. Indeed, economists and psychologists have found that charitable giving makes people healthier, happier, and even more financially successful. Giving is, in and of itself, a source of value for those who donate to charity. See ARTHUR C. BROOKS, WHO REALLY CARES: THE SURPRISING TRUTH ABOUT COMPASSIONATE CONSERVATISM (2006); STEPHEN POST & JILL NEIMARK, WHY GOOD THINGS HAPPEN TO GOOD PEOPLE (2007).

and disingenuous transactions, market interactions can take on a wider and more virtuous role. This deeply human-centered conception of business is supported by a long tradition of thought common to ancient cultures. That intellectual tradition emphasized the dependence of commercial life on human characteristics taken to be ennobling and immutable.

C. Mental Model of Lawmakers and Legal Authorities

A key limitation of this model inheres in the reality that the law ordinarily intervenes to supply enforceable norms where trust is lacking. Legal regulation, however, is no substitute for trust in business. The impotence of law to replace trust poses an especially acute problem in the context of the financial debacle, as it was precisely a retreat from trust that was one of the principal reasons for the near collapse of the world’s financial markets. Credit, which constitutes the lifeblood of the world economy, had virtually dried up. Even large banking establishments were adverse to lending to one another; they simply did not trust that they were going to obtain repayment. Granted, legal structures assist in the enforcement of contracts, and contracts in turn facilitate the creation and enforcement of innumerable deals, agreements, and other business transactions. Nevertheless, one is not likely to sign a contract if there is no basis for trusting his counterparty. The existence of trust is vital for any business to forge solid relationships with key constituencies such as customers, employees, suppliers, and the wider social orders within which the business carries on its activities. Furthermore, trust impels the basic dynamic of taking risks, which serves to foster progress and innovation.

Not surprisingly, consistent with their disposition to approach all problems with increased regulation, many government agencies started contemplating new laws and regulations in response to the subprime housing and credit crisis as early as 2007. Thus, United States federal regulators started proposing new rules requiring mortgage lenders to peg loan decisions on borrowers’ capability to repay adjustable rate mortgages at the full interest rate rather than on borrowers’ ability to pay lower introductory

56. See id. at 3.
rates. Moreover, industry trade journals began sending out smoke signals to their constituents announcing that new regulations would be a virtually certain consequence of the crisis.

Nevertheless, it is clear that such efforts at legal and regulatory intervention did not stop the crisis from unfolding. What the mindset of lawmakers and legal experts typically ignores is that a great deal of business activity cannot be effectively regulated, partly because it is normally too difficult or costly to do so and partly because legal regulation typically triggers ever more elaborate loophole-hunting avoidance schemes. Moreover, excessive regulation threatens to dilute, if not completely annihilate, entrepreneurial initiative.

One might turn to music as an analogy. The idea of perpetrating some mode of malfeasance on par with fraud while delivering a live violin performance is inconceivable. Without authentic technical and artistic mastery of the instrument there can be neither genuine musicianship nor decent music. Consider that for purposes of fostering musical artistry there are not, nor could there be, government regulatory agencies charged with such a mission. Imagine the absurdity of a law specifying how properly to deliver a trill, complete with a list of penalties for violations. Music is, in its essence, a self-regulating enterprise. A technical execution of all of the notes of a piece of music—call it "minimal compliance"—is understood by all reputable musicians to be merely the barest of requirements. Outstanding musicianship is all about the artistry that is added to the "minimal" accurate rendering of the notes. Just as integrity in music cannot be externally imposed, neither can in-


59. For Michael Novak, the innovative spirit becomes the hallmark of capitalism. Criticizing Max Weber who holds "economic rationality" to be the essence of capitalism, and drawing from Hayek, Schumpeter, Kirzner, and others, Novak states that:

   The heart of capitalism . . . lies in discovery, innovation, and invention. Its fundamental activity is insight into what needs to be done to provide a new good or service. The distinctive materials of capitalism are not numbers already assembled for calculation by the logic of the past. On the contrary, its distinctive materials are new possibilities glimpsed by surprise through enterprising imagination.

tegrity in business be legislated. In both music and business, the exercise of virtue is fundamental, unavoidable, and part of the very lifeblood of the endeavor.

D. Moral-Cultural Mental Model

Beneath the all-too-real empirical crisis revealed by the mental models of economics, business, and law, there is a moral malaise that calls for a fresh mindset that can penetrate deeper and reach wider than these disciplines. To bring the distinctly moral dimension of the crisis into focus, consider the extent to which the subprime business market has been intimately bound up with a host of moral malfeasances. Moral failures leading to the financial crisis include:

- lenders enticing homebuyers into unsuitable mortgage arrangements;\(^6^0\)
- approximately seventy percent of homebuyers falsifying data on their mortgage applications;\(^6^1\)
- financiers creating nontransparent financial products (securitized mortgages) with risks obscured in vague or utterly indecipherable legal terminology, if disclosed at all;\(^6^2\)
- rating agencies immersed in massive conflicts of interest issuing biased valuations of companies' financial postures;\(^6^3\)
- hedge funds intentionally circulating false information to "short" the shares of companies' stock ("predatory short selling");\(^6^4\)

\(^6^0\) Steven Malanga, *Whatever Happened to the Work Ethic?*, 19 CITY J. 36, 36-45 (2009). The existence of easy credit, along with the belief that home prices would keep on appreciating, persuaded legions of subprime borrowers to assume adjustable-rate mortgages. The financial institutions that offered these products lured homebuyers with below market interest rates for pre-established terms, followed by market interest rates for the rest of the mortgage's term. Unable to afford increased payments at the end of the initial grace period, many borrowers attempted to refinance. But refinancing proved difficult as housing prices started to drop across the United States. Borrowers found themselves incapable of avoiding heftier monthly payments by refinancing and started to default. Patrice Hill, *Treasury seeks to stem second wave of foreclosures*, WASH. TIMES, Feb. 13, 2008, at A1; Kathleen M. Howley, *Plummeting home values sinking American dream*, DETROIT FREE PRESS, Nov. 22, 2009, at 2.

\(^6^1\) Malanga, *supra* note 60, at 36-45.

\(^6^2\) See Khanna, *supra* note 22.

\(^6^3\) See id. (arguing that credit agencies failed in their role as "gatekeepers" to the financial system).
corporations instituting compensation plans ("golden parachutes") that rewarded executives for poor performance and for making decisions that contributed to the financial crisis by fueling excessive risk taking.\textsuperscript{65}

- hedge funds misleading investors by faking high performance.\textsuperscript{66}

We are thus barking up the wrong tree by looking to mathematized economics and positivist business management theory for enlightened understanding, and to stepped-up legal regulation for solutions. Given the moral dimensions of the crisis, where might we turn in the quest for a solution?

One answer might be to require business ethics courses in MBA programs. Regrettably, however, it is doubtful that the conventional business school ethics curriculum is capable of giving present and future business leaders the proficiencies they will need to navigate the dangerous currents flowing out of the current economic tumult.\textsuperscript{67} Several serious defects in business

\textsuperscript{64} See Charles R. Schwab, Restore the Uptick Rule, Restore Confidence, WALL ST. J., Dec. 9, 2008, at A17 (describing the harm caused by "manipulative short sellers").


\textsuperscript{66} A recent study found that it is "quite easy for a hedge fund manager to 'fake' high performance over an extended period of time without getting caught." Dean P. Foster & H. Peyton Young, Hedge Fund Wizards, ECONOMISTS' VOICE, Feb. 2008, at 1, 1. Hedge fund managers sometimes make risky speculative moves by investing in transactions that may yield higher-than-average returns because of the minute yet real risk that the whole venture may blow up. Id. This kind of arrangement, dubbed a "Taleb distribution," has a strong likelihood of producing moderate gains and only a slight chance of resulting in huge losses in a given period. Martin Wolf, Why today's hedge fund industry may not survive, FIN. TIMES, Mar. 19, 2008, at 15. Thus, even if the probability of suffering a large loss is one in ten, the fund manager might stand ready to assume the risk because, after all, his own money is not on the line, and he is likely to pull down a tidy profit for years to come. For instance, although the manager will likely be ousted should that one-chance-in-ten risk occur, the investment might nevertheless produce sufficiently large returns for the fund manager to get large returns, reap a "2 and 20" commission, and satisfy his clients along the way. To his clients, the fund manager will seem to have immense talent. The problem is that his clients have no way of suspecting that the manager is basically gambling their money away. See Thomas Donaldson, Hedge Fund Ethics, 18 BUS. ETHICS Q. 405, 409 (2008).

\textsuperscript{67} In a recent editorial Professor Michael Jacobs describes how failures related to board oversight, executive rewards, and agency costs, which contributed to the financial meltdown, were not even on the radar screens of America's business schools. In his words, "[m]ost B-schools paper over the topic [of corporate governance] by requiring first-year students to take a compulsory ethics class, which
education cripple the ability of a large number of business schools to come to terms with business's moral sphere. One defect is their tacit encouragement of the attitude that if something is not illegal then it must be acceptable. Another defect is their retreat from any rigorous engagement of matters of right and wrong. Their reason for shirking from such matters is the threat that a careful study of right and wrong poses to the strong moral relativism that pervades so many cultures and societies around the world today. Consequently, business education mistakes the idea of morality to be coextensive with, on the one hand, a program of ethics "window dressing," and on the other hand, a program of "corporate social responsibility."

Under the "window dressing" approach, efforts to inculcate authentic moral sensitivity in future business leaders get sidetracked into image-conscious marketing strategies. Armed with such strategies, MBA graduates, once absorbed into the corporate culture for which their business education has prepared them, perfect the art of crafting pious declarations of rectitude and peppering them throughout the annual reports, codes of conduct, and mission statements of business organizations. In the aftermath of the financial crisis, we have learned that many of these same institutions have been culpable for unprecedented levels of fraud and other forms of misconduct.

is necessary, but not sufficient." Michael Jacobs, How Business Schools Have Failed Business, WALL ST. J., Apr. 24, 2009, at A13. Jacobs continues his critique by posing two rhetorical questions: "Would Bernie Madoff have acted differently if he had aced his ethics final? Could we have avoided most of the economic problems we now face if we had a generation of business leaders who were trained in designing compensation systems that promote long-term value?" Id.

68. For a detailed explanation of why the attitude "if it's legal, then it's morally okay" is insufficient, particularly in the intensively regulated field of finance, see BOATRIGHT, supra note 45, at 9-10.

69. There is probably no better exposition of the moral relativism that pervades our age than the one given by Alasdair MacIntyre. He shows how contemporary moral fragmentation, in the form of emotivist and utilitarian culture, is connected to the loss of Aristotelian ethics together with the inability of the Enlightenment to supply any suitable substitution for it. See ALASDAIR MACINTYRE, AFTER VIRTUE: A STUDY IN MORAL THEORY 22–59 (1981).


71. Enron's mission statement listed the following values: respect, integrity, communication, and excellence. In addition, it proclaimed that all business dealings were to be "open and fair." Chris Penttila, Missed Mission: Watch Out! If your mission statement is a joke, Enron may be the punchline, ENTREPRENEUR, May 2002, at 73, 73. Almost all Fortune 500 companies have a mission statement. Within the
Under the “corporate social responsibility” approach, the province of “business ethics” gets denigrated to harum-scarum stratagems formulated as reactions to alarms sounded by “stakeholders” that are in turn dictated by galleries of activists purporting to be their appointed representatives. This variety of business ethics is mainly bent on promoting politically-correct agendas. The list goes on and on: Sustainability and environmental propriety, multiculturalism, diversity, and a host of similar agenda-based directives establish the criteria for a “good company.” Moreover, these criteria are placed under strict accountability, compliance, and enforcement demands in utter disregard of the type and character of the business at hand and the conditions under which it might prosper. This mindset concerning the nature of business ethics engenders the technocratic mental model of the lawmaker and legal expert discussed earlier. Those who espouse this mindset instinctively turn to government to concoct increasingly detailed regulations and to impanel officious bureaucrats (who are typically clueless about—if not downright antagonistic to—the world of business) to go about putting such regulations into effect.

It is reasonable to look to business education to provide professional guidance and intellectual leadership for a post-crisis moral-cultural mental model. Rather than relying on the run-of-the-mill “business ethics” approach, however, moving out of the crisis calls for a reckoning with enlightened philosophical concepts. Our thinking must be guided with timeless ideas like trust, honor, dignity, virtue, and the common good, wrought from ancient heritage. Yet equally importantly, we need to see clearly the demands that moral wisdom anchored in the past imposes upon us today.

At this point the moral relativist is likely to object, questioning the fundamental premise of the moral-cultural model, text of nearly every mission statement there appears some statement of the firm’s commitment to moral values. Yet it is evident that legions of senior executives behave contrary to such pronouncements. For discussion of how misalignment of formal and informal messages sent out by firms to their employees poses challenges for developing ethical corporate culture, see LINDA KLEBE TREVIÑO & KATHERINE A. NELSON, MANAGING BUSINESS ETHICS (4th ed. 2007).


73. For a more detailed look at such tendencies to over-regulate the business world, see CATHERINE CRIER, THE CASE AGAINST LAWYERS (2002); PHILIP K. HOWARD, THE DEATH OF COMMON SENSE: HOW LAW IS SUFFOCATING AMERICA (1994).
namely, that the concepts of right and wrong are objective realities. Granted, there is no universally persuasive argument for the objectivity of moral standards. Nevertheless, the absence of a knock-down argument does not imply that the notion of an objective moral order is just a matter of parochial social construction, as the post-modernists, deconstructionists, and ethical relativists claim. If, however, enough people in our society and around the world are unable to identify something objectively wrong with the culture of business scandal that is beneath the financial collapse, the result will be to encourage behaving as if there are no moral standards in business at all.

It is now appropriate to discuss the three pillars of ethical thought that provide a foundation for a new moral vision in today’s subprime mortgage market: virtue, human dignity, and the common good. These ethical concepts invoke the language of the natural law tradition. That venerable tradition offers an alternative to the reigning vision of economic life, which has brought many institutions and investors to ruin.

1. Moral Virtue

In the *Nicomachean Ethics*,74 Aristotle grounds his moral philosophy on a number of basic propositions. To start with, Aristotle holds that possessing the capability for reason constitutes the essence of what it means to be human, with abstraction and moral reasoning comprising the uppermost modes of thinking.75 This capacity includes the ability to decide among ethical and unethical means of living one’s life and of arranging human enterprises. Accordingly, individual moral virtue arises from cultivating one’s faculty of reason. In other words, we complete our humanity through cultivating our naturally given aptitude for rationality. All human beings thus possess the capability to learn and develop. The good life consists of being engaged in a process of fulfilling one’s capacities—not in the attainment of complete fulfillment, which is impossible. Although improving on a person’s natural capabilities constitutes the *sumnum bonum*, it does not comprise the “complete good.” One does not develop oneself

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75. Id. at 15–16.
for narrow self-centered purposes, but rather to add to the good of the community to which one belongs.

Human happiness, for Aristotle, arises from having chosen virtuous actions. A virtuous action falls within the "golden mean," which rests midway between two vices that make up the extreme endpoints of any character trait: deficiency and excess. For example, Aristotle states that people should be generous, meaning that they should neither be too wasteful nor parsimonious. They ought to be temperate. As such they will prevent having their lives dictated by irrational appetites like envy and lustfulness. Happiness demands that they remain even-tempered. Of course, they may exhibit some measure of anger when the occasion warrants, yet they will eschew irascibility or wrath. They should take appropriate pride in their attainments without being boastful. Aristotle thinks the golden mean can be struck for other character traits as well.

Some contend that certain types of executive compensation arrangements have contributed to the financial collapse. The arrangements are supposed to have offered inducements to cheat, perpetrate fraud, and cook the books to fabricate levels of reported corporate performance so as to elicit exorbitant payoffs. That is, they would reward businesspeople for immoral practices. Accordingly, such executive compensation plans are squarely counter-Aristotelian and contrary to virtue ethics. Executive compensation plans that motivate managers to manipulate performance levels rather than to build genuine value for their firms fail to promote virtue; instead they encourage and reward vice, namely the character deficiency of "acquisitive ungenerosity," which for Aristotle amounts to the dishonorable worship of profit.

76. Id. at 267–71.
77. Id. at 42.
78. Id. at 43–44.
79. Id. at 43–46.
81. Aristotle notes that this trait can be found in a certain class of people: [Some] go to excess in receiving by taking anything from anybody; for instance, those who follow illiberal occupations, like pones and all people of that kind; and moneylenders who make small loans at a high rate of interest; for all these receive more than is right, and not from the right sources. Their common characteristic is obviously their sordid
2. Human Dignity

The idea of human dignity encompasses the intrinsic worth inherent in all human beings. From the natural law perspective, and in the eyes of Catholic social thought, the source of human dignity is the concept of *imago Dei*, which conceives of the human person as having been created in the image and likeness of God. Human dignity surpasses any particular social order as the foundation for moral rights, and can neither be bestowed nor legitimately infringed by society. As such, human dignity forms the conceptual core of human rights. Within the tradition of Catholic moral thinking, insofar as there is a communal or social aspect to human dignity, persons ought not to be regarded in excessively individualistic terms. Rather, persons should be considered as essentially connected to the rest of society.

Immanuel Kant states that it is morally impermissible to treat people merely as a means rather than as an end. That is to say, it is wrong to treat a human being simply as if he were an instrument, tool, or object. This aspect of Kant’s philosophy encourages us to reflect on our reaction to treatment received in situations of indignity where we may have exclaimed “Hey, you’ve been using me!” Kant’s thinking also helps us to envision avarice, because they all put up with a bad reputation for the sake of gain—and a small gain at that. I say this because we do not call illiberal those who wrongly take large sums from wrong sources, e.g. despots who sack cities and plunder temples—they are more properly called wicked and impious and unjust. But the cardsharper and the clothes-stealer belong to the illiberal class, because they are sordidly avaricious: it is for gain that both types follow their profession and submit to a bad reputation, the one accepting the severest risks for the sake of their pilferings, the other profiting at the expense of their friends, to whom they ought to give; so both are sordidly avaricious, because they want to make gain from a wrong source. All such ways of obtaining money are illiberal.

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what it means to treat people in morally permissible ways—that is, as ends in themselves, dignified beings worthy of respect.

Many of the kinds of unethical business conduct that have rendered the financial crisis a serious moral scandal fail to respect human dignity, in the sense that such behavior infringes upon the moral rights of others. For example, consider the practice of predatory lending, which involves entering into unsound secured loans for inappropriate purposes. Countrywide Financial Corporation used a bait-and-switch technique, advertising low interest rates for home refinancing. Loans were written into extensively detailed contracts, and then swapped for more expensive loan products at closing. An advertisement might show that 1% or 1.5% interest would be charged. Then, a consumer is placed into an adjustable rate mortgage (ARM), allowing homeowners to make interest-only payments, yet the interest charged is more than the amount of interest paid. This mismatch creates negative amortization, which the homeowner might not notice until long after the loan transaction has been consummated. It is clear that business practices such as predatory lending treat people merely as means to an end. Businesspeople flout principles of human dignity whenever they deceive, manipulate, or otherwise treat individuals as if they were not worthy of moral respect.

Rabbi David Novak stresses, in his reflections on the threat to human dignity that sundry improprieties associated with the financial crisis represent, the need for cultivating a greater awareness of moral conscience in business culture. According to Novak:

What is new is not what these [corporate] thieves have done, or even how they have done it. What is new is the political culture that has deprived them of the capacity for any real agony before they steal, or the capacity for any real remorse after they have stolen, even after they have been caught. What is new is the political culture that has deprived too many of us, who are not thieves, of the capacity to demand any real regret from those who are thieves, because we have lost the capacity to judge thievery with any real opprobrium.

The key... is to distinguish a political culture that cogently encourages one to be ashamed of wrongdoing, and a political

84. Mark Brown, Countrywide Wasn’t Really on Your Side; Mortgage Crisis Comes Down to Plain Old Consumer Fraud, CHI. SUN TIMES, June 26, 2008, at 8.
culture that only pragmatically judges the good or bad consequences resulting from the exercise of one's self-interest or actually approves of what one has done. That kind of culture only pities the criminal for his or her bad luck in getting caught, and especially for having to "do hard time" in prison.85

3. The Common Good

How should we understand the concept of the common good? Certainly, we can associate a variety of meanings with the term.86 For purposes of the present discussion, the common good is more than the competing interests of selfish individuals and more than the composite interests of special groups. It is the good we have in common—the communal conditions necessary for the virtuous pursuit of human fulfillment, flourishing, and perfection by all in society.87 Ultimately, the common good is the aggregation of collaborative initiatives and shared restraints by which society helps everyone achieve what in the end only each individual can accomplish for himself: shaping a good will and constituting an authentically human self by freely choosing to actualize the good every time one is given the chance and responsibility to do so.88 In addition to its tendency to reward unscrupulous conduct, the executive compensation schemes connected to the financial crisis are inimical to the common good in that they provide powerful incentives to people to maximize their selfish interests at the expense of the wellbeing of persons throughout society.

The moral degradation leading to the financial crisis reminds us of our interdependence and summons us to mutual responsibilities. Catholic thought provides a rich resource for embarking upon just such a path. Consider John Paul II's encyclical Centesimus Annus:

87. Vatican II defined the common good similarly as "the sum of those conditions of the social life whereby men, families and associations more adequately and readily may attain their own perfection." Gaudium et Spes, supra note 82, ¶ 74.
88. I have elsewhere provided an analysis of how such a notion of authenticity and self-actualization applies to a variety of the moral dilemmas one confronts in the world of business, drawing upon the existentialist philosophy of Jean-Paul Sartre. See Kevin T. Jackson, Towards Authenticity: Taking a Sartrean Perspective on Business Ethics, 58 J. BUS. ETHICS 307 (2005).
[W]e see how [Rerum Novarum] points essentially to the socioeconomic consequences of an error which has even greater implications. As has been mentioned, this error consists in an understanding of human freedom which detaches it from obedience to the truth, and consequently from the duty to respect the rights of others. The essence of freedom then becomes self-love carried to the point of contempt for God and neighbor, a self-love which leads to an unbridled affirmation of self-interest and which refuses to be limited by any demand of justice.89

For a reframing of our mental model to occur in the aftermath of the financial scandal, we must return to the ethics of virtue, human dignity, and the philosophy of the common good. Here is where human freedom and individual interest reach their proper proportion.90

III. MORAL-CULTURAL DYSFUNCTIONS INDICATED BY THE CRISIS THAT ARE NOT TREATABLE BY LEGAL REGULATION

A. Post-Modernism

What are the moral-cultural roots of the economic crisis? Could it be that, as historian Harold James has suggested, under the influence of postmodernism within the broader culture, what has emerged is a greater eagerness to take irrational risks and to supplant reason with subjective feeling and intuition? Has such a trend in turn fostered a willingness, for instance, to provide and accept valuations of complex and basically incomprehensible securities?91

To posit the existence of linkages between postmodern culture and financial decrepitude may not be as implausible as it first appears. Recall the movie Wall Street.92 Oliver Stone’s masterful portrayal of a postmodern abandonment of reality through the character of Gordon Gekko depicts a financial

90. The reference to “proper proportion” refers us back to Aristotle’s idea of virtue as a mean between extremes. ARISTOTLE, supra note 74, at 39–42.
92. WALL STREET (20th Century Fox 1987).
world that has become as ephemeral as streaming real-time stock quotes. Thus, in one of Gekko’s memorable lines, he intones that “money itself isn’t lost or made, it’s simply transferred from one perception to another.” In a scene with his ex-lover, Darien, (immediately following his purchase of obscenely overpriced abstract expressionist artwork in an auction) Gekko announces: “We are smart enough not to buy into the oldest myth running: love. A fiction created by people to keep them from jumping out of windows.” And in a soliloquy to his protégé, Bud Fox, Gekko cynically proclaims:

The richest one percent of this country owns half the country’s wealth: 5 trillion dollars. One third of that comes from hard work, two thirds of it comes from inheritance, interest on interest accumulation to widows and idiot sons and what I do—stock and real estate speculation. It’s bullshit. Ninety percent of the American people have little or no net worth. I create nothing: I own. We make the rules, buddy, the news, war, peace, famine, upheaval; the cost of a paper clip. We pull the rabbit out of the hat while everybody else sits around their whole life wondering how we did it.

Looking back at the various forms of financial innovation and complexity that precipitated the economic crisis, one can see that the financial experts who appeared to be selling wealth-producing innovative ideas did so with the encouragement of a cultural climate that is enamored of excessive experimentation; prone to disrespect for discipline, authority, and hierarchy; and opposed to traditional values. The shocking result is that any kind of value—whether moral, aesthetic, or financial—is in danger of becoming regarded as arbitrary and fundamentally absurd.

It is important to point out that, in earlier times, mainstream education stressed these virtues. For instance, the study of musical harmony, undertaken within a framework of tonality, emphasized order and hierarchy. Similarly, in the study of syllogisms of logic, students were made aware of external authority and the demands of order and stability.93 Contrast this tradition with today’s violent rap music and trends in education, such as the “self-esteem” movement, which essentially serve to cultivate indiscip-
Is it any wonder that signs of disorder and systemic crisis eventually appeared in the sphere of finance and business?

B. Rise in Speculative Culture

In finance, the concept of a speculative bubble can be explained roughly as follows. First, a quick yet normally short-lived run-up in prices comes about, not as a result of basic underlying market fundamentals, but rather from irrational exuberance. Then, while the speculative bubble grows, increasing numbers of investors are prone to buy, until it starts to look as if “everyone” thinks that prices are going to move yet higher. Finally, when the bubble eventually bursts, prices drop even more quickly than they ascended, with everybody clamoring to sell at once. Such panic selling in turn triggers widespread and acute losses.

To think about how the speculative bubbles underlying the recent financial crisis are connected to the rise of “speculative culture,” it is helpful to go back to the work of Thorstein Veblen. Writing at the beginning of the twentieth century, Veblen offered a nuanced distinction between entrepreneurs and speculators: The entrepreneur is a businessman with a project who calculates the success of his business according to its realization of that project. To the entrepreneur, however, profit represents only one gauge of the goodness of the activity, not the end-all-and-be-all. A speculator, on the other hand, pursues a particular project with the sole objective of making money. Whatever the material object of the activity happens to be is inconsequential. Indeed, a speculator will switch ventures or change to a different economic sector the moment he finds a more profitable pathway to generate money.

An illustration of the peculiar fascination with—indeed outright glorification of—speculative pursuits in our culture can be seen in bestselling books such as Victor Niederhoffer’s The Education of a Speculator, in which representations of stock charts are absurdly juxtaposed with the musical manuscripts of such timeless masters as Ludwig von Beethoven and Alexander Scriabin.

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94. See id. at 17–18.
95. See THORSTEIN VEBLEN, THE THEORY OF BUSINESS ENTERPRISE 41–42 (1904).
96. See id. at 27–29 (comparing a businessman whose “end is pecuniary gain” to a “speculator in grain futures”).
interesting to note that, on its back cover, the book’s promotional blurb proudly recites the paradox that its author is “a contrarian trader” who attained “staggering wins and stellar performance” yet “was forced to close his fund due to heavy losses.”

Turning to the economic crisis, examples abound of unsound business practices fueled by a speculative economic culture. For instance, consider “flipping.” In the case of house flipping, a speculator might buy a house for $300,000 in February. The speculator’s intention is not to live in the house or even to rent it out for others to live in, but rather to turn around and sell it for $400,000 as early as July and pocket the profits. Flipping has become so popular in the United States that some do-it-yourself television programs, such as A&E’s “Flip This House,” portray the method in detail.

Another example of speculative culture is the prevalence of so-called “NINJA” loans, a variety of subprime loans issued to borrowers with “No Income, No Job and No Assets.” They were especially prominent during the subprime mortgage crisis, serving as an example of poor lending practices. The term grew in usage as the subprime mortgage crisis came to be blamed on such loans.

C. Egoistic Individualism

It is a symptom of our disorder that a sizable segment of today’s culture is inclined toward the glorification of the self, a trend that is based on the philosophy of egoistic individualism. This philosophy embraces the belief that the individual exists solely for her own happiness and thus that rational self-interest is the only objective basis for moral action. There are no moral constraints on the selfish pursuit of personal happiness, except force and fraud. And there is no moral duty to sacrifice individual advantage for

98. Id. at Back Cover.
99. In general, “flipping” refers to the practice of buying an asset and quickly reselling it for profit. Although flipping can apply to any asset, the term most often refers to real estate and initial public offerings.
100. The phrase was coined by HCL Finance to designate one of its financial products. Edward Chancellor, Ponzi Nation, INSTITUTIONAL INvEsTOR, Feb. 2007, at 56. The phrase is a play on words on two levels: first, as an acronym; second, as a signal that NINJA loans frequently end up in default, with the borrower vanishing into thin air like a ninja.
any greater good, because there simply is no greater good than personal happiness. 101

Such an outlook goes hand-in-hand with two of the chief tendencies toward which contemporary business education is inclined: subjective moral relativism (emotivism) and the assumption that if something is not illegal, it must be okay.

According to the storyline of this philosophy in the context of business, "corporate executives . . . seek what [is] best for the institution and its investors—and . . . self-interest . . . align[s] private profit with institutional good."102 Market participants pursue their respective individual "advantage[s] regardless of others, because individual happiness is the ultimate good."103 Consider how this ideal works in the context of executive compensation. In many instances the compensation packages of high-ranking executives provide lavish remuneration irrespective of the firm's stock performance. As in the collapse of Washington Mutual, Lehman Brothers, Bear Stearns, and others, top executives were able to escape with "golden parachutes" such as cash bonuses, severance pay, stock options, and other benefits.

The egoist ethos amplifies this divergence between private interest and common good throughout many sectors of the financial market. Consider the mortgage market. For the mortgage lender, issuing risky loans that are unlikely to be repaid is a good investment, as long as the secondary mortgage market allows him to pass the risk of default to others by selling mortgage-backed "securities." Even if the borrower later goes into default, the mortgage lender has gained in the market so long as he is able to remove the loan from his books and reap his commission.

Furthermore, for the investment banker, purchasing bonds backed by risky loans is also a good investment, so long as a derivatives market allows him to "swap" the risk with a leveraged investor or an insurance company. Even if the underlying loans go into default, the investment banker has still maintained his market position, so long as his credit-default swaps pay out and he covers his losses.

102. Snyder, supra note 101, at 12.
103. Id.
In short, so long as there is a market for betting on loan defaults
and so long as there are investors willing to take the bets, financial
risks that promise individual profit with potential cost to the
common good make rational sense. Of course, this game of risk is
sustainable only so long as the bets continue to pay off—which
means in the case of the financial crisis, only so long as housing
prices continued rising. With the burst of the bubble in the hous-
ing market, resulting in a flood of mortgage defaults, bond sellers
and default insurers alike were left unable to make good on their
promises, leaving bondholders to absorb the losses that they had
gambled on others paying. Although the risk-takers have reaped
their reward, stockholders and taxpayers have borne the real cost.

The proposals of those using the mental model of legal ex-
erts to expand regulation of capital markets and executive
compensation to rein in self-interest do not get to the heart of
the matter. The deeper philosophical issue is that the egoist
ethic as such is an insufficient foundation for economic life.
What the financial crisis teaches is that excessive self-interest is
economically destructive. Unrestrained selfishness is a vice,
undermining not only the general welfare but also self-interest.

The pursuit of rational selfishness untempered by moral con-
straint erodes the trust between financial institutions necessary to
sustain the flow of credit upon which a market-capitalist economy
depends. Insofar as buying into the market carries risk, it also ne-
cessitates trust. Trust in the market, however, can neither be pur-
chased nor legislated into existence. Trust arises out of the trust-
worthiness of market participants, whether they be buyers or
sellers, borrowers or lenders. Without mutual trustworthiness, op-
portunities for commercial interaction are constricted. In this sense,
whether in the public square or the marketplace, moral virtue is at
the heart of human liberty. What Benjamin Franklin wisely said
about political liberty is therefore true of economic liberty as well:
"[O]nly a virtuous people are capable of freedom."\textsuperscript{104}

IV. SAFEGUARDING MARKET ECOLOGY

Since Aquinas, the natural law tradition has sought to use
human reason to derive moral principles that promote human

\textsuperscript{104}. Letter from Benjamin Franklin to Abbots Chalet & Arnaud (Apr. 17, 1787),
wellbeing. The moral urgency engendered by the present economic crisis ought to prompt a return to reason so as to discern moral principles that impose civic moral obligations on market participants from corporate leaders to behind-the-scenes "gatekeepers," such as accounting and law firms, to avoid the infliction of systemic abuse upon—indeed, the outright sabotage of—the overall market system. Such duties of avoidance are important to achieve all market participants' shared goal of overall economic welfare as a necessary, albeit not sufficient, condition for achieving human wellbeing. We might think of this as the "ecology" of market efficiency.

A. Moral Coordination

Maintaining market ecology demands moral coordination. The challenge of preserving the ecology of market efficiency is particularly relevant to the present problem of subprime business scandals, because it requires that market participants not, among other things, distort information that ought to be available to other market participants—that is, information upon which market efficiency itself depends. Turning to the ideas of Adam Smith and Friedrich Hayek will prove particularly instructive with respect to the concept of market ecology.

1. Adam Smith

For Adam Smith, individual choice and personal freedom drive free commerce and enlightened commercial society in general. They inspire an attitude of industry that brings about enhanced opportunities, leading vast portions of humanity to enjoy a more appealing and remarkable existence.

Across the expanses of a free capitalist economy, individuals—seeking betterment for themselves, their loved ones, and their communities—willingly contribute vigor, aptitude, and expertise. In the process—by the operation of an "invisible hand"—they are simultaneously improving the economy as a whole. The strength of their initiative, and consequently the,


fruit of their productive efforts, will diminish if they sustain it only by force. Moral behavior is a prerequisite for the invisible hand to operate. Business activity is not possible without basic regard for ethical standards that respect property rights, honor promises, and ensure mutual commitments.

It does not follow, however, that the impulses responsible for enlivening the market are purely self-interested. Nor is the invisible hand simply a disinterested curative for greed and selfishness. Adam Smith argued that humans have a basic regard for others, or a sentiment of beneficence, in the absence of which the market would not function properly. Economic activity thus flourishes among people only in the presence of moral sentiments, including norms of duty, integrity, and fairness.

Smith’s portrayal of free market competition is best interpreted in association with his views on human motivation, as laid out in The Theory of Moral Sentiments. Sympathy, benevolence, and the stance of the “impartial spectator”—part and parcel of our moral nature—continuously modulate the brute pursuit of profit. According to Smith, what appears from one perspective as self-gain is seen from another viewpoint as benevolence. Indeed, the most profitable business strategy often involves sublimating short-term financial yield to long-term investments in honor, kindheartedness, or benefaction.

2. **Friedrich Hayek**

According to Hayek, social institutions such as money, credit structures, markets, and property represent “spontaneous orders.” Hayek asserts that spontaneous orders are complex.

107. For an extended analysis of Smith’s argument for the necessity of beneficence to a well-functioning marketplace, see RYAN PATRICK HANLEY, ADAM SMITH AND THE CHARACTER OF VIRTUE (2009).


109. *Id.* at 184–85 (“The rich . . . consume little more than the poor, and in spite of their natural selfishness and rapacity, though they mean only their own convenience, though the sole end which they propose from the labours of all the thousands whom they employ, be the gratification of their own vain and insatiable desires, they divide with the poor the produce of all their improvements. They are led by an invisible hand to make nearly the same distribution of the necessaries of life, which would have been made, had the earth been divided into equal portions among all its inhabitants . . . .”).

and abstract, and depend on general rules. In his words, “[t]he insight that general rules must prevail for spontaneity to flourish, as reaped by Hume and Kant, has never been refuted, merely neglected or forgotten.”\(^\text{111}\)

Although spontaneous orders are governed by general rules of conduct (which in turn are under the influence of human choice in various times and places), they depend mainly on self-generating characteristics resting at the center of market activity. Individual freedom and personal choice make up the heart of the market economy. For Hayek, a well-working market economy cannot be a constructed order, because the market is much too complicated to be designed by humans. Instead, the market is the byproduct of countless human interactions over time.\(^\text{112}\)

For Hayek, “we are able to bring about an ordering of the unknown only by causing it to order itself.”\(^\text{113}\) Failure to recognize the difference between constructed orders and spontaneous orders amounts to the “fatal conceit,” which breeds social engineering that restricts individual freedom and erodes market economies. The result of treating spontaneous orders such as the market as if they were merely constructed orders formed by human design is to advance on a path toward totalitarian serfdom.\(^\text{114}\)

Conducting business freely belongs to the realm of spontaneous ordering that draws upon self-generating features. Stressing the fundamental difference between spontaneous ordering and artificial ordering is fundamental in Hayek’s thought. His writings continually stress the supremacy of the former over the latter, claiming that it is next to impossible to make spontaneous order better by supplanting it with artificial varieties. Indeed, trying to “fix” apparent problems in spontaneous orders just ends up making things worse:

Most defects and inefficiencies of such spontaneous orders result from attempting to interfere with or to prevent their

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111. Id. at 73.
112. See id. at 84.
113. Id. at 83.
114. Id. at 7 (“The main point of my argument is . . . that the conflict between, on one hand, advocates of the spontaneous extended human order created by a competitive market, and on the other hand those who demand a deliberate arrangement of human interaction by central authority based on collective command over available resources is due to a factual error by the latter about how knowledge of these resources is and can be generated and utilised.”); see also HAYEK, supra note 2.
mechanisms from operating, or to improve the details of their results. Such attempts to intervene in spontaneous order rarely result in anything closely corresponding to men’s wishes, since these orders are determined by more particular facts than any such intervening agency can know. Yet, while deliberate intervention to, say, flatten out inequalities in the interest of a random member of the order risks damaging the working of the whole, the self-ordering process will secure for any random member of such a group a better chance over a wider range of opportunities available to all than any rival system could offer.\textsuperscript{115}

The natural law tradition supplies a theoretical basis for Hayek’s preference for the classical liberal ideal of limited government and strong confidence in competitive markets for the production and distribution of goods and services. Hayek deemed the free-enterprise economy to be a spontaneous order, and any substitute for it, like socialism, to be artificial. As such, the ascendancy of the free market over planned economies follows a fortiori from the preeminence of spontaneous order over artificial alternatives to it.

Applying Hayek’s insights to the ecology of the modern market, it is evident that today’s financial institutions are not isolated entities. Instead, they are thoroughly enmeshed in a web of property rights and innumerable day-by-day dealings, conventions, and traditions, including reputation and trust.

Pulling together the conceptual threads that have been spun, private property, private initiative, private risk, and private profit are all essential attributes of the capitalist system. These things, however, are economically effective only against a background of norms and values in which profit may certainly be kept in view, but seldom is the only goal at which business activity aims.

Francis Fukuyama has shown that populations possessing a culture of integrity and trust will succeed in generating material wealth and prosperity despite being situated under unfavorable conditions.\textsuperscript{116} In this regard, a society that has succeeded in amassing pools of social capital, such as that of the United States, not just through law and regulation, but also through the development of a broader culture, social networks,
and a wide array of private institutions, is going to be ahead of the curve in its ability to emerge from economic devastation.

Furthermore, it is reasonable to suppose that human nature leads us to build up, in addition to reputational and social capital, more tangible assets such as health care, food, housing, income, and so on. We regard an increase in such resources as good even before considering how the increase will be passed around to everyone.

Other things being equal, achieving more efficiency means having greater aggregate resources, in both tangible and intangible forms. Yet because regulatory regimes are unable to legislate and enforce all of the moral conduct necessary for optimal efficiency, market participants, in their pursuit of profit, have basic civic responsibilities to support cooperative business practices that enhance the overall efficiency of the market. What does this duty mean in the specific context of the current financial debacle? Market participants ought to:

- promote transparency of relevant information (for example, disclose the value of mortgage-related securities and other investments);
- refrain from abusing business-government relationships (for example, creating a dependency on, and expectation of, government bailouts);
- honor contracts, promises, and other commitments;
- avoid crony capitalism;
- avoid fraud;
- avoid insider trading;
- develop compensation programs that are fair and reasonable and reward executives for forthright conduct, not for indulging in vice.

Business leaders must develop virtues of cooperative action that will foster market efficiency, not burn it down. Based on views such as those of Smith and Hayek, it is clear that the task of cultivating such economic virtues penetrates far beyond the reach of legal regulation. Moral coordination, as a response to the rash of scandals, promises to circumvent the drawbacks of overt regulation and will be a step in the direction of building trust from Wall Street to Main Street.
B. No Bailout for Loss of Reputational and Social Capital

The preservation of overall market efficiency requires much more than market freedom and government regulation—it requires trust, transparency, and truth. In principle, governments possess the authority to enforce business agreements. Yet official efforts to provide legal insulation from all contractual breaches would be utterly futile were it not for a thick blanket of shared moral standards of promise-keeping and honor. Moral standards are essential for facilitating efficient economic activity. In a free market, these moral standards are properly “enforced” against individuals and firms alike, not primarily or exclusively with government regulation, but rather with reputational standards established by members of a free society.\textsuperscript{117} Recent studies show that a majority of people believe businesses ought to be held to the same or even higher moral and ethical standards as individuals.\textsuperscript{118} Moreover, a sizable percentage think we ought to hold companies to even more stringent standards than those to which we hold people, because businesses’ size, resources, knowledge, and impact greatly exceed those of individuals.\textsuperscript{119}

One important lesson from the crisis is that a deep connection exists between economic value and moral virtue. The physical and financial assets that market participants work so hard to establish on their books are fundamentally linked to the way they deploy—or destroy—intangible reputational assets such as credibility and transparency. Such intangible assets, which represent the most powerful force behind a firm’s long-term performance, are vanishing from our financial system virtually unnoticed. Thus, all of the effort to tally up the staggering financial losses from the collapse of Lehman and other financial institutions ignored a much greater and more significant loss of wealth from the raft of financial scandals: the catastrophic exodus of reputational and social capital from financial institutions and from corporate and political leaders. Indeed, even the reputation of capitalism itself has been sullied as a consequence of financial malfeasance.

\textsuperscript{117} See Kevin T. Jackson, Global Corporate Governance: Soft Law and Reputational Accountability, 35 BROOK. J. INT’L L. 41 (2010).
\textsuperscript{118} See, e.g., Valerie P. Hans, Business on Trial: The Civil Jury and Corporate Responsibility 120–21 (2000).
Both reputational capital\textsuperscript{120} and social capital\textsuperscript{121} constitute valuable forms of intangible wealth. Any business typically is involved in either creating or depleting them in their day-to-day activities. When tallying up the assets of a business enterprise one should include trust, good will, respect, fellowship, and sympathy among its stakeholders, as well as social networks that will serve to implant the enterprise within the field of moral sentiments of its constituencies. Among the valuable contributions of emerging theories of social capital and reputational capital are their explanation for why running a successful business does not necessarily require the kind of relentless pursuit of profit that is emblematic of the shareholder-centric theories of business.\textsuperscript{122} What it takes to build the reputational capital of a business—perhaps its most valuable capital asset—comes about from working towards things that are not readily

\textsuperscript{120} The concept of reputational capital refers to the intangible long-term strategic assets of a businessman or a business organization. Reputational capital is a hybrid of economic values and moral values. See RONALD J. ALSOP, THE 18 IMMOVABLE LAWS OF CORPORATE REPUTATION: CREATING, PROTECTING, AND REPAIRING YOUR MOST VALUABLE ASSET (2004); GRAHAME DOWLING, CREATING CORPORATE REPUTATIONS: IDENTITY, IMAGE, AND PERFORMANCE (2001); CHARLES J. FOMBRUN & CEES B.M. VAN RIEL, FAME & FORTUNE: HOW SUCCESSFUL COMPANIES BUILD WINNING REPUTATIONS (2004); CHARLES J. FOMBRUN, REPUTATION: REALIZING VALUE FOR THE CORPORATE IMAGE (1996); KEVIN T. JACKSON, BUILDING REPUTATIONAL CAPITAL: STRATEGIES FOR INTEGRITY AND FAIR PLAY THAT IMPROVE THE BOTTOM LINE (2004); PAINE, supra note 119.

\textsuperscript{121} The concept of social capital refers to intangible assets encompassing features such as personal aptitudes, social cohesion, and competency in problem-solving—traits that are entrenched in and conveyed by cultures. See DEMOCRACIES IN FLUX: THE EVOLUTION OF SOCIAL CAPITAL IN CONTEMPORARY SOCIETY (Robert D. Putnam ed., 2002). Francis Fukuyama, one of the earliest scholars of social capital, notes “the improbable power of culture in the making of economic society.” FUKUYAMA, supra note 116, at 1. Fukuyama further explains that the notion of social capital “has to do with people’s ability to associate with each other,” which is vital “not only to economic life but to virtually every other aspect of social existence as well.” Id. at 10.

\textsuperscript{122} In the United States, the legal roots of the shareholder-centered view extend back to the landmark case of Dodge v. Ford Motor Co., in which the Michigan Supreme Court held that a business corporation is organized primarily for the profit of the stockholders, rather than for the good of the community or its employees. 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.”).
captured explicitly on the balance sheet, even if part of their valuation concerns their contribution to the bottom line.\textsuperscript{123}

People are apt to flourish in surroundings in which overall social progress and cultural advancement are taking place. Growth comes about as a cooperative—not simply an individual—enterprise. The ability of sizeable groups to operate in conjunction with one another generates social trust, one of the essential components of market activity. Fukuyama states that “[t]rust is the expectation that arises within a community of regular, honest, and cooperative behavior, based on commonly shared norms . . . .”\textsuperscript{124} “These norms,” he notes, “can be about deep ‘value’ questions like the nature of God or justice, but they also encompass secular norms like professional standards and codes of behavior.”\textsuperscript{125}

The notions of reputational capital and social capital should both be brought squarely into the province of economic study. Both of these concepts capture intangible assets that businesses must cultivate. Although their origins are non-monetary, the resultant value of such assets can be reckoned in monetary terms. Established econometric theory is capable of making allowance for forms of intangible capital assets, such as social and reputational capital, just as it has for other varieties of capital—financial capital, organizational capital, human capital, and knowledge capital.\textsuperscript{126}

\section*{Conclusion}

Contrary to the amoral forms of discourse in which it has customarily been framed, the financial crisis is freighted with moral and cultural significance. Attempts to understand the crisis purely in functionalist, mathematical, and legal terms inevitably lead to a distorted view that will not help in mustering the enlightened leadership required to advance beyond the crisis toward a preferable situation of a sustainable market ecology. In this regard, the current economic scandal provides a special opportunity to recalibrate moral standards for market participants.

Two vital components of market ecology—reputational capital and social capital—are in part created and deployed by market participants themselves. In this sense, we might refer to

\begin{itemize}
  \item \textsuperscript{123} See generally Jackson, supra note 117.
  \item \textsuperscript{124} FUKUYAMA, supra note 116, at 26.
  \item \textsuperscript{125} Id.
  \item \textsuperscript{126} See Jackson, supra note 117, at 49–50.
\end{itemize}
them as micro intangible assets. Moreover, such intangible capital assets are created and deployed by the broader culture in which businesses operate. In this sense, we could speak of them as macro intangible assets. Whether we are talking about their micro or macro forms, reputational and social capital are fostered by cultivating moral virtue, according respect for human dignity, and advancing the common good, rather than aiming at profit maximization directly.

The ecology of the market, because of its deep dependence on spontaneous ordering and its imperilment in the face of constructed ordering, will be sustained more by increasing the stock of reputational and social capital (at both micro and macro levels) than by legal and regulatory intervention. The big lessons for leadership are therefore to be found in seeking moral reform rather than passing new laws.

In summary, there are two crucial points to bear in mind. First, there are grave perils in conceiving of the market as detached from the rest of society. Market failure points to a more general failure of responsibility, not only in business institutions but in the wider culture as well. This Article suggests how, by looking beyond the mindsets of the increasingly dehumanized fields of business management and economics and into a moral paradigm that sees the essential challenges as abiding in the hidden chambers of the human heart, we might approach the interconnected challenges of moral reconstruction and economic recovery.

Second, rather than ceding our freedom by responding with legal regulation, we need to look to moral reform. Regulation is no substitute for virtue. Stepping up government regulation in an attempt to enforce moral conduct in business will provide neither a satisfactory nor a lasting solution. What is lacking in the received narratives of the financial crisis is a robust conception of moral virtue, human dignity, and the common good. Adopting a wider moral-cultural mental model to examine the crisis has revealed that ultimately the economy and its current malaise rest not simply on observable and repeatable dynamics played out in housing and credit markets, but on a moral and cultural framework. If suffering the costly experience of our financial turmoil has not been enough, perhaps the foreshadowing of a much bigger collapse—that of our moral and cultural framework, which stands imperiled by the insidious and profound financial scandals beneath the crisis—will serve to summon us all to a higher calling.
DOES THE STATE CREATE THE MARKET—AND SHOULD IT PURSUE EFFICIENCY?

TIMOTHY SANDEFUR*

INTRODUCTION

The economic turmoil that began in late 2008 has led many pundits to trumpet the death of free markets and welcome the final proof that allowing individuals to make economic choices without government oversight will lead to injustice and poverty. It is therefore time not merely to examine the specific policies proposed to deal with present economic problems, but to address the broader context in which we interpret those problems and the deeper premises on which contemporary policy proposals rely. Whether it be the push for nationalized health care, for economic “stimulus” through government spending, for government takeovers of lending institutions, or for a host of other interventions, many of today’s proposals for expanding government’s role in private life have at their core a deeply flawed conception of the nature and function of markets. Only by reexamining these premises can we hope to make sense of the specific proposals advanced today.

The basic error is the common notion—shared by both left and right—that governments create markets, and must manage and control individual economic choices to ensure that those choices serve collective goals. President Bush famously confessed to having “abandoned” his “free-market principles” in order to “save the free-market system” and “ensure that the economy doesn’t collapse.”¹ In his book The Audacity of Hope,


President Obama complains about what he sees as a "tendency to take our free-market system as a given, to assume that it flows naturally from the laws of supply and demand and Adam Smith's invisible hand." President Obama believes that markets instead "depend[] on government action" to "open up opportunity, encourage competition, and make the market work better." Many of President Obama's intellectual allies are even more explicit on this point. Former Clinton Administration Labor Secretary Robert Reich has written that "[g]overnment creates the market by defining the terms and boundaries for business activity, guided by public perceptions of governmental responsibility for the overall health of the economy." Professor Cass Sunstein, recently appointed to a prominent office in the Obama Administration, agrees, and, quoting President Franklin Roosevelt's statement that economic laws are "not made by nature" but "by human beings," he contends that people "created economic markets and existing distributions. Laws underlay markets and made them possible. If they had good reasons for doing so, people might change those markets and existing distributions." A popular book on economics for the layman asserts that government "does not just fix the rough edges of capitalism; it makes markets possible in the first place." Another commenter holds that the "great fallacy of laissez-faire" is that "markets come first and social intervention thereafter," whereas "[t]he reality" is that "the state creates markets and sustains them: the important point being that it should do so in such a way that the individual energies released lead to socially desirable results."

In short, government supposedly creates the market by defining and enforcing property and contract rights; consequently, there is nothing particularly wrong with the government radically altering those rights, or the other terms on which individuals engage in economic transactions. Such alterations are not infringements on existing freedoms, but merely shifts in the distribution of rights that the state created in the first place.

I want to challenge this premise and defend the classical liberal proposition that markets do, in fact, come first—although I consider all such terminology misleading. The state is neither historically nor ontologically prior to the market. Nor is it prior to other types of free human interactions. It can therefore assert no “ownership” claim over the market as a justification for controlling individual economic choices. After addressing these issues, I conclude with some observations expressing reservation about the related argument that government policy should be organized to increase economic efficiency.

I. TANSTATM (“THERE AIN’T NO SUCH THING AS ‘THE MARKET’”)

The initial error in the claim that the state creates the market is that there is no such thing as “the market” in the first place. The term “market” is terribly misleading. When we speak of “the market” we are using shorthand for a whole spectrum of exchanges that take place between individuals. There is nothing unitary about these exchanges except in the abstract. To reify them, and to speak of “the market” as an existing entity, or as a corporate agent with an identity in itself, creates confusion, as expressed in the phrase “the market will do such and such.” Of course, markets do not do anything at all; only individual actors do. Economists observing transactions might group these individual actions into categories and observe certain trends within those categories, but “the market” is simply not the sort of thing that acts the way a living being does. When defenders of economic freedom say “the market will provide” a good or service in the absence of government interference, they are doing themselves a disservice. What they mean is that individuals are likely to pursue their self-interest by providing that good or service if they are free to do so.

It would be nice if the term “market” could be abolished entirely and replaced with another. The Framers preferred “commerce,” which has the advantage that it cannot take on that

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misleading definite article “the.” Even better would be “commercial intercourse,” or simply “intercourse.” This term would be preferable because it would emphasize that markets are interactions among people—just as sexual intercourse is intercourse between people. Nobody would speak of “the sexual intercourse” doing something, because such a phrase is incoherent; “sexual intercourse” is simply shorthand for a certain kind of interaction between people, which takes place in a variety of different contexts. Likewise, commercial or economic intercourse is a shorthand phrase, not a unitary entity that can do any particular action or act in any particular way.

The primary error of the assertion that the state creates the market lies in envisioning the market as a unitary institution that could be “created” in the sense that a car or a sculpture or Paley’s watch is created. The “market” is not such a thing—it is not a thing at all; it is a term for the multitude of economic interactions between individuals, each choosing for himself or herself which transactions are worthwhile. This mistake is by no means limited to those who advocate greater government control over economic choices; even so emphatic a defender of laissez-faire systems as Ayn Rand sometimes spoke of capitalism as having been “created.” Capitalism and free markets were never “created”; these words describe a category of intercourse that evolved along with other human behaviors. The market has characteristics and a nature, but no unitary purpose or design.

II. ECONOMIC INTERCOURSE IS NOT CREATED BY POLITICS BUT IS A RATIONAL RESPONSE TO INHERENT BUDGET AND TIME CONSTRAINTS

Economic exchange—what we sometimes call “the market”—arises from the intersection of limited resources and unlimited desires. Human beings are finite creatures, limited at the very least by their mortality. Every action therefore imposes an opportunity cost, and that means that, even in a state of nature, there would be limits on what human beings could accomplish in their efforts to survive and thrive. That they seek to thrive is the basic element of human ethical life. That they

have limited time and unequal capacities for thriving is simply an objective fact. Specialization and exchange is the rational solution to this problem. Economic intercourse is the logical response to comparative advantage, which is an inescapable consequence of differential opportunity costs. Exchange is implied by the need of living creatures to maintain their existence within the inescapable constraints of reality. The state need not enter into the picture at all.\textsuperscript{10}

Does the state create the exchanged resources? No, the resources exchanged are products of the earth, transformed into wealth by human effort. Does the state create demand? No, demand arises from the desire to thrive and the need for certain material elements—at the least, food and water. Does the state create the idea of mutual exchange? Unlikely; mutual exchange is a universal human trait. Adam Smith famously noted that nobody saw dogs deliberately and fairly exchange bones,\textsuperscript{11} but more recent research suggests that apes will make exchanges according to what appear to be norms.\textsuperscript{12} Indeed, most animals make "exchanges" of some sort, possibly even according to rudimentary social rules.\textsuperscript{13} Interactions between human beings of widely different cultures—for example, between American Indians and Western explorers in the fifteenth century and after—show that exchange (not to mention resentment at being cheated!) is a cross-cultural, universal human capacity. There was much wisdom in John Locke's observation:

The promises and bargains for truck, etc. between \ldots two men in [a] desert island \ldots or between a Swiss and an Indian, in the woods of America, are binding to them, though they are perfectly in a state of nature in reference to one another. For truth and keeping of faith belong to men as men, and not as members of society."\textsuperscript{14}

\textsuperscript{10.} See \textsc{Tara Smith, Moral Rights and Political Freedom} 31–59 (1995). This is a "state of nature" argument, but not vulnerable to the common criticism levied against state of nature arguments—that they depend on fictions.


\textsuperscript{12.} \textsc{Frans de Waal, Chimpanzee Politics: Power and Sex among Apes} 202 (2007).

\textsuperscript{13.} See Gerald S. Wilkinson, \textit{Reciprocal Altruism in Bats and Other Mammals}, \textsc{Ethology and Sociobiology} 85 (1988).

\textsuperscript{14.} \textsc{John Locke, Two Treatises of Government} 276–77 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690).
III. STATES ARE NEITHER HISTORICALLY NOR ONTOLOGICALLY PRIOR TO MARKETS

A. History Strongly Suggests that Trade Precedes the State

It is impossible to trace the historical origins of the state separately from the origins of economic intercourse. Most likely, the state evolved from tribal groups that cohered through different types of exchange and found it necessary also to exchange with other tribes.\(^{15}\) We can be certain that early man, like the higher apes, traded according to certain norms that were not the result of a deliberative political process, although they were certainly expanded and facilitated by such processes.\(^{16}\) Very likely, political institutions originated through a barter ritual such as Roger Masters describes: "[G]oods being offered by one group are placed next to an encampment without face-to-face contact; the resident group then inspects the offer and sets out a counteroffer if interested; finally, the group initiating the exchange either consummates the bargain or takes back its own goods and leaves."\(^{17}\) But because intertribal trading, especially over long distances, can be managed more effectively under a single individual or small group, political leadership may have originated to facilitate such trading\(^{18}\)—a tradition carried on into historical times in the form of ambassadors who simultaneously represent a nation’s commercial and political interests.

Many fundamental cultural institutions, including institutions central to the definition of a state, originated to serve the needs of trading and obtained their clearly political character only later. American Indian tribes, including the Cherokee, evolved pidgin “trade languages” to communicate when visiting other tribes on their trade routes. These languages predated European contact and clearly predated the formal legal institution of the Cherokee state.\(^{19}\) Even our own alphabet is inherited from Phoenician trad-

\(^{17}\) Id. at 101–02.
\(^{18}\) SERVICE, supra note 15, at 292–93.
\(^{19}\) JAMES MOONEY, HISTORY, MYTHS, AND SACRED FORMULAS OF THE CHEROKEES 187–88 (George Ellison ed., 1992). Indeed, formal legal institutions were adopted by (or were forced upon) the Cherokee largely in response to the needs of trade, or in response to the political consequences of trade. RENNARD STRICKLAND, FIRE AND THE SPIRITS: CHEROKEE LAW FROM CLAN TO COURT 40–72 (1975).
Does the State Create the Market?

ers who likely invented it to catalogue their wares.\footnote{Steven Roger Fischer, A History of Writing 90 (2001).} Countless other market institutions, including many types of contracts and trading instruments—even, probably, money itself—were invented not by states as such but by groups of traders.\footnote{James Buchan, Frozen Desire: The Meaning of Money 22-35 (1997); see also Niall Ferguson, The Ascent of Money 34-39 (2008).} And there are many examples of political or legal devices being fashioned by traders to suit the needs of trade.\footnote{The dearest example of political institutions arising out of existing economic institutions is probably the formation of the legal and political institutions of Iceland in the Medieval period, which “gives us a well-recorded picture of the workings of particularly pure forms of private enforcement and creation of law, and of the interaction between the two.” David Friedman, Private Creation and Enforcement of Law: A Historical Case, 8 J. LEGAL STUD. 399, 401 (1979).} The most famous example is the \textit{lex mercatoria} or Law Merchant, a legal system that had an ambiguous relationship with the state\footnote{Ralf Michaels, The True Lex Mercatoria: Law Beyond the State, 14 IND. J. GLOBAL LEGAL STUD. 447, 453-54 (2007).} and was perhaps entirely created by private actors who needed enforceable mores of trade.\footnote{Bruce L. Benson, The Enterprise of Law: Justice Without the State 30-35 (1990). Historians dispute the degree to which the \textit{lex mercatoria} was truly a private system of ordering. See, e.g., Stephen E. Sachs, From St. Ives to Cyberspace: The Modern Distortion of the Medieval “Law Merchant,” 21 AM. U. INT’L L. REV. 685 (2006). But however that dispute may be resolved, it is clear that the \textit{lex mercatoria} was not a centralized ordering system by which the state “created” the “market.”} Similarly, the eleventh-century Maghribi traders devised a privately enforced system of trading norms based on reputation.\footnote{Avner Greif, Institutions and the Path to the Modern Economy: Lessons from Medieval Trade 58-90 (2006).} In many countries, ethnically oriented codes substitute for formal institutions of contract law.\footnote{See Philip M. Nichols, A Legal Theory of Emerging Economies, 39 VA. J. INT’L L. 229, 273 (1999).} Even seventeenth- and eighteenth-century pirates—about as far from state actors as one could imagine—privately devised mores of trade to solve collective action problems that hampered the success of their enterprises.\footnote{See Peter T. Leeson, The Invisible Hook: The Hidden Economics of Pirates (2009).} Formal institutions that guide behavior and are backed by coercion or other penalties are a logical response to such collective action problems, which are endemic to any organization. It is therefore not surprising to find evidence that many of the formal legal institutions that we recognize, including norms of trade and the boundaries of property rights, evolved through the private...
decisions of economic actors rather than being given to economic actors by a state apparatus.\textsuperscript{28}

It is not that the market necessarily created the state: Economic intercourse and political intercourse grew up together in human history.\textsuperscript{29} Just as it was one of the great accomplishments of Enlightenment thinkers to formulate the distinction between government and society,\textsuperscript{30} so it was one of their great accomplishments to formulate the distinction between state and market. Locke, Milton, Defoe, Smith, Jefferson, and their contemporaries discovered that the state does not create individual liberty, but can help defend it. Likewise, the state does not create property or contract rights, but can facilitate them by publishing and enforcing norms of trade and respect. There is no obvious reason private institutions cannot perform this service,\textsuperscript{31} and such private institutions are in fact ubiquitous even today. For example, eBay employs a feedback mechanism as well as a private dispute resolution system to police the conduct of traders.\textsuperscript{32} And it may be that these

\textsuperscript{28} It might be thought that slavery was a market created by state intervention, and that property “rights” in human beings was an institution of positive law. In fact, however, slavery in the United States was not an institution created by law. See \textsc{Thomas R.R. Cobb}, \textit{An Inquiry into the Law of Negro Slavery in the United States} 82 (Philadelphia, T & J.W. Johnson 1858) (“[W]ith the exception of Georgia (where it was at first prohibited), no law is found on our statute books authorizing [slavery’s] introduction.”).

\textsuperscript{29} Robert Stevenson, after studying the formation of tribal states in Africa, concluded that “in far the majority of cases the process involved at least a three-way nexus between developing trade and trade routes, developing political and economic organization, and higher population densities, all reciprocally interacting and feeding back upon each other.” \textit{Service, supra} note 15, at 280.

\textsuperscript{30} See \textsc{Thomas Paine}, \textit{Common Sense}, in \textit{Collected Writings} 5, 6 (Eric Foner ed., 1995) (1776) (“Some writers have so confounded society with government, as to leave little or no distinction between them; whereas they are not only different, but have different origins.”). The central element of “social justice” movements is to break down this distinction and thereby allow the state to control any relationship that political leaders deem worthy of outside control. This is the source, among other disputes, of attacks on the “state action” doctrine in Fourteenth Amendment jurisprudence. See \textsc{Erwin Chemerinsky}, \textit{The Supreme Court and the Fourteenth Amendment: The Unfulfilled Promise}, 25 \textsc{Loy. L.A. L. Rev.} 1143, 1147–48 (1992).

\textsuperscript{31} See \textsc{Stephen Davies}, \textit{The Private Provision of Police During The Eighteenth And Nineteenth Centuries}, in \textit{The Voluntary City} 151, 151–81 (David T. Beito et al. eds., 2002). The collective action problem of funding such activities, which is handled through coercive taxation, is one serious problem, but there are theoretical solutions to this and other collective action problems. See \textsc{Ayn Rand}, \textit{Government Financing in A Free Society}, in \textit{The Virtue of Selfishness} 157, 157–63 (1964).

\textsuperscript{32} These policies are described in brief on eBay’s website. eBay, How Feedback Works, \texttt{http://pages.ebay.com/help/feedback/howitworks.html} (last visited Feb.
private alternatives are more cost-effective and suit the needs of buyers and sellers better than a state institution. Economist Peter Leeson has observed that although government contract enforcement does enhance certain kinds of trade, it does not do so to an impressive degree, and may actually hamper trade by crowding out more cost-effective private enforcement mechanisms.\footnote{33. Peter T. Leeson, \textit{How Important is State Enforcement for Trade?}, 10 AM. L. \\ \\ & ECON. REV. 61, 83 (2008).}

Fundamentally, the state does not create the things that are exchanged, the concept of or desire for exchange, or many of the formal institutions of exchange. It can help to enforce the norms of trade, thereby transferring the transaction costs in part from the contracting parties to taxpayers, but the effectiveness of such mechanisms is open to question. Either way, the proposition that political institutions \textit{create} the market appears to be untenable on historical grounds. In addition, there are some profound philosophical problems with that proposition.

\textbf{B. States Do Not Create Freedom}

It might be said that I am putting up a straw man; the assertion that states create markets is not intended as an historical assertion but as a theoretical model to show that political institutions are ontologically prior to economic exchange. But here, too, the argument falls short. Professors Laurence Tribe and Cass Sunstein, to name only two, start from this premise when criticizing \textit{Lochner v. New York}\footnote{34. 198 U.S. 45 (1905).} and other cases that struck down laws limiting the individual’s freedom of economic choice. According to Professor Tribe, the problem with \textit{Lochner} is that the Court compared the challenged restriction to a hypothetical “liberty” that did not really exist: “[T]he law is inevitably embroiled in the dialectical process whereby society is constantly recreating itself.”\footnote{35. Laurence H. Tribe, \textit{The Curvature of Constitutional Space: What Lawyers Can Learn from Modern Physics}, 103 HARV. L. REV. 1, 8 (1989).} In this process there is no such thing as a “neutral, ‘natural’ order of things,” and it is therefore impossible to compare a law to any such baseline.\footnote{36. Id. at 7.} Rather, we must realize that “legal ‘freedom’ of contract and property” are
“an illusion,” and that there is no such thing as natural freedom to which political or legal institutions can be compared. Rather, there is only a fluctuating set of rules and rights created by the state, a set that changes with social circumstances (in other words, the “dialectical process”). Professor Sunstein shares this view when he writes that the

private or voluntary sphere...[is] actually itself a creation of law, and hardly purely voluntary. When the law of trespass enable[s] an employer to exclude an employee from “his” property unless the employee [meets] certain conditions, the law [is] crucially involved. Without the law of trespass, and accompanying legal rules of contract and tort, the relationship between employers and employees would not be what it now is; indeed, it would be extremely difficult to figure out what that relationship might be, if it would exist in recognizable form at all.

These arguments run directly counter to the “leading principle” of American constitutionalism, which is that each of us is equally born free. This principle holds that each of us is presumed free to act and that those who would limit our freedom bear the burden of justifying such limits. This is the “presumption of liberty” that Professor Randy Barnett has rightly observed is implicit in the Constitution. It is explicit in the Declaration of Independence, which speaks of each person’s equal right to freedom as a fundamental principle and explains that governments are instituted only to protect that freedom. The presumption of liberty is not merely a rhetorical device or an arbitrary preference for a convenient starting point in philosophical argument. It inheres in the structure of logic itself—just as one cannot be expected to prove a negative, so one cannot be expected to prove that he ought to be free.

Using freedom from coercion as a natural baseline for policy analysis—the starting point for evaluating a legal regime—allows us to evaluate states in terms of universal human rights,

37. LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 578 (2d ed. 1988).
38. SUNSTEIN, supra note 4, at 30.
41. THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776).
42. See ANTHONY DE JASAY, JUSTICE AND ITS SURROUNDINGS 150 (2002).
as opposed to historically contingent dialectics. That we are born with a right to life means that we cannot justly be deprived of our lives without some good reason (for example, that we have committed a capital offense). Recognizing an individual’s right to life means that the burden of proof rests on the party who would restrict or eliminate that right—as opposed to a presumption in favor of death, which would require the living person to justify his existence. If we presume that individuals are born free and that coercion against them requires some justification, then we must also recognize that the freedom to engage in commercial intercourse is a logical starting point and that deviations from that starting point must be justified. This makes the ontological order clear, as it is in the Declaration of Independence. We are born with liberty, including the liberty to pursue happiness by commercial intercourse, and government is instituted to protect or to foster that freedom. That freedom may be limited only for good cause.

By contrast, the position advanced by Sunstein, Tribe, and others presumes that individuals have no rights unless they can propose and successfully defend their claims. If individuals can meet that burden, then the rights they receive are simply realms of individual action that government chooses to protect or subsidize—that is to say, privileges. Professor Sunstein is quite explicit: “[R]espect for private rights, the private sphere, and limited government should themselves be justified by publicly articulable reasons... In the United States, any particular conception of the private sphere must be defended by substantive argument.”

43. Cf. RICHARD A. EPSTEIN, BARGAINING WITH THE STATE 25 (1993) (“Baselines offer the initial positions against which the propriety of subsequent individual or government action can be judged. The selection of these baselines is the first part of any inquiry into bargaining with the state...”).

44. As John Locke put it when attacking a very similar argument, “His System lies in a little compass, ‘tis no more but this, That all Government is absolute Monarchy. And the Ground he builds on, is this, That no Man is Born free.” LOCKE, supra note 14, at 142.

45. What exactly would such a burden entail? As de Jasay observes, it appears that such a burden would be literally infinite, because the person would be required to disprove an infinite series of potential justifications for limiting rights. DE JASAY, supra note 42, at 150. It is conceivable, of course, that the state could set some lower standard as sufficient for a proposed rights claim, but such a lower standard would then be arbitrary. One can hardly imagine a weaker foundation for a right than a privilege that is given by the state to citizens on the basis of literally arbitrary criteria.

46. SUNSTEIN, supra note 4, at 247.
This model is replete with serious problems. First, it reduces all rights to potentially conflicting assertions with no guiding principle for resolving conflicts that do arise. If the state chooses to create one right for me and a different, contradictory right for my neighbor, how is this conflict to be settled? Do we have any right to be treated equally? Not if the state fails to grant us that right. And yet the whole purpose of rights, and of law, is to limit the power of the state, at least pursuant to some comprehensible standard that treats like cases alike.

The Tribe-Sunstein model would, in fact, give the lawmakers a degree of freedom withheld from ordinary citizens. Presumably, the lawmakers must deliberate over whether to grant people privileges, and that deliberation requires the lawmakers to have freedom to deliberate. Where do *they* derive this freedom? Evidently they gave it to themselves, or enjoy it by some inherent principle of superiority—something like "divine right." This contradicts the American conception of a government of the people, by the people—the principle underlying the legitimacy of our Constitution. Despite their appeals to principles of democracy, Tribe and Sunstein actually deny the principle of equal freedom on which democracy necessarily rests. Without a guiding principle of political rule, the lawmakers grant and withhold privileges on the basis of mere will, and their will trumps that of the citizens because they are of a different caste. This rule is not democratic.

Second, as Tom G. Palmer has observed, the Sunstein-Tribe model collapses into an infinite regress. According to their view:

I cannot have a right not to be tortured by the police unless the police have an obligation not to torture me, and the police can only have an obligation not to torture me if there are some taxpayer-funded persons (monitors) above the police who can punish them. . . . But to have a right not to be tortured I would have to have a right that the monitors exercise their power to punish the police for torturing me. Do I have that right . . . ? I would have such a right only if the monitors had a duty to punish the police, and the monitors would have a duty to punish the police only if there were some taxpayer-funded persons above the monitors who could (and would) punish the monitors for failing to punish the police, and so on, ad infinitum. For there ever to be a right of any sort . . . there would have to be an infinite hierarchy of people

threatening to punish those lower in the hierarchy. Since there is no infinite hierarchy, we are forced to conclude that [this is] actually ... an impossibility theorem of rights in the logical form of modus tollens: If there are rights, then there must be an infinite hierarchy of power; there is not an infinite hierarchy of power; therefore there are no rights. 48

In addition, under Tribe and Sunstein's view, the State cannot have any rightful authority to grant rights or privileges to individuals. If there is no prepolitical ground for individual rights, how can there be any prepolitical ground for political legitimacy? According to the social compact tradition articulated in the Declaration of Independence and the Constitution, government is legitimate because the people consent to it. But we can consent only because we have a prepolitical right to choose whether to consent or withhold that consent. By denying the existence of such prepolitical rights, Tribe and Sunstein reject—as did their Progressive-era progenitors, following Hegel49—the possibility of any principle by which the state might be justified or legitimized. Instead, the state is simply a historical inevitability (Professor Tribe's "dialectical process") in the face of which all talk of prepolitical standards is incoherent. 50 There can be no "principle" by which lawmakers may "rightly" create or withhold privileges from the people when forming a Constitution—they simply do what they want, because politics is at bottom an act of will, not of reason. This way of seeing things, of course, makes it impossible to distinguish free states from tyrannies, just rulers from unjust rulers, or

49. Harry V. Jaffa, in discussing the political philosophy of John C. Calhoun, makes an insightful comment on the subtle distinction between Hobbes and Hegel. Although Hobbes, like Hegel, advanced an intellectual framework for totalitarianism by denying the existence of prepolitical limits on the state, he started with the proposition that there is a state of nature in which all men are equal—a proposition Hegel rejects. For Hobbes, this equality and the capacity for reason in the state of nature leads man to make the rational agreement to create the state. But Hegel (like Sunstein and Tribe) denies the possibility of a state of nature, holding instead that man has no capacity for reason outside of the forces of history and is not equal in any prepolitical sense. See HARRY V. JAFFA, A NEW BIRTH OF FREEDOM 448-50 (2000) ("The equal right of all men to life and liberty is a foundation stone of Hobbes' political teaching, and this is anathema to Calhoun."). It is also anathema to Tribe and Sunstein.
healthy regimes from abusive regimes. In practice, it means that whatever political group happens to take power, by arms or by propaganda, is, *ipso facto*, legitimate. When it comes to political legitimacy, the citizen’s is not to reason why; his is but to do or die. If there are no such things as prepolitical standards of justice, then there is no such thing as a prepolitical legitimizing principle for any state. And this fact means that there is no difference between the arbitrary dictatorship of a military strongman and a polity governed by just laws; whatever the political authorities choose to call just is, by definition, just.

It cannot be too strongly emphasized how contrary this picture is to the principles underlying the American Constitution. The Framers believed the Constitution would help “decide the important question, whether societies of men are really capable or not of establishing good government from reflection and choice, or whether they are forever destined to depend for their political constitutions on accident and force.” Tribe, Sunstein, and their allies have rendered their answer strongly in favor of accident and force. But America’s founders knew, better than do the stars of today’s legal community, that if political leaders can choose which rights to give citizens, then they must constitute a caste enjoying by divine right greater freedom than the citizens whose rights they can grant or withhold at will. Such a scheme is at war with the principle of equality on which our democratic

51. Consider Aristotle’s distinction between true forms of government and perverted forms of government. This distinction is based on the principle that “governments which have a regard to the common interest are constituted in accordance with strict principles of justice, and are therefore true forms; but those which regard only the interest of the rulers are all defective and perverted forms, for they are despotic, whereas a state is a community of freemen.” ARISTOTLE, POLITICS BK. III CH. 6, in THE BASIC WORKS OF ARISTOTLE 1185 (Richard McKeon ed., 1941). These strict principles of justice are prepolitical even though Aristotle lacks a modern conception of individual rights.


53. In fact, this is merely a confession of their theory’s inadequacy. If one rejects all of the principles of an intellectual discipline that make the object of study comprehensible, then that object will seem arbitrary. The fact that their view of justice renders them unable even to distinguish just from unjust regimes, or to understand politics as anything other than an endless series of arbitrary claims to rule backed by mere coercion, is evidence enough that Tribe and Sunstein offer us not spectacles but a blindfold. See generally Leo Strauss, *Restatement on Xenophon’s Hiero*, in WHAT IS POLITICAL PHILOSOPHY? 95 (Univ. of Chicago Press 1988) (1959) (“A social science that cannot speak of tyranny with the same confidence with which medicine speaks, for example, of cancer, cannot understand social phenomena as what they are.”).
political institutions are based—an equality that, again, is not an arbitrary cultural preference, but a fact of reality, aptly described by Jefferson: "[T]he mass of mankind has not been born with saddles on their backs, nor a favored few booted and spurred, ready to ride them legitimately, by the grace of God."54

At bottom, the position advanced by Tribe and Sunstein is that all rights are actually privileges—benefits given to us by the grace of the state. But the fundamental difference between rights and privileges is that a right is not held at the mercy of another, or of the state. We deserve rights and are not answerable to our neighbors or the state when we exercise these rights. We cannot be made to pay for them. Privileges, on the other hand, are accorded to us by one in a superior position, who retains authority to restrict or eliminate those privileges; you do not deserve a privilege, and you can be required to pay for it. To say that the state "creates" our rights is to transform rights into privileges.

Let me reiterate that this difference between rights and privileges was seen by the Framers as the distinguishing grace of the American regime when contrasted with those that preceded it. Under the British monarchy, all rights were simply privileges accorded by Parliament or the crown, but revocable at any time.55 The American constitutions were written to ensure that rights would not be held at the sufferance of any government. "In Europe, charters of liberty have been granted by power," wrote James Madison. "America has set the example... of charters of power granted by liberty. This revolution in the practice of the world, may, with an honest praise, be pronounced the most triumphant epoch of its history...."56

C. What Would It Mean If the State Did Create Freedom?

In addition to the historical and philosophical flaws in the argument that states create economic or other kinds of freedom, the argument also implies several problematic consequences. The first is obvious if we return to my earlier analogy between commercial and sexual intercourse. The confusion between the state's protection of rights and the state's creation of rights becomes clear when

55. See 1 WILLIAM BLACKSTONE, COMMENTARIES *49 (arguing that the sovereign is "supreme, irresistible, absolute, [and] uncontrolled").
we ask whether the state also creates, say, a woman's right not to be raped. Following the argument advanced by Sunstein and Tribe, a woman has no inherent human right not to be raped; after all, her so-called private or voluntary sphere is a creation of law and hardly voluntary. Without the criminal laws against rape—and accompanying legal rules regarding marriage, divorce, and child-rearing, and the regulation of contraceptives, maternity care, or abortion—the relationship between men and women would not be what it now is. Indeed, it would be extremely difficult to figure out what that relationship might be, if it would exist in recognizable form at all. If a woman has a right not to be raped, then the burden would be on her to advance and justify that right in the public forum. The state might give her that right by promulgating and enforcing rules against rape, and it may do so because the lawmakers stand in a superior position to her—not in a position of equality—and are free to decide who does, and who does not, deserve this right.

This analogy makes clear that the notion that rights are created by the state—whether they be so-called economic rights or any other kind of right—can have horrifying consequences.

57. Although I use the analogy of rape here, one could choose many others. John Locke used cannibalism, pointing out in his First Treatise that if rights are merely permissions given to us by absolute governments, then “Princes might eat their Subjects, too.” Locke, supra note 14, at 160. Mark Twain, probably inadvertently, used this same example to comic effect in his story Cannibalism in The Cars (1868), reprinted in Mark Twain: Collected Tales, Sketches, Speeches & Essays 1852–1890, at 269–77 (Louis J. Budd ed., Library of America 1992). The humor in Twain's story comes precisely from the elected officials, who in the story are stranded on a train in the snow, arguing with great care and precision over the procedural details of a proposal to kill and eat one of their fellow passengers. The story would not be humorous at all to one who truly believed that individual rights are permissions extended to us by elected representatives.

58. Cf. Sunstein, supra note 4, at 30 (“Without the law of trespass, and accompanying legal rules of contract and tort, the relationship between employers and employees would not be what it now is; indeed, it would be extremely difficult to figure out what that relationship might be, if it would exist in recognizable form at all.”).

59. It is no answer simply to assert that this right is qualitatively more precious than the right to make free economic choices because if such a distinction exists, then it, and not the rest of their theory of rights, is doing the real work in Tribe and Sunstein's formulation.

60. I had thought this analogy somewhat fanciful until the Seventh Circuit Court of Appeals held that there is no constitutional barrier to the state eliminating the right to use deadly force in self-defense. See Nat'l Rifle Ass'n of Am., Inc. v. City of Chicago, 567 F.3d 856, 859–60 (7th Cir. 2009), cert. granted sub nom. McDonald v. Chicago, 130 S. Ct. 48 (2009).
Specifically, it empties the concept "right" of any real content, and replaces it with a "privilege" extended by a superior (the state) to the inferior individual, for the state's own purposes. Turn this argument whichever way one will, it is always the same old serpent, and one might say that every laudable effort in the history of American law has been aimed at exploding it in various forms. Few would suggest that the state creates the freedom of sexual intercourse—and nobody should argue that the state creates the freedom of economic intercourse.

There are two other (comparatively minor) problematic consequences implied by the notion that the state creates markets. First, if the state really is responsible for the existence of markets, it is not clear how black markets are possible. America's tragic thirteen-year experience with the prohibition of alcohol should have proved how difficult it is for government to eliminate commercial exchanges. But for decades now, federal, state, and local governments in the United States—armed with hundreds of billions of dollars, the highest quality weaponry and surveillance equipment available, and the dedicated service of thousands of brave and ingenious law enforcement officers, and aided by foreign governments and everyone from teachers to television writers—have hopelessly failed to eliminate the illegal drug trade. Black markets flourished even in the U.S.S.R. and North Korea—two of the most intense police states in human history. If governments do create markets, how can they be so inept at shutting markets down?

In a related vein, it is hard to explain the existence of inflation on the premise that economic exchange is the creature of the state. Inflation, simply put, occurs because consumers

61. Cf. ABRAHAM LINCOLN, Speech at Chicago, Ill. (June 10, 1858), in SPEECHES AND WRITINGS, supra note 39, at 1032-58 ("[T]he arguments in favor of kingcraft were of this class; they always bestrode the necks of the people, not that they wanted to do it, but because the people were better off for being ridden. That is their argument, and this argument...is the same old serpent that says you work and I eat, you toil and I will enjoy the fruits of it. Turn in whatever way you will—whether it come from the mouth of a King, an excuse for enslaving the people of his country, or from the mouth of men of one race as a reason for enslaving the men of another race, it is all the same old serpent...\ldots\). That Tribe and Sunstein add no racial character to their argument for inequality and the superiority of the rulers to the ruled changes nothing.

62. As Justice Blackmun wrote, "We protect those rights not because they contribute, in some direct and material way, to the general public welfare, but because they form so central a part of an individual's life. [T]he concept of privacy embodies the moral fact that a person belongs to himself and not others nor to society as a whole." Bowers v. Hardwick, 478 U.S. 186, 204 (1986) (Blackmun, J., dissenting) (citations omitted).
know that a dollar bill is not actually worth a dollar—or in Zimbabwe's case, that a fifty billion dollar bill is not actually worth fifty billion dollars. But how is this possible, if the state creates the market by formulating the conditions of exchange, and if, as Roosevelt and Sunstein assert, economic laws are not made by nature but by human beings? Evidently there are universal limits on the degree to which economic behavior can be controlled by the state's mere fiat. Where do these limits come from? They come from the interchange of supply and demand—that is, economic laws antecedent to the state's authority. The state does not create markets; it steps into markets—into the swarm of transactions that make up "the market"—and in doing so, the state is subject to principles of exchange over which it cannot assert absolute control.


64. There are some situations in which the state can more realistically be said to create markets, or rather, pseudo-markets. In these cases, the traded commodities are state-created privileges that would not exist in a state of nature—for example, transferable development rights (TDRs) or pollution credits (today called "cap and trade"), as well as copyrights and patents. These commodities are promises by the government to employ its coercive power (that is, monopolies), or refrain from employing coercion in certain ways. Government may permit consumers to trade these privileges, and trade in them will allow participants to rank priorities and allocate these privileges to more efficient uses. Such trade therefore resembles a market. But there are crucial differences between these pseudo-markets and genuine markets that reinforce my broader point that states do not create markets.

First, pseudo-markets exist purely at the discretion of a single entity—the state—and are therefore more like an auction within a single firm than like an open market of competing sellers. The state does not set the rules of trade (for example, the "cap") in response to actual consumer demand, but to its own political incentives. See Jerome W. Milliman, *Can Water Pollution Policy Be Efficient?*, 2 CATO J. 165, 185 (1982) ("[T]he market here is not a true market in that the number of permits would be fixed in relation to some predetermined environmental target . . . . There is no feedback from the users about water quality achieved and their willingness to pay on the supply of rights . . . ."). David M. Driesen argues that "mimicking free market features that do not coincide with desired policy outcomes proves counterproductive." David M. Driesen, *Is Emissions Trading an Economic Incentive Program?: Replacing the Command and Control/Economic Incentive Dichotomy*, 55 WASH. & LEE L. REV. 289, 337 (1998) (emphasis added). Desired by whom? Under conditions of voluntary exchange, economic incentives are created by consumer demand; any other sense of the phrase "desired policy outcome" is meaningless. Only a pseudo-market is organized around a "desired policy outcome"—desired by the state, that is.

Second, the items sold are created entirely by government fiat; they are not created, as is economic wealth, by the interaction of humans with nature. The state's
D. States Must Respect, Not Create, Our Rights

On an episode of *Meet the Press*, then-Senator Barack Obama summed up his view of the relationship between the state and the market: "If the market solution works, let's go with the market solution. If a solution requires government intervention, let's do that." But the moral equivalence suggested by this answer is actually shocking. A "market solution" is the result of uncoerced choices by individuals pursuing their interests with the knowledge and resources available to them. Government intervention, on the other hand, is an act of coercion, backed by state force, which deprives someone of the freedom to make choices and set priorities based on his knowledge and resources. Although intervention may benefit some, it simultaneously deprives others of their freedom and of their resources. Respecting the right of individuals to make free economic choices—just like respecting the rights to speak, worship, or love—is not just one among other morally equivalent options. It is a fundamental aspect of the freedom to which all people are naturally entitled, and depriving innocent persons of that freedom is an injustice. To regard these alternates as morally equivalent requires one to assume that the right to make economic choices for oneself is only a grace or privilege granted, however temporarily, by the state.

Yet states do not create—though they may foster or protect—the freedom of economic intercourse. Government is, among other things, a protective agency that can help individuals preserve rights that already belong to them. They could legitimately act to protect these rights themselves if they so chose. But because doing so is costly, time consuming, and potentially dan-

moral authority to create such goods is dubious. See Richard A. Epstein, *Takings* 189 (1985) ("How, it must be asked, is the city in a position to grant these rights . . . ? To do this, the city must first own the rights, which it acquired not by purchase . . . but by zoning [or other legislation] . . . . It is as though A uses money stolen from B to pay B for property purchased from him thereafter."); see also James L. Johnson, *Pollution Trading in LA LA Land*, 3 Regulation 44, 48 (1994). In addition, substitute goods are rarely possible, and there is no competition by producers who can lower prices.

Third, it is impossible for there to be a black pseudo-market. There can be a true black market in government privileges, but by definition there cannot be an unauthorized pseudo-market because the pseudo-market is by definition created by the government authorization. Pseudo-markets are therefore distinct from true markets in ways that support my thesis here.

gerous, the state acts as their deputy, doing so on their behalf and by their authority. That service could also be provided by other entities, and often is—by private security firms, for example. It would, of course, be unjust for a person to hire the services of a protective agency with money stolen from his neighbor, which is why legitimate government must be based on consent: It is a kind of contract of mutual protection, in which individuals purchase protective services with tax dollars. Here again we see why the freedom of economic exchange must precede the state and serve as one of the sources of its legitimacy.

IV. A COMMENT ON EFFICIENCY

I have thus far argued against the proposition that the state creates markets and thereby acquires authority to regulate markets to serve state ends. My point is obviously not to deny the importance of legal institutions in the working of economic intercourse. Rather, it is to challenge the premise upon which a number of policy arguments are based, particularly the view that “the market” is a thing that the state creates and that it might shape to achieve certain political goals. But this same error of considering “the market” as a unitary thing is also related to a different kind of policy argument.

Policy arguments on the left generally contend that legal institutions should organize “the market” to accomplish social justice goals, an argument that has been sufficiently refuted elsewhere, principally on the grounds that the term “social justice” is meaningless. But such an approach has at least the virtue that its normative house is in order: It explicitly aims to coerce economic choices in service of certain guiding principles. In this, it is unlike the typical claim on the right, which is that institutional ar-

66. See, e.g., MASS. CONST. of 1780 pmbl. (“The body politic is formed by a voluntary association of individuals: it is a social compact, by which the whole people covenants with each citizen, and each citizen with the whole people, that all shall be governed by certain laws for the common good. It is the duty of the people, therefore, in framing a constitution of government, to provide for an equitable mode of making laws, as well as for an impartial interpretation, and a faithful execution of them; that every man may, at all times, find his security in them.”).
68. See DEJASAY, supra note 42, at 127–69. See generally HAYEK, supra note 8.
69. The terms “left” and “right” are imprecise, particularly as there are people identified with the political left who nevertheless argue in favor of efficiency-maximization as a goal to be pursued in institutional arrangements. For example, President Obama
rangedments should be oriented to produce economic efficiency. A great deal of ink has been wasted explaining how various legal rules produce economically efficient results, or arguing that certain reforms would produce more efficient results. The problem is that the concept of efficiency is not a helpful guidepost for organizing economic or legal institutions, and in fact it smuggles in normative propositions that ought to be examined more openly.  

“Efficient” is an adjective that describes the fitness of a means to a given end. A means is efficient if it accomplishes an end with the least amount of waste—where “waste” is defined, somewhat circularly, as the unfitness of the means to the given end. Obviously what qualifies as efficient will differ depending on what ends one is pursuing. If a person wants to drive quickly from Los Angeles to Sacramento, it is efficient to travel north on Interstate 5, as opposed to, say, Highway 99. On the other hand, if the person wants to stop along the way to shop in various towns, it would be more efficient to take Highway 99 and arrive later. Efficiency measures the effectiveness of a trade-off: which actions will accomplish the desired end with the least amount of ineffective energy expenditure. The efficiency of the driver’s trade-off—time versus shopping detours—depends on the driver’s priorities. No transaction is entirely waste-free, but some trades are more effective than others.

What this discussion means is that there is no such thing as efficiency per se—there are only efficient means to particular ends. But ends are agent-specific, that is, different people pursue different ends. Which ends are rational for me to pursue may not be—indeed, are rarely—rational for another person to pursue. Thus, the means that are efficient for one person’s ends are not necessarily efficient for another person’s. There can be

argues that government must intervene in economic decisions to “deal[] with market failures—those recurring snags in any capitalist system that either inhibit the efficient workings of the market or result in harm to the public.” OBAMA, supra note 2, at 153.

70. For an outstanding elaboration of this point, see Louis De Alessi, Efficiency Criteria for Optimal Laws: Objective Standards or Value Judgments?, 3 CONST. POL. ECON. 321 (1992).

71. I am purposely avoiding the term “subjective,” used by Austrian economists when discussing this point. See, e.g., LUDWIG VON MISES, HUMAN ACTION 332 (3d ed. 1963). I think that word is misleading because the economic proposition here does not necessarily entail moral subjectivism. See generally Tara Smith, The Importance of the Subject in Objective Morality: Distinguishing Objective from Intrinsic Value, 25 SOC. PHIL. & POL’Y 126 (2008).

72. And with good reasons, chief among which is comparative advantage.
no such thing as “social efficiency”\textsuperscript{73} or “collective efficiency” because societies and collectives do not pursue ends—only individuals do.\textsuperscript{74} Moreover, there is no way to determine what means are most efficient for a rational agent other than to observe the transactions that a person makes.\textsuperscript{75} As James M. Buchanan puts it, “voluntary exchanges among persons, within a competitive constraints structure, generate efficient resource usage, \textit{which is determined only as the exchanges are made."}\textsuperscript{76} Given our limited knowledge of another person’s spectrum of needs and desires, it is impossible for any one person to say with confidence what is and is not efficient for another person.\textsuperscript{77}

\textsuperscript{73} See ISRAEL H. KIRZNER, MARKET THEORY AND THE PRICE SYSTEM 35 (1963) (“Society has no single mind where the goals of different individuals can be ranked on a single scale. . . . We are not invoking the notion of a society having its goals in any sense apart from the goals of the individuals making up the society. Efficiency for a social system means the efficiency with which it permits its individual members to achieve their several goals.”); FRANK HYNEMAN KNIGHT, THE ETHICS OF COMPETITION 34–35 (1997) (“It is impossible to form any concept of ‘social efficiency’ in the absence of some general measure of value . . . . Only within rather narrow limits can human conduct be interpreted as the creation of values of such definiteness and stability that they can serve as scientific data, [because] life is fundamentally an exploration in the field of values itself and not a mere matter of producing given values. When this is clearly seen, it will be apparent why so much discussion of social efficiency has been so futile.”).

\textsuperscript{74} See De Alessi, \textit{supra} note 70, at 335–36.

\textsuperscript{75} See Donald J. Boudreaux et al., \textit{Talk is Cheap: The Existence Value Fallacy}, 29 ENVTL. L. 765, 785 (1999) (“In market transactions, we can assume that all individual trades increase individual utility, because the occurrence of the trade itself suggests that the individual values the good received more highly than the good surrendered.”).


\textsuperscript{77} As Hayek said in his Nobel lecture,

\begin{quote}
Into the determination of . . . prices and wages there will enter the effects of particular information possessed by every one of the participants in the market process—a sum of facts which in their totality cannot be known to the scientific observer, or to any other single brain. It is indeed the source of the superiority of the market order, and the reason why, when it is not suppressed by the powers of government, it regularly displaces other types of order, that in the resulting allocation of resources more of the knowledge of particular facts will be utilized which exists only dispersed among uncounted persons, than any one person can possess. But because we, the observing scientists, can thus never know all the determinants of such an order, and in consequence also cannot know at which particular structure of prices and wages demand would everywhere equal supply, we also cannot measure the deviations from that order; nor can we statistically test our theory that it is the deviations from that “equilibrium” system of prices and wages which make it impossible to sell some of the products and services at the prices at which they are offered.
\end{quote}
Consider Richard Pryor's character in the movie *Brewster's Millions*, who must get rid of as much money as he can as quickly as possible, but is repeatedly frustrated that his purchases end up accidentally making him richer instead. The comedic value of the movie arises because, although these purchases would be brilliant investments for most people, they are economically inefficient for Brewster. For him, they are not wise. They are not means that fit his ends; they are inefficient.

The same is true of all coercive policies. If I want to spend money on X, and government makes me buy Y instead, that is not an efficient or wise investment for me, because I did not want Y. I wanted X. Even if Y is something that most people prefer, it is not one of my ends. (If it were, coercion would be unnecessary.) Even apparently universal goods—literacy, or a college education—are not actually universally good; there are circumstances in which it would be economically unwise for a person to undertake the costs of obtaining them. An illiterate man on his deathbed with only hours to live would probably prefer to spend that time with his grandchildren rather than learning to read. A single mother raising three children on her own would not find it economically efficient to quit her job and enroll in college. Economic choices are trade-offs, and although we all may make mistakes, the person with the best access to the knowledge necessary for determining which trade-offs are efficient is that person himself.

In short, ends are inherently personal, which means that economic efficiency is inherently personal. A transaction thus can be efficient only if it is voluntary. An involuntary transaction is one that the actors did not consider worthwhile—that is to say, it was not efficient in light of the transaction costs or other considerations. At the very least, a coercive transaction

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79. Viktor J. Vanberg, *Individual Choice and Institutional Constraints: The Normative Element in Classical and Contractarian Liberalism*, in *Rules and Choice in Economics* 208, 210 (1994) (“In saying that market outcomes are efficient, one claims, in effect, that the processes by which they are generated are ‘good,’ in the sense that through their market choices the constituent individuals reveal what they consider ‘good’ in their own judgment. . . . There is no reference to any standard that would allow one to judge the outcome independently of the transaction itself.”).
80. Nor, incidentally, can it be considered a moral good because choice is a necessary element in any moral good. See Tara Smith, *Viable Values: A Study of Life as the Root and Reward of Morality* 99 (2000). Note also that an individual need not
deprives a person of free choice, and for any compensation to truly make him whole—that is, to make the transaction efficient—the compensation would have to make up both for his economic and his psychological harm.

Economists have sought various substitutes for an agent-centered conception of efficiency in an attempt to rationalize coercive transactions under the efficiency criterion, but none of them have succeeded. For example, some define efficiency as an increase in social wealth; legal institutions ought therefore to aim for increasing the amount of wealth in society as a whole. But not all persons seek an increase in social wealth; a monk who has taken a vow of poverty certainly does not seek an increase in social wealth. To impose coercive policies on such a citizen in the pursuit of social wealth is to deprive him of utility. Moreover, if "wealth" is (mis)defined by reference to market prices, we risk overlooking that monetary prices do not accurately reflect utility; a transaction that appears efficient based only on the bottom line figures could easily result in a loss of total utility. Psychological factors not measurable in monetary terms must factor in. To implement—coercively or otherwise—a transaction that results in more cash value but reduces overall utility would be inefficient. And to impose a coercive transaction that deprives a person of free choice, and for any compensation to truly make him whole—that is, to make the transaction efficient—the compensation would have to make up both for his economic and his psychological harm.

Rather, the individual need merely act on the basis of transaction costs. The transaction cost of obtaining information may outweigh the value of a possible transaction. In such a case, the non-occurrence of a mutually advantageous exchange because of ignorance would still be efficient, because in light of the transaction costs, the exchange would not actually be mutually advantageous.

81. See, e.g., Richard A. Posner, The Ethical And Political Basis of The Efficiency Norm in Common Law Adjudication, 8 Hofstra L. Rev. 487 (1980). Posner contends that "[o]ne objection to using autonomy directly as an ethical norm . . . is that it requires an arbitrary initial assignment of rights." Id. at 496. But as we have seen, rights are not assigned, nor are they arbitrary. See DOUGLAS B. RASMUSSEN & DOUGLAS J. DEN UYL, NORMS OF LIBERTY: A PERFECTIONIST BASIS FOR NON-PERFECTIONIST POLITICS 299 (2005).

82. See De Alessi, supra note 70, at 330 ("At best, private (subjective or personal-use) values approach market (objective or observable) prices only at the margin.").

83. Anyone who has done a crossword puzzle without checking Google knows that the value of "doing it myself" differs from the value of completing the puzzle.

84. See De Alessi, supra note 70, at 334 ("The maximization of aggregate wealth implies that sources of utility not reflected in the aggregate do not matter and that changes in the wealth of individuals that do not result in a reduction of aggregate wealth also do not matter.").
party of utility and provides insufficient monetary compensation for that injury is simply to extract wealth from him to benefit others. That transaction is not efficient, at least for him, because efficiency to him means the accomplishment of his ends with the least amount of what he considers waste.

It is not that Pareto efficiency is a senseless concept, but it must subsume the agent-centered definition of efficiency: An outcome is Pareto efficient if it leaves nobody "worse off." But "worse off" can be defined only by each agent pursuant to that agent's own utility function—which means that if Pareto efficiency is to be meaningful, it must rely on individual value assessments. Substituting the pursuit of any other kind of ends (for example, maximization of society's monetary wealth) to decide whether people are made better or worse off is simply to smuggle in an outsider's own values under the counterfeit of objective assessment, and to impose them on the parties.

The same is true of Kaldor-Hicks efficiency, which is achieved if an outcome makes some people better off and if those who are made worse off could in theory be compensated for their loss. Given the personal nature of utility, such an outcome can only be truly efficient if, in fact, people accept that transaction voluntarily.

This point is not disproven even by a case in which an otherwise Pareto efficient transaction fails to occur because of the parties' lack of knowledge. It is true that parties may forego ex-

85. See id. at 336 ("The opinion that rules which lower transaction costs enhance efficiency is not value-free and may not be correct even within its own frame of reference.").

86. There are many problems with the notion. As De Alessi observes, Pareto efficiency requires an unattainable degree of knowledge if taken literally: Because all economic transactions have an endless chain of economic consequences, it is impossible to determine whether any transaction will make all persons better off. Cutting off the chain of consequences to say that only the parties to the transaction must be made better off is to smuggle in the normative premise that only the actual parties to that transaction have interests that ought to matter in the calculus. See id. at 338. Whatever criterion one uses to draw the line for cutting off the measurement of utility will then become the criterion with regard to which a given institution's "efficiency" will then be measured; the individuals' ends and valuations are no longer being consulted.

87. Note for instance that Posner defends the use of wealth maximization as a goal for social policy in part on the ground that, because it weighs the value of individual autonomy "less heavily" than does the classical liberal deontological principle of rights-protection, this approach fosters "the human impulse, apparently genetically based, to share wealth with people who are less effective in producing it." Posner, supra note 81, at 496. In fact, this is a euphemistic and disingenuous defense of forcible wealth redistribution; it means that the state is really doing us a favor when it coerces us to give our wealth away to others.
changes that would benefit them because they are unaware of the profitability of the transaction, or because one side is holding out above his reserve price. But the parties’ ex ante ignorance must be seen as a transaction cost that outweighs the foreseen benefits of the transaction. For the government to coerce the parties into such a transaction means that the taxpayers must assume those transaction costs instead, which requires its own set of justifications because each taxpayer now becomes a third (or fourth) party to the transaction. Moreover, those who would advocate that the state coerce the parties into the transaction bear the burden of proof to show that the state has better access to the information the parties lack. States rarely have superior information, even if we disregard the ways that rent seeking distorts the state’s decision of whether or not to force such transactions. Finally, there is the fact—particularly keen in the context of eminent domain—that a great deal of the utility that a prop-

88. In at least the vast majority of such cases, the result will be inefficient because the taxpayer's costs are rarely exceeded by whatever attenuated benefits they might enjoy as a consequence of such subsidies. See Richard A. Epstein, Takings: Private Property And The Power Of Eminent Domain 200 (1985).

89. See Bruce L. Benson, The Mythology of Holdout as a Justification for Eminent Domain and Public Provision of Roads, 10 Indep. Rev. 165, 186 (2005) (“Clearly, such transfers are not efficient in a Pareto sense, and we have no way to know whether they are efficient in a Kaldor-Hicks sense.”); Nicole Stelle Garnett, The Neglected Political Economy of Eminent Domain, 105 Mich. L. Rev. 101, 139 (2006) (“Determining the ‘efficiency’ (whether Pareto or Kaldor-Hicks) of any project enabled by eminent domain is difficult at best, given the multiplicity of a project’s possible costs and benefits, the length of the relevant time horizons, and so on.”); Daniel B. Kelly, The “Public Use” Requirement in Eminent Domain Law: A Rationale Based on Secret Purchases and Private Influence, 92 Cornell L. Rev. 1, 6-7 (2006) (“Because courts have no mechanism for determining how much existing owners actually (i.e., subjectively) value their property, courts routinely ignore actual value and instead rely on a property’s ‘fair market value’ . . . . However, because market value neither calculates nor compensates for a taking’s full costs (i.e., the actual value to the existing owners), a socially undesirable transfer may occur whenever the existing owners’ actual value deviates from the court-determined objective value. As a result, eminent domain may force a transfer where the existing owners value the land more than the private assembler.”). Thomas W. Merrill acknowledges that requiring the state to actually compensate a property owner for the full measure of his loss “would pose difficult valuation problems, for subjective value is inherently difficult to measure” and that “[i]f these difficulties suggest that full indemnification is unrealistic, then we can no longer be confident that every exercise of eminent domain authorized by the basic model is in fact efficient.” The Economics of Public Use, 72 Cornell L. Rev. 61, 84 (1986). He proceeds, however, to justify such takings by abandoning the principle of full compensation. For a discussion of the rent-seeking effects of redevelopment condemnations, see Donald J. Kochan, “Public Use” and the Independent Judiciary: Condemnation in an Interest-Group Perspective, 3 Tex. Rev. L. & Pol. 49 (1998).
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ty owner derives from his land is precisely his ability to determine the uses to which it may be put. The Supreme Court thus has observed that the right to exclude others is “one of the most essential sticks in the bundle of rights that are commonly characterized as property . . . .”90 In most cases, compensating a property owner even at fair market value will not make up for the injury done to this essential autonomy value.91

The theory of eminent domain advanced by some proponents of redevelopment is thus problematic.92 Susette Kelo’s house might have a monetary value of X, but that is not an adequate measure of her utility, which must include the value of her freedom of choice regarding the disposal of the property.93 If there existed a price that would compensate her for these things, she would willingly sell her home for that amount. It is true that she might “hold out” above her real reserve price, but there is no reason to believe that the state can accurately determine this fact, and every reason to suspect that its assertions on such matters are motivated more by rent seeking than by an actual access to greater stores of information. In any case, for the outcome to be truly Pareto efficient, the compensation would have to be enough to pay for her loss of free choice, something that is exceedingly unlikely. The far more likely outcome is that at least one party will end up worse off than if the exchange had not taken place. Pareto criteria are therefore more confusing than helpful when analyzing takings. The use of Kaldor-Hicks criteria—that the parties could in theory be compensated, but are not actually—is even worse, as it unapologetically incorporates the forcible elimination of one person’s just deserts for the benefit of others.94

As Louis De Alessi concludes, the use of economic efficiency as a guideline for the organization of legal and political institutions “suffer[s] from the use of implicit social welfare functions and the presumption that values can be measured by outside

91. I am indebted to my colleague R.S. Radford for these observations.
94. See De Alessi, supra note 70, at 337 (“Supporting a move on Pareto grounds without compensation implies the value judgment that the welfare gains of the gainers outweigh the welfare losses of the losers.”).
observers." The use of "increase in social wealth" or other poor substitutes for actual efficiency as goals for legal institutions is merely an attempt to substitute allegedly more scientific criteria for the old-fashioned standard of justice.

Justice, after all, is now widely considered an outdated term, burdened with normative baggage. And yet, as we have seen, the various criteria for "efficiency" used by law and economics scholars are also burdened with normative baggage: They presume that legal institutions ought to aim at an increase in wealth because an increase in wealth is good. I submit that, given the problems inherent in abusing words like "efficiency" and its failure to avoid the normative connotations it is supposed to avoid, it would be best for lawyers to return to their more comfortable homeland and to unembarrassed arguments about justice.

CONCLUSION

Recent efforts to increase government control over the economy are largely premised on the view that government is the source of our economic freedom and that it therefore has a responsibility to use its coercive powers to ensure that private decisions are made in accordance with the collective's priorities (as articulated by political leaders). But this premise is untenable. Economic freedom is not a creature of the state any more than our other freedoms are. The state may facilitate our freedom, but it only does so subject to moral and economic principles that precede politics. These principles cannot be escaped through the allegedly more "scientific" route of pursuing policies devoted to economic efficiency. The state ought to respect the preexisting rights of individuals; only that approach is truly efficient—or truly just.

95. Id. at 340.

96. Cf. Letter from James Madison to James Monroe (Oct. 5, 1786), in SELECTED WRITINGS OF JAMES MADISON 28–29 (Ralph Ketcham ed., 2006) ("I shall never be convinced that it is expedient, because I cannot conceive it to be just. There is no maxim in my opinion which is more liable to be misapplied, and which therefore more needs elucidation than the current one that the interest of the majority is the political standard of right and wrong. Taking the word 'interest' as synonymous with 'Ultimate happiness,' in which sense it is qualified with every necessary moral ingredient, the proposition is no doubt true. But taking it in the popular sense, as referring to immediate augmentation of property and wealth, nothing can be more false. In the latter sense it would be in the interest of the majority in every community to despoil and enslave the minority of individuals.... In fact, it is only reestablishing under another name and, a more spe[c]ious form, force as the measure of right....").
INTELLECTUAL HAZARD: HOW CONCEPTUAL BIASES IN COMPLEX ORGANIZATIONS CONTRIBUTED TO THE CRISIS OF 2008

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INTRODUCTION

This Article identifies an important but previously unrecognized systemic risk in financial markets: intellectual hazard. Intellectual hazard, as we define it, is the tendency of behavioral biases to interfere with accurate thought and analysis within complex organizations. Intellectual hazard impairs the acquisition, analysis, communication, and implementation of information within an organization and the communication of such information between an organization and external parties. We argue that intellectual hazard was a cause of the Crisis of 2008 and suggest that this risk may be an important factor in all financial crises. We offer tentative suggestions for reforms that might mitigate intellectual hazard going forward.

NASA's Mars Climate Orbiter, launched from Cape Canaveral with great expectations in December 1998, reached Mars on September 23, 1999. The spacecraft passed behind the planet and out of radio contact at 9:04 UTC and should have re-established contact twenty-one minutes later. It never reappeared. An investigation revealed that one of the two navigation teams assigned to the mission had been using metric system units and the other had been using the English system. Because of the difference between measurement units, the spacecraft entered orbit at too low an altitude and failed due to atmospheric stress and friction.

On February 20, 1995, Dr. Rolando R. Sanchez, a surgeon in Tampa, Florida, scrubbed and entered the operating room for a routine leg amputation. A blackboard in the operating room specified the leg to be amputated, as did the operating room

2. MARS CLIMATE ORBITER MISHAP INVESTIGATION BD., PHASE I REPORT 13 (1999).
4. Doctor Who Cut Off Wrong Leg Is Defended by Colleagues, N.Y. TIMES, Sept. 17, 1995, at 28 (reporting that the patient received an award of more than one million dollars); see also LELAND GREGORY, HEY IDIOT!: CHRONICLES OF HUMAN STUPIDITY 50–51 (2003).
schedule and the hospital's computer system. When Dr. Sanchez entered the room the patient had already been prepped for surgery, with one of her legs draped and sterilized. The doctor performed the surgery, only to learn that he had cut off the wrong leg. It turned out that other paperwork available in the operating room, including the patient's consent form and medical history, specified the proper leg. Dr. Sanchez had apparently relied on the more commonly used sources of information about the procedure and never consulted the materials that could have prevented the mistake.

Each of these disasters resulted from a common, dangerous, but little-recognized phenomenon. These events took place within complex organizations—a bureaucratic agency with numerous teams and subcontractors working on the same project, and a hospital with its network of physicians, nurses, equipment, and systems for medical and financial record-keeping and control. The mistakes were elementary—so elementary that if a single person had been carrying out the task, rather than a complex team, they never would have happened. Yet the consequences of those mistakes were devastating. The problem in both cases was the failure of the complex organization to properly acquire, communicate, analyze, and implement information pertinent to risk and crucial to the success of the operation.

The catastrophic events in financial markets during the fall of 2008—events we will refer to hereafter as the "Crisis of 2008"—

5. Doctor Who Cut Off Wrong Leg Is Defended by Colleagues, supra note 4.
6. Id.
were more complicated than these disasters, but there are also significant parallels. Financial markets today are among the most sophisticated, well-funded, well-informed, and technologically advanced institutions in the world. They process trillions of dollars in transactions each year. Many highly trained, hard-working, brilliant people work in the industry. Yet these markets and their regulators suffered an astonishing breakdown in 2008. Few people fully appreciated the implications of the housing market bubble or understood the risk that the burgeoning market in subprime mortgage-backed securities posed for the world’s financial system. Those who did understand were unable to make their voices heard. When the storm made landfall, in September 2008, financial markets and their regulators were as woefully unprepared as the City of New Orleans in the face of Hurricane Katrina. What went wrong?

The thesis of this Article is that the Crisis of 2008 was partially caused by a problem with the processing of risk-related information in complex organizations. In the Crisis of 2008, as in the Mars mission and the leg amputation, actors in complex organizations failed to properly acquire, process, transmit, and implement key information pertinent to risk. We call this problem “intellectual hazard.” Intellectual hazard, as we define it, is the tendency of behavioral biases to interfere with accurate thought and analysis within complex organizations, thus interfering with the acquisition, analysis, communication, and implementation of information both within an organization and between an organization and external parties. Our conception of intellectual hazard, to the best of our knowledge, has not been previously identified as a systemic problem in financial markets, although astute commentators have pointed to many specific examples without recognizing that all are part of the same general phenomenon. We suggest that efforts to reform financial markets should address the problem of intellectual hazard in order to mitigate the risk of future disasters.


8. This Article is thus a contribution to the growing literature on the psychological determinants of the financial crisis. For other work dealing with the general topic, see Claire A. Hill, Investor Psychology and the Financial Crisis (unpublished manuscript), available at http://ssrn.com/abstract=1407138.
Part I of this Article discusses the concept of intellectual hazard. Drawing on research in psychology, behavioral finance, and behavioral economics, we identify three general types of intellectual hazard: complexity bias, incentive bias, and asymmetry bias. Part II illustrates how intellectual hazard manifested itself in some of the key institutions of financial markets before and during the Crisis of 2008. Part III offers possible reforms that take account of the risk of intellectual hazard.

The analysis in this Article is preliminary. Any comprehensive analysis of the problem of intellectual hazard in financial markets would require a much more extensive treatment than is possible here. We hope that these ideas may contribute to the debate on financial market reform and stimulate greater concentration on the problems of information processing in complex organizations of the financial market.

I. INTELLECTUAL HAZARD

One should understand the concept of intellectual hazard in reference to the better-known problem of moral hazard, a term drawn from historical practices in the insurance industry. Actuaries who set premiums would assign values to known hazards. So, for example, an ocean voyage by a merchant might carry the risk that the ship will go down in a storm, that the cargo will be eaten by rats, that the vessel will be captured by pirates, and so on. The actuary will give each of these risks a value for purposes of calculating the insurance premium. But in addition, actuaries recognized a special kind of hazard—the risk created by the insurance contract itself. An insured policyholder loses much of the incentive he would otherwise have to avoid risk. Even worse, if the value of the property falls below that of the policy, the policyholder gets an affirmative incentive to cause the very harm against which he has obtained insurance. People may thus burn down their houses with the intention of collecting the insurance benefit. In the insurance industry, the risk from the insurance policy itself is the "moral hazard."  

9. See Paul Milgrom & John Roberts, Economics, Organization and Management 195 (1992) (defining moral hazard as "any behavior under a contract that is inefficient, arises from . . . differing interests . . . and persists only because one party to the contract cannot tell for sure whether the other is honoring the contract terms").
The term “moral hazard” later became associated with financial markets. The problem arises when governments provide implicit or explicit insurance against the failure of financial firms. Deposit insurance is the obvious example. When depositors are insured against losses from the failure of their bank, they lose the incentive to monitor their banks to prevent failure. Freed from this form of market discipline, bankers have less incentive to avoid risks, and instead gain an incentive to undertake socially undesirable levels of risk.10 Deposit insurance is an obvious example of moral hazard, but it is not unique. As the events of 2008 illustrate, governments are often unwilling to allow any financial firm to fail, whether or not it has insured deposits, if that firm is either so large or so interconnected to others that its failure would jeopardize the stability of financial markets as a whole. Moral hazard is a well-known phenomenon, and a great deal of work has gone into identifying its incidence and designing strategies to reduce its effects.11

Intellectual hazard is similar to moral hazard in the following respects. Moral hazard is a problem that results from a structural feature of markets that is in other respects highly beneficial: the shifting of risk to more efficient risk-bearers. Similarly, intellectual hazard results from the otherwise beneficial division of responsibility among specialized instrumentalities. Like moral hazard, intellectual hazard is pervasive. Just as moral hazard exists whenever risk is shifted away from an actor whose actions may cause harm, intellectual hazard exists whenever production becomes segmented into complex organizational forms. And like moral hazard, intellectual hazard can present systemic risks: Because it affects organizations that are large, interconnected, or linked to many other similarly situated organizations, intellectual hazard can pose a threat to the stability of an entire system of markets or institutions.12 In particular,

intellectual hazard poses a threat to the smooth, orderly, and efficient functioning of the world’s financial markets.

Scholars and astute market participants have already identified aspects of intellectual hazard in financial markets.\(^{13}\) Useful examples fall into three broad categories: complexity biases, incentive biases, and asymmetry biases. These categories, although generally descriptive, are not necessarily exclusive: Some of the biases we identify as falling within one of the categories may also reflect elements of other categories as well, and sometimes a given bias will be the result of the simultaneous operation of two or more of these categories. The tripartite grouping, however, is a helpful way to organize the different manifestations of intellectual hazard, even if the category system is not always clear-cut.

A. Complexity Bias

The first type of intellectual hazard arises from an actor’s tendency to analyze a situation wrongly because the actor has a limited ability to interpret complex sets of information within the time period needed for decision. An example is tunnel vision. An actor tasked with carrying out a particular function within a complex organization tends to see only the information apparently necessary to carry out that task. All other information is excluded, even if it is available. Like a horse with blinders, the actor is shielded from other information in order to allow that actor to focus on the specific task at hand. The term “tunnel vision” is derogatory, but the focus it implies is often beneficial because it enhances the efficiency of operations. But sometimes the limitation on the field of vision can be dangerous. A horse with blinders may not be able to see a train oncoming from the side.

Another complexity bias is confirmation bias.\(^{14}\) When the world presents a welter of information to an actor, he needs to

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13. The field of behavioral finance is largely concerned with identifying biases of the sort we have classed under the general heading of intellectual hazard. For a good introduction, see ADVANCES IN BEHAVIORAL FINANCE (Richard H. Thaler ed., 1993); BEHAVIORAL LAW & ECONOMICS (Cass R. Sunstein ed., 2000); KAUFMAN, supra note 7; MICHAEL M. POMPIAN, BEHAVIORAL FINANCE AND WEALTH MANAGEMENT: HOW TO BUILD OPTIMAL PORTFOLIOS THAT ACCOUNT FOR INVESTOR BIASES (2006); RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008); RICHARD H. THALER, QUASI RATIONAL ECONOMICS (1991).

14. See POMPIAN, supra note 13, at 187 (describing confirmation bias as “a type of selective perception that emphasizes ideas that confirm our beliefs while devaluing whatever contradicts our beliefs”).
make sense of it within the context of his assigned role. The actor, examining the information available, will tend to see a confirmation of his previous expectations, even if the evidence is more consistent with a different state of affairs.\textsuperscript{15}

Representativeness bias is another response to the problem of complexity that occurs when a person wrongly assumes that a sample is a reliable measure of an unobserved variable.\textsuperscript{16} An actor in a complex organization may have only a limited exposure to a particular problem or issue. He may assume from past experience that the sample is an accurate estimate of the phenomenon in the future, when in fact it may be too small to support reliable population inferences, or may have come from the population in a non-random way.\textsuperscript{17}

Oversimplification bias is a different response to the problem of complexity. People in complex situations do not have the time, energy, or capacity to analyze all of the available information. They need to use simplified rules of thumb to enable them to operate. Given bounded rationality, rules of thumb or heuristics are valuable resources for allowing actors with limited capacities to function efficiently in complex organizations. Because rules of thumb are simplified, however, they introduce error.\textsuperscript{18} And because rules of thumb tend, for obvious reasons, to be developed as means for coping with normal and expected situations, they are likely to operate poorly when an actor confronts abnormal or unexpected conditions.

Still another example of complexity bias is authoritarian bias, the tendency to overvalue information from authoritative

\textsuperscript{15} Confirmation bias is similar to “conservatism bias,” which refers in behavioral finance to the tendency of investors to under-react to new information, maintaining impressions from a previous estimate rather than acting on updated information. See id. at 119, 187.

\textsuperscript{16} See id. at 62. A related phenomenon, “recency bias,” refers to the tendency to recall and emphasize recent events more prominently than events that occurred long ago. See id. at 216.

\textsuperscript{17} For some evidence on representativeness bias, see Geoffrey P. Friesen et al., Price trends and patterns in technical analysis: A theoretical and empirical examination, 33 J. BANKING & FIN. 1089, 1099 (2009) (concluding that investors’ interpretation of signals with relatively low information content tends to be biased by the recently observed large signals).

\textsuperscript{18} See POMPIAN, supra note 13, at 94 (explaining a similar bias known in behavioral finance as the “availability bias”).
Hierarchies of authority, formal or informal, inevitably define the scope of an actor’s autonomy in complex organizations. In some cases the authority will be within the organization—the actor reports to a supervisor who has the power to instruct him on how to carry out his responsibilities. In other cases the authority will be someone from outside the organization whose opinion is used as a basis for decision (rating agencies, attorneys, auditors, and so on). In still other cases the authority will have no formal role in the actor’s activities, but will nevertheless exercise influence because of the authority’s prestige or position of power in some other organization. In any of these situations, the actor may tend to defer excessively to the authority without exercising independent thought or judgment as to whether the information received is actually reliable.

B. Incentive Bias

A different category of bias has to do with the self-interest of the actor. In many cases actors have a personal interest in the facts being one way rather than another. They thus want to see the world in accordance with their self-interest.

An example of incentive bias is herding behavior. An actor in a complex organization observes other actors similarly situated interpreting the world in a particular way. The actor has a choice between following the crowd or dissenting and offering a different view of the situation. Often the actor might determine that the better course of conduct is to conform to the consensus opinion. If he does so he is unlikely to receive criticism, even if the conventional view turns out to be wrong, because nearly everyone else was making the same mistake. On the other hand, if he dissents, he calls potentially unfavorable attention to himself. Even if he turns out to be right, he may suffer adverse consequences in the short term, and the long-term

rewards he can anticipate from being right may well be outweighed by the sanctions he can anticipate from being wrong.\footnote{21}

Another example of incentive bias is cognitive dissonance.\footnote{22} An actor working in a complex organization may have an incentive to see things in a particular way. But the information available to the actor suggests a different interpretation, inconsistent with the actor's self-interest. This inconsistency creates cognitive dissonance in that the actor finds it uncomfortable to see things in a way that potentially threatens his interests. A solution to the problem is to see things in the more convenient, comfortable way and to put out of mind concerns about possible competing interpretations. Complacency effects could also be examples of cognitive dissonance. Actors in complex organizations, especially senior actors, want to believe that someone is minding the store, that risks are properly accounted for, and that proper checks and balances are in place to prevent things from getting out of hand. Wanting to believe these things, the actors are likely to consider the organization to be well organized to manage risk even when it is not.\footnote{23}

Loss aversion is also a form of incentive bias.\footnote{24} Loss aversion occurs when an actor wishes to avoid the recognition of a loss for which the actor may have some responsibility. The actor wishes to cover up the loss, or to put off the evil day in which the loss is recognized, in hopes that some stroke of good fortune prevents that day from ever happening. Loss aversion bias can be a key factor in situations involving rogue traders,


\footnote{23. Complacency bias, in this sense, has certain features in common with overconfidence bias, a term in behavioral finance referring to the propensity of investors to underestimate the downside risks of their portfolios and to feel too certain of the correctness of their judgments. See POMPIAN, supra note 13, at 51–52. On overconfidence bias generally, see Donald C. Langevoort, Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms), in BEHAVIORAL LAW & ECONOMICS, supra note 13, at 144, 149.

\footnote{24. See POMPIAN, supra note 13, at 208 (referring to the tendency of investors to feel a stronger impulse to avoid losses than to acquire gains).}
where an actor who has incurred a loss because of unauthorized activity engages in ever-riskier gambles in hopes of never being called to account for his or her misconduct.

Incentive bias is also manifested in self-serving behavior. In this case, the actor knows or has good reason to know that the facts are a certain way, but deliberately ignores the facts, suppresses information, or distorts analysis out of a conscious intention to promote the actor's own interests.

C. Asymmetry Bias

Asymmetry bias arises when actors in a complex organization bring pre-formed and fixed ideas, judgments, or attitudes to bear in the analysis of information. The biases that concern us influence market participants to act in ways that give inappropriate or unequal weight to information and analysis supporting certain conclusions.

A common form of asymmetry bias is status quo bias, first identified in work by Professors Samuelson and Zeckhauser. Actors have a tendency to overvalue the status quo even if evidence and analysis suggests another course of action more strongly. Other biases that relate closely to status quo are the endowment effect and loss aversion bias. The endowment effect is reflected in an individual's asymmetric unwillingness to sell an asset to purchase an asset of like (or even somewhat greater) value. Loss aversion bias (which we also noted as a self-serving bias) is manifested in an actor's greater unwillingness to take actions that would result in a loss compared to actions that would result in a comparable (or greater) gain. Taken together, these biases impair the ability of organizations to appropriately process


and act on information and analysis. These biases are particularly harmful in times of market stress, when undue attraction to the status quo, the endowment effect, and the loss aversion bias inhibit the organization from taking actions that are in its economic best interest. Thus, these biases tend to be pro-cyclical.

Other asymmetry biases contribute to intellectual hazard. The ostrich effect is the tendency for market actors to ignore news, data, or analysis that imply negative outcomes. It is a specific instance of positive outcome bias or optimism bias. These biases result in the systemic overvaluation of data and analysis that fall in the "right-hand" tail of outcomes and result in suboptimal actions. Another form of asymmetry bias is regret aversion, the tendency to avoid making decisions that turn out badly.

D. Intellectual Hazards in Financial Markets

These various biases take different forms and manifest themselves in different ways, but all of them have the common feature that they reflect the failure of actors in complex organizations to engage in independent, unbiased analysis of information in carrying out their responsibilities. Intellectual hazard, in this sense, is present in all complex organizations at all times. Ordinarily, however, the negative aspects of intellectual hazard are managed at reasonable cost through systems such as cross-checking within organizations, independent auditing by third parties, and scrutiny by government regulators.

Intellectual hazard, however, becomes problematic in two situations. One of these is the "bet the ranch" scenario where a single decision can have profound consequences. In such a case it is no solace that complex organizations get it right most of the time; it is not acceptable that they get it wrong even once. Dr. Sanchez's patient probably felt that way upon waking up in recovery with the wrong leg missing. It would not have been particularly comforting to know that most doctors cut off the proper leg most of the time.

The second situation where intellectual hazard is problematic—and the one most pertinent for purposes of this Article—is

29. See Niklas Karlsson et al., The ostrich effect: Selective attention to information, 38 J. RISK & UNCERTAINTY 95, 96 (2009).

30. See POMPian, supra note 13, at 227 ("People exhibiting regret aversion avoid taking decisive actions because they fear that, in hindsight, whatever course they select will prove less than optimal.").
when the ordinary safeguards of checks and balances break down because of unusual conditions affecting the entire organization or system. In financial markets, this danger manifests itself particularly strongly in the case of asset bubbles. When asset prices experience an unusual and prolonged rise—say, four or five years of uninterrupted unusual growth—the usual checks and balances against intellectual hazard can be severely eroded.

In normal circumstances, financial markets are populated by a mix of optimists and pessimists—bulls and bears. If the market does better than expected in a single year, optimists will tend to receive rewards for having predicted outcomes correctly. They will receive bigger bonuses, be preferred for promotion, and so on. But because everyone knows that markets go up and down, the effect will not be pronounced. If, however, asset prices continue to surge for a number of years, the selection effects will become significant. Positive thinkers will come to dominate trading desks and management positions, bullish analysts will attract larger followings among investors, optimistic journalists will see their stories given greater prominence and read by more people, sunny thinkers will gain prominence in government. And because optimists value optimism, they will promote other optimists to positions of power and influence. The power of positive thinking will give further force to the market expansion. All this optimism triggers intellectual hazard—optimism bias (obviously) and also phenomena such as herding, self-serving bias, policy bias, confirmation bias, tunnel vision, and authority bias.31

Problems with intellectual hazard also manifest themselves at the point where the economic boom turns into a bust. At this point, complex organizations are likely to be poorly equipped to deal with the sudden changes. Actors who have grown accustomed to seeing things in a particular way cannot quickly readjust to the influx of new information. Meanwhile, they will probably need to engage in crisis management that allows little time for thought or reevaluation of fundamental assumptions. Being unprepared for the sudden change, they may handle decisions

poorly or panic in the face of information overload. The panic, moreover, can further exacerbate the problem by eliminating the healthy diversity of viewpoints that tends to keep intellectual hazard in check during normal times. The very definition of a panic is that everyone, or nearly everyone, comes to evaluate market conditions in the same way and therefore rushes to reduce their exposure to risk, creating a vicious cycle in which losses of liquidity trigger even more panic and greater turmoil.

Because intellectual hazard is a special problem during periods of unusual asset price increases, it is not just a general phenomenon of complex organizations. It is also a form of systemic risk. It is pro-cyclical—magnifying and extending the duration of asset price increases on the way up, and enhancing and extending asset price collapses on the way down. Intellectual hazard is therefore more than a pervasive but low-grade problem for financial markets. It can metastasize into a serious threat to the stability of the system as a whole in unusual times.

II. INTELLECTUAL HAZARD AND THE CRISIS OF 2008

It is impossible to provide a full description of all the ways intellectual hazard contributed to the market turmoil of 2008. This Article will attempt to provide some examples, however, with a view to encouraging further investigation.

32. Bear Stearns's quarterly filing with the SEC in the quarter following its failure in March 2008 nicely illustrates this point. The company stated:

Human error in times of extreme difficulty and turmoil, such as the Company recently experienced and continues to experience, can occur. Moreover, control and process breakdowns may be more frequent when a company is operating under duress and its employees become distracted by crisis management and the uncertainty surrounding the viability of the enterprise. These events and potential impacts may have had and may have an adverse impact on the efficacy of our disclosure controls and procedures and our internal controls over financial reporting.

Bear Stearns Co., Quarterly Report (Form 10-Q), at 80 (Feb. 29, 2008).


A. Banks

An important source of intellectual hazard in the crisis was the over-reliance of investment banks on mathematical or computer models. The models themselves are potentially useful tools. But like all tools, they can be misused. In the case of the financial system, traders and others employed the models uncritically, while having little if any clue about their inherent limitations. The models assumed a life of their own, and ordinary judgment and common sense were forgotten.

Three main problems impair the accuracy of financial models. First, they are inevitably based on historical assumptions about the behavior of markets and prices. Although historical data points can be useful in ordinary times, they are not necessarily reliable predictors during a crisis. The models must extrapolate from the ordinary to the extraordinary by using assumptions that may not be accurate, as the founders of Long Term Capital Management discovered to their dismay when that firm failed in 1998, largely because of trading strategies based on models that broke down in unstable markets. In the case of subprime mortgage securities, Wall Street’s models tended to predict accurately the effects of a significant downturn in housing prices, but few took these predictions seriously because most considered a housing collapse to be unlikely.

A second problem with models is that they deal with complex dynamic systems in which outcomes may be path-dependent and sensitive to differences in initial conditions.

35. For a review of the costs and benefits of economic models in addressing real-world economic problems, see, for example, DAVID C. COLANDER, ECONOMICS (5th ed. 2004).
36. For criticism of excessive reliance on models, see, for example, Steve Lohr, Wall Street’s Extreme Sport: Modeling Risk, Financial Engineers Didn’t Account for Human Factor, N.Y. TIMES, Nov. 5, 2008, at B1.
37. See LOWENSTEIN, supra note 7, at 233–34.
38. See Kristopher S. Gerardi et al., Making Sense of the Subprime Crisis, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: FALL 2008, at 69, 69 (Douglas W. Elmendorf et al. eds., 2009) (finding that “analysts generally understood that falling prices would have disastrous consequences but assigned that outcome a low probability”).
Such systems—the weather being a classic example—turn out to be difficult to model in a way that yields reliable forecasts over the medium to long term.

A third problem with economic models is that they deal with the behavior of actors who are likely to behave strategically in response to changes in incentives and risk. This factor makes the task of prediction even more daunting by introducing game-theoretical behavior into the mix.40

Sometimes the developers of these models understood their inherent limitations.41 But sometimes the temptation to replace reality with the models was irresistible. Professors of finance, in particular, may have been beguiled by the beauty of the mathematics and the purity of the intellectual constructs into believing that the models were true and accurate representations of the real world.42 Their confidence in model-building was supported by self-serving bias (that was what they did, so they wanted to promote it), authoritarian bias (most of the leading finance economists in the world shared similar views), complacency bias (because many in the profession believed the essential problems had been solved, at least in terms of the proper methodology, and they did not probe deeply into the possible shortcomings of the technique), and recency bias (the benign behavior of financial markets during the first part of the 2000s suggested that the assumptions of market efficiency and rational behavior were correct).

40. See Uday Rajan et al., The Failure of Models that Predict Failure: Distance, Incentives and Defaults (Stephen M. Ross Sch. of Bus. at the Univ. of Mich., Research Paper No. 1122; Chi. Graduate Sch. of Bus., Research Paper No. 08-19), available at http://ssrn.com/abstract=1296982 (concluding that lenders are likely to collect less soft information about borrowers as securitization becomes common, resulting in worse loans being issued to borrowers with similar hard information characteristics, and concluding that regulations that rely on conventional default models may be undermined by strategic actions of market participants).

41. For an entertaining inside account by one of these modelers, a physicist who became a managing director at Goldman Sachs, see Emanuel Derman, My Life as a Quant: Reflections on Physics and Finance (2004).

42. Paul Krugman recently stressed this point. See Paul Krugman, How Did Economists Get It So Wrong?, N.Y. TIMES, Sept. 6, 2009 (Magazine), at 36, 37 ("As I see it, the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth . . . . [T]he central cause of the profession's failure was the desire for an all-encompassing, intellectually elegant approach that also gave economists a chance to show off their mathematical prowess. Unfortunately, this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong.").
Even when the academics who developed economic models and their counterparts at investment banks understood the potential shortcomings of their models, actors charged with implementing the models tended to ignore the implications. Investment banks made heavy use of financial models for a number of purposes, including valuing securities, formulating trading strategies, measuring aggregate risk to the institution, and asserting compliance with accounting and capital rules.43 When actors at investment banks used the models, they hardly ever took account of the assumptions and inherent limitations. They had neither the time nor the expertise to do so, even if they were interested. Subtleties were forgotten in the hurly-burly of operations.

The process of translation from model-builders to operators resulted in several forms of intellectual hazard. The operators, not understanding the models, manifested oversimplification bias, using the models as rules of thumb or heuristics to aid them in carrying out their day-to-day tasks in a way that was not sensitive to possible limitations on their validity. These traders manifested tunnel vision, seeing only the model and not the limitations on its use. Authoritarian bias also played a role, as the models were often created by PhDs in math or finance, people of frightening intelligence whose technical expertise was beyond question. The models also generated output with an impressive level of precision, discouraging people who used them from questioning their basic assumptions.

A related phenomenon at investment banks has to do with the irony that the Crisis of 2008 erupted in the very institutions for which the quantification and management of risk had become a central aspect of business strategy.44 Risk-management strategies—often employing the type of sophisticated financial models just described—created the impression, both in banks and among their regulators, that the problem of risk had been controlled through technological means and therefore that judgment could be subsumed to the careful implementation of strategies spat out by the computers. Meanwhile, because risk


44. For an insightful commentary, see Hyun Song Shin, Risk and Liquidity (unpublished manuscript), available at http://hyunsongshin.org/www/riskliquid0.pdf.
was controlled, bank managers came to see excess capital reserves as an idle asset that needed to be put to work,\textsuperscript{45} thus increasing rather than reducing risk. The intellectual hazard here takes several of the forms we have identified above: authoritarian bias (undue deference to the models), complacency bias (loss of critical judgment based on the assumption that risk-management systems are handling the problem), asymmetry bias (uncritical carrying out of policies adopted by the organization without a thorough analysis of their potential defects), and confirmation bias (seeing the results of operations and changes in markets through the lens of the risk-management protocols).

In addition to problems of using models, intellectual hazard manifested itself in another way. Banks and other financial institutions are subject to dynamic pressures that make it difficult for the senior managers of these institutions to adopt policies reflecting independent thought. The problem was especially pronounced during the boom times of the 2000s when banks earned big profits through strategies that in retrospect look foolhardy. In such an environment, bank managers faced hydraulic pressures to follow the crowd. If they did not do so they were likely to be penalized for achieving less-than-stellar results in the short term—a phenomenon former Citicorp CEO Chuck Prince famously described in 2007 when commenting that despite the risks of a collapse in credit markets, he did not intend to back off from subprime and other risky but profitable activities: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you got to get up and dance."\textsuperscript{46} The suggestion was that Prince not only foresaw the problems that sparked full-blown panic in 2008, but also recognized that he had no choice but to stay in the game.

A similar story occurred in the case of the Reserve Primary Fund, one of the oldest and best-established money market mutual funds. This fund was the brainchild of Bruce Bent, one of the giants of the mutual fund industry. Bent had long been

\textsuperscript{45} See \textit{id.} at 8 ("In the eyes of the bank's top management, a bank with surplus capital is like a manufacturing plant with idle capacity. Just as good managers of the manufacturing plant will utilise surplus capacity to expand their business, so the bank's top management will expand its business.").

an apostle of caution in the industry, sharply criticizing competitors who invested in higher-yielding but higher-risk paper. But when his own fund began to lose investors to funds offering higher return, Bent capitulated to market forces and began to purchase subprime-related securities, including $785 million in securities issued by Lehman Brothers. The consequence was that the Reserve Primary Fund was forced to mark its Lehman Brothers investments to zero after the latter’s bankruptcy in September 2008, causing the Reserve Primary Fund to “break the buck” (that is, to report a net asset value of less than $1 per share). This markdown in turn caused a massive run by institutional investors and a destabilization of the entire money market mutual fund industry.47

These competitive pressures reflect intellectual hazard. Firms facing pressure from investors or shareholders to generate profits have an incentive to rationalize the decisions they make in seeking to meet these expectations. They manifest herding bias (following the practices used by others in the industry), self-serving bias (promoting interpretations of information that justify this behavior), cognitive dissonance bias (rationalizing and justifying their actions), and authoritarian bias (following the lead of others who have prestige or influence in the industry).

B. The Fed

The Fed manifested intellectual hazard in several different ways. It displayed asymmetry bias in the form of a fixed policy about asset bubbles. The view, championed by now-Chairman Bernanke, was that a central bank should not try to pop an asset bubble.48 Weighty arguments of policy supported this view, including that it is difficult to distinguish an asset bubble from ordinary market fluctuations or changes in prices due to market fundamentals. In addition, the central bank’s policy tools are so broad-ranging that they are likely to affect all economic markets, not just the market in which the asset bubble is occurring.49 The Fed also had historical reasons not to attempt to pop an asset bubble. The few times central banks had intervened

47. For a description of these events, see Eamonn K. Moran, Wall Street Meets Main Street: Understanding the Financial Crisis, 13 N.C. BANKING INST. 5, 74 (2009).
48. See WESSEL, supra note 7, at 60.
against bubbles (during the stock market boom of the 1920s and in the Japanese "bubble economy" of the 1980s), the results had not been satisfactory. In contrast, the Fed's decision not to pop the tech bubble of the late 1990s had apparently worked out well, with the economy lapsing only into a shallow recession followed by robust recovery.

The Fed's unwillingness to pop asset bubbles became a policy at that institution, one that arguably impaired the ability of the Fed to appreciate fully the consequences of the run-up in housing prices in the United States and many other countries during the 2000s. Because popping the bubble was not in the cards, the Fed did not need to pay that much attention to housing price increases. Leading Fed officials raised doubts about whether a housing bubble was even underway, notwithstanding plentiful evidence that price increases were above historical trend lines. Not having to worry about asset prices, moreover, suggested that the Fed did not need to worry much about the massive amounts of credit it was pouring into the economy with its low-interest rate policies of the mid-2000s. This oversight arguably exacerbated the collapse of the subprime market and the ensuing financial crisis.

Another fixed attitude at the Fed was the belief that the self-interest of lending institutions was an adequate check against excessive risk-taking. Assuming that markets would check themselves, the Fed did little to prevent the excesses of credit that poured into subprime real estate mortgages during the 2000s. Chairman Greenspan later issued an uncharacteristic mea culpa on this score: "I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms." The Fed's commitment to free-market ordering arguably interfered with its ability to understand that markets do not always function perfectly, and in particular may have blinded the central bank to the

50. See Krugman, supra note 42, at 36 (noting that at the Fed there was "a general belief that bubbles just don't happen. What's striking, when you reread Greenspan's assurances, is that they weren't based on evidence—they were based on the a priori assertion that there simply can't be a bubble in housing.").
51. There is consensus today that in the mid-2000s the Fed kept interest rates at too low a level for too long. See WESSEL, supra note 7, at 61.
52. Id. at 65–66.
Still another problematic doctrine at the Fed during the 2000s was the notion of the "great moderation." Ben Bernanke gave voice to this idea in a speech to the Eastern Economic Association in 2004: "One of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility." Ben Bernanke painted a rosy picture of an economy basking in the benefits of low inflation, stable employment, and stable output. Although not ruling out the possibility that the observed effects might be the result of luck, Bernanke speculated that a principal cause was good monetary policy by his own institution. The idea of a great moderation was an important part of the Fed's self-concept during the 2000s. The idea had a seductive appeal—things were better, and not just better for a while, but better for the long run. The Fed and other central banks had figured out how to conduct monetary policy so as to promote healthy economic growth, low inflation, and stable markets. The bugaboos that had haunted developed economies in years past—and in particular the instability that led to market breaks such as the Great Depression of the 1930s—were no longer serious threats. Given this ideology, it is not surprising that the Fed manifested little concern about the housing market bubble, did nothing to limit the spectacular growth of subprime mortgage-backed securities, and continued to pump credit into financial markets long after the ostensible reason for doing so (softening the effects of the tech crash of 2000) had faded away.

The Fed's notion of a great moderation manifests elements of intellectual hazard. It reflects self-serving bias, because it allowed the Fed to take credit for the benign economic conditions of the early to mid-2000s. It manifests authoritarian bias, because the idea was promoted by a Fed governor and a man who enjoyed influence with Chairman Greenspan. Given Bernanke's endorsement of the idea, it is unlikely that anyone in

54. Id.
the Fed's research department would have taken issue with the concept. Asymmetry bias is also present in this concept: The idea of a great moderation became a fixed star in the Fed's firmament, one that precommitted the agency to viewing the evidence at hand in a particular way (increases in housing prices were not a matter of real concern because the economy was in a period of great moderation in which volatility in prices and output was a thing of the past).

Another belief that enjoyed currency among central bankers is the notion that the fundamental job of a central bank is only to maintain stable prices. The idea that price stability should be the overriding objective at central banks was backed by the widespread belief that inflation offers no long-run economic benefits but imposes significant costs. Because inflationary policies cannot affect the employment rate over the long run, the primary objective of the central bank should be price stability. These ideas fit nicely into the case for central bank independence. Because independent central banks are less responsive to political influence than dependent central banks, they are more likely to deliver stable prices.\footnote{A classic exposition is \textit{Alex Cukierman, Central Bank Strategy, Credibility, and Independence: Theory and Evidence} (1992).} Central bankers naturally appreciated the idea that they should be independent of politicians. The result was the view that a central bank was doing its job well as long as it delivered price stability. We may conjecture that the focus on price stability as the overriding desideratum of good central banking could have caused a form of tunnel vision at the Fed and other major central banks. Because inflation was moderate during the 2000s, central banks did not worry much about the destabilizing effects of asset bubbles or about the risk that the financial system could fall prey to a liquidity crisis rather than to inflation.

\textbf{C. Rating Agencies}

Rating agencies also appear to have been vulnerable to intellectual hazard in a number of ways. These agencies use models to evaluate the default risk posed by the companies they evaluate. They faced the same risk of overreliance on models as was present in the case of banks and regulators, but in their case the risk may have been greater because of the limited nature of
their enterprise. Their sole function is to identify the risk that a company will fail to pay off its debts when due. Models are arguably more important to this narrow question than to others that face financial institutions.

Ratings agencies also experienced complexity bias: They needed to sort through large amounts of information about the firms they were rating, and to do so they used simplifying heuristics that allowed them to derive the ratings quickly and at reasonable cost. They fell prey to recency bias to the extent that they took as fixed the behavior of home prices that, during the post-World War II period, had never declined year-to-year on a nationwide basis. With this input into their models, they greatly underestimated the risk profiles of subprime mortgage-backed securities.56 Perhaps most significantly, ratings agencies were subject to self-interest bias. Because they were rating the securities of companies that were paying them to perform the service, they had an incentive to understated, at least to some extent, the risks of the securities they were evaluating.

Meanwhile, the ratings created intellectual hazard of their own. Other actors in the financial sector relied on these ratings in performing their job. The reliance—or perhaps overreliance57—on credit ratings generated its own intellectual hazard: tunnel vision (looking only to the ratings without inquiring into the credibility of the agency’s judgments), oversimplification bias (using the ratings as a proxy or shorthand for a more complex inquiry into risk), incentive bias (for many in the industry, reliance on the ratings served their self-interest in earning fees or other profits from deals), and asymmetry bias (the complex organization may have had a policy of relying on rating agency ratings in the performance of its job). Intellectual hazard also may have played a role in the ability of rating agencies to maintain credibility in the wake of previous failures, notably the Enron scandal. Professor Claire A. Hill has argued that investors may have continued to rely on ratings because they were displaying an adaptive trait of “incorporating new data that poten-

D. The Basel Committee

The Basel Committee on Banking Supervision, a group of regulators that meets in Basel, Switzerland at the offices of the Bank for International Settlements, has been an influential force in banking regulation during the past twenty years. The Basel Committee's Capital Adequacy Guidelines are among the most successful regulatory initiatives in the history of global finance. The Basel II guidelines introduced in June 2004 promised, at one time, to be even more influential. These guidelines are not law, but their prestige has contributed to their implementation in many countries around the world. The Crisis of 2008, however, forced a reassessment of the Basel Committee's contribution and raised questions about the utility of its project. The market turmoil highlighted four features of the Basel process that appeared questionable in light of the market breakdown.

First, the Basel guidelines were fundamentally concerned with capital. The Basel I guidelines were entirely concerned with capital adequacy at banking firms, and the Basel II guidelines were principally focused on capital, although they bowed also to the objectives of market discipline and banking supervision. The dominating concept behind the Basel process is that capital adequacy is the benchmark of sound banking. A bank with good capital ratios is a sound bank; a bank with bad capital ratios is an unsound one. The focus on capital promoted by the Basel process proved to be misguided in 2008. The commercial banks that ran into trouble in that year did not have inadequate regulatory capital until a short time before their failure. Argua-

60. Id. at 17.
62. Barr & Miller, supra note 59, at 17.
bly, the Basel process contributed to complacency bias and tunnel vision by focusing the attention of regulators on a single feature—capital—and blinding them to other risks, most importantly the risk of a liquidity crisis in financial markets.

Second, the Basel process contributed to intellectual hazard because of its treatment of housing finance. Housing has long enjoyed favorable treatment under the Basel framework. Under the Basel I guidelines, first mortgage loans on residences were assigned a risk-weighting of fifty percent, in contrast with all commercial lending, which had a one-hundred percent risk weighting. The implication seemed to be that a loan secured by a home mortgage—even a loan to a subprime buyer with poor credit and a questionable employment history—was safer than a line of credit to ExxonMobil or Microsoft. The favorable treatment of mortgage lending, carried forward in the Basel II guidelines, was based on two well-understood historical patterns. First, as a historical matter people did not, in general, default on their mortgages. No one wanted to lose his house. Second, home prices around the world had generally been stable and rising. The collateral backing home mortgages was therefore deemed to be adequate to cover the loan even if the homeowner did default.

The Basel Committee could not be criticized for drawing on history here, but the problem was that the guidelines treated default probabilities as fixed and did not take account of the possibilities that home prices would not remain stable or that borrowers would depart from their historical pattern of paying off mortgages. The guidelines also implicitly conveyed the message that home loans were the gold standard, and that a bank would not be undertaking unacceptable risk by making home mortgage loans. In retrospect, these messages were inaccurate, and may have contributed to the collapse in the subprime mortgage-backed securities market that was the trigger for the broader market meltdown of 2008.

Third, the Basel II guidelines encouraged reliance on credit ratings. Banks using the “standardized” approach to credit risk

64. BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS ¶¶ 41–42 (1988).
65. See BASEL II, supra note 61, ¶ 72 (“[U]nder the standardized approach to risk-weighting] [l]ending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk weighted at 35%.”).
were instructed to use ratings from "external credit assessment institutions" (that is, credit rating agencies) in determining the amount of capital to hold against loans to particular borrowers. The Basel Committee thus implicitly endorsed the opinions of credit rating agencies and gave imprimatur to their operations. In the wake of the financial crisis, the reputation of credit rating agencies has been tarnished by their failure to assess accurately the risk posed by subprime mortgage and other securities.

Fourth, the Basel II guidelines drew heavily on banks' own internal risk-weighting methodologies and strategies. Under the internal ratings-based approach to credit risk, banks are permitted to use "their own internal estimates of risk components in determining the capital requirement for a given exposure." The theory is that banks know much more about the actual risk profile of their assets than regulators, and that the larger banks that would be subject to the internal risk-weighting approach have the expertise and resources to develop sophisticated in-house methodologies to assess risk. Basel II sensibly attempted to piggyback on this expertise by using banks' own internal risk assessment methodologies when assigning capital requirements. The problem with the theory is that it depends on the accuracy of banks' internal methodologies, which in turn are based on models with all the problems previously mentioned. For some banks, those models proved grossly inaccurate during the Crisis of 2008.

The Basel process, in retrospect, was rife with intellectual hazard. The guidelines are almost poster child examples of authoritarian bias. They purport to be highly sophisticated and wonderfully precise. Basel II bristles with equations and terminology so arcane that a cottage industry has grown up to assist banks in figuring out how to comply with its requirements. The complex development of the guidelines also imbued the process with an aura of infallibility. Few if any initiatives in global finance have been vetted so thoroughly, by such sophisticated commentators, over so extended a length of time. The guidelines carried credibility and technical brilliance similar to that of the economic models used by financial firms. Naturally, government agencies charged with implementing the guidelines and banks tasked

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67. BASEL II, supra note 61, ¶ 211.
with complying with them tended to defer to their wisdom in a way that in retrospect appears to have been misguided.

The Basel II process also arguably manifested complexity bias. Given the complicated and demanding, but also very specific calculations required under the guidelines, actors in complex organizations charged with risk-control and compliance naturally faced the temptation to display tunnel vision. That is, they faced pressure to do what was demanded of them and not to look beyond the four corners of the regulations. The guidelines also arguably introduced oversimplification bias because bankers and regulators faced with rapidly shifting information about performance and risk of financial institutions found it convenient to use a ready rule of thumb as a means for making sense of the environment in which they operated. Even though the Basel guidelines are themselves complicated, once someone learns how to use them, the natural tendency is to allow the guidelines to take the place of reality by seeing a bank that is in compliance with regulatory capital requirements as a safe bank, regardless of its actual risk profile.

E. Regulators

Regulators also manifested intellectual hazard. A principal example is the tendency—promoted by the Basel framework—to focus on capital adequacy as the benchmark for safe and sound banking. United States law enforces a system of prompt corrective action under which regulators are required to take a series of increasingly draconian steps as a bank's capital falls into the danger zone. The prompt corrective action rules,68 like the capital adequacy guidelines, have the appearance of scientific validity and precision. Capital ratios are divided into tranches and precisely defined, and exacting mandatory administrative actions are specified as a bank falls below the required minimum levels.69 The appearance of precision and the comfortable set of prescriptions contained in the prompt corrective action regime could lull the agency into losing track of the more fundamental questions going to the bank's solvency. Because U.S. banks—including banks that later ran into finan-

69. Id. at 331–33.
cial trouble—had adequate capital ratios under the prompt corrective action rules, the natural inference was that the industry as a whole, and these banks in particular, were not in grave danger. The exaggerated focus on capital adequacy reflects aspects of intellectual hazard such as tunnel vision (obsessive focus on capital), authoritarian bias (deference to the Basel Committee), availability bias (use of readily available data on capital ratios), and oversimplification bias.

Intellectual hazard also played a major role in the failure of regulators to identify the fraud perpetrated by Bernard Madoff.\(^7\) In retrospect, many observers have concluded that the performance Madoff purported to generate for his investors was too good to be true; no one could so consistently generate returns of more than ten percent, year-in and year-out. An objective and dispassionate review of Madoff’s operation might have stimulated regulators to question the accuracy of his financial reporting, even if they had not also been repeatedly alerted by a whistle-blower that Madoff was operating a Ponzi scheme. Why did the regulators not recognize the problem earlier? The answer lies partly in intellectual hazard. Madoff was a prestigious, powerful member of the securities industry. He was one of the founders of NASDAQ and a former member of its board of directors. His firm was well known in the financial world. The regulators may have been victims of authoritarian bias. They were bedazzled by Madoff’s reputation and failed to see the signs of fraud.\(^7\) They also displayed confirmation bias: When examining Madoff’s operations they expected to find a reputable firm, so they interpreted the evidence in front of them as indicating that Madoff was operating a legitimate enterprise. As a result, they failed to identify the pattern of fraudulent illegal behavior that only became evident after Madoff’s confession.

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71. Madoff himself recognized that his stature in the industry was an asset that tended to deflect regulatory suspicion. See Diana B. Henriques, Lapses Kept Scheme Alive, Madoff Told Investigators, N.Y. TIMES, Oct. 31, 2009, at A1 (“In fact, Mr. Madoff said in the jailhouse interview that, on two occasions, he was certain it was only a matter of days or even hours before he would be caught. The first time, in 2004, he assumed the investigators would check his clearinghouse account. He said he was ‘astonished’ that they did not, and theorized that they might have decided against doing so because of his stature in the industry.”).
This Article so far has argued that intellectual hazard is a systemic risk in financial markets, and one that is particularly problematic because it is most pronounced during boom times—exactly the period when the market most needs independent thought and judgment. We now turn to the question of whether the concept of intellectual hazard is anything more than a useful intellectual trope, a way of conceptualizing problems and organizing thought, but without concrete payoffs for public policy.

Intellectual hazard is a pervasive and unavoidable feature of financial markets—and indeed of all complex social systems. It is as impossible to eliminate intellectual hazard as it is to eradicate the agency costs of management in corporations. Inherent in the corporate form is the allocation of management responsibility to actors, and actors always have the incentive to favor their own interests over those of their companies, no matter how much one tries to prevent that from happening. By the same token, we cannot eliminate intellectual hazard from financial markets, nor should we wish to do so, because if we could perform that impossible feat, the costs of doing so would outweigh the benefits.

That being said, the identification of intellectual hazard as a systemic risk in financial markets suggests that policymakers would do well to pay greater attention to the findings of behavioral finance when they formulate or evaluate proposals for reform. The following suggestions for reform are not fully developed policy recommendations, but rather invitations for thought and debate about how intellectual hazard might be better managed and controlled in the future.

A. Complexity Bias

Complexity is a fertile source for intellectual hazard. In some cases, the level of complexity chosen by an institution may exceed what appears reasonably necessary to achieve the desired outcome. Enron is a prime example: Its financing structure, re-

72. See generally Emilios Avgouleas, *The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy*, 9 J. CORP. L. STuD. 23 (2009) (arguing that proposed actions by governments worldwide will be less effective than expected because they lack a focus on behavioral finance).
plete with special purpose entities and complex asset transfers, was beyond the ken of virtually everyone.\textsuperscript{73}

Recognizing that different forms of complexity bias are pervasive in complex organizations, corporate directors and external regulators might demand that the relevant actors provide simple, cogent answers to questions about the underlying assumptions and how those simple answers would change in unusual circumstances. A mild approach could be that the regulator or corporate manager requests an explanation for why the relevant actor has opted for a byzantine structure. Alternatively, the regulators might require that firms engage in more extensive disclosures of their financing structure, and that they include in the disclosure documents a discussion by management as to why particular forms and structures were used. Regulators could also take the complexity of the financing structure into account when calibrating the intensity of scrutiny that they apply to a given firm.

\textbf{B. Corporate Governance Reforms}

Given the problems of complexity bias, self-serving bias, and other intellectual hazard, policymakers might also attempt to introduce greater skepticism and independent judgment into the processes by which firms in the financial sector evaluate information and make policies related to risk. Such independence is already mandated and encouraged, to some extent, under existing law. The Sarbanes-Oxley Act requires that publicly traded companies maintain audit committees comprised of independent directors who oversee accounting, internal controls, and financial reporting.\textsuperscript{74} An office of independent evaluation, not part of a financial institution's general management and reporting directly to the board of directors, might provide greater independence of judgment, although we are somewhat skeptical of the ability of any in-house operation, however insulated, to manifest independent thought in practice. Regulators could also seek to understand more clearly the motivations of the presenters of analyses or the advocates for corporate policies so that they can weigh these recommendations with


respect to their impact on the individuals themselves. Compensation policies are an obvious area where such investigation would be appropriate, but any policy or analysis that differentially and substantially impacts the interests of the relevant actor would be a subject of concern.

C. Education

Some of the problems of intellectual hazard might be addressed through education.\textsuperscript{75} Educators could clarify and assess the applicability of complex models in ways that address complexity biases. Educators could also focus more of their instruction on questions of professional responsibility or ethics training courses. Economics and business courses could highlight issues that heretofore have often been ignored or assigned to higher level courses, such as the institutional basis of financial markets, the role of speculation, asset-price bubbles, economic crises, the uses and abuses of economic modeling, and the pros and cons of leverage in a firm's financial structure. Business school courses would not discount the fundamental importance of quantitative analysis, rather they could focus more on qualitative factors such as the application of judgment and common sense. Continuing education of the workforce, either formal or informal, might also stress these matters and encourage the application of independent judgment at all levels of management.

D. Government Reforms

Perhaps it would be useful to create a government agency specifically charged with assessing potential systemic risks to the financial system. President Obama has, in fact, called for an entity—a systemic risk council—that would be tasked with this function.\textsuperscript{76} At the international level, the former Financial Stability Forum—an association of regulators that, like the Basel Committee on Banking Supervision, maintained its secretariat within the Bank for International Settlements in Basel—has been reconstituted by the G20 as the Financial Stability Board,\textsuperscript{77} an operation established to "address vulnerabilities and to de-

\textsuperscript{75} We thank Henry Kaufman for suggesting this reform in private conversation.
\textsuperscript{76} See Sewall Chan, Agreement is Near on New Overseer of Banking Risks, N.Y. TIMES, Feb. 18, 2010, at A1.
\textsuperscript{77} See G20, DECLARATION ON STRENGTHENING THE FINANCIAL SYSTEM—LONDON, 2 APRIL 2009 (2009).
velop and implement strong regulatory, supervisory and other policies in the interest of financial stability.” The European Commission has also entered the debate, issuing a communiqué calling for the creation of a European Systemic Risk Council charged with the task of “monitor[ing] and assess[ing] risks to the stability of the financial system as a whole” and “provid[ing] early warning of systemic risks that may be building up and, where necessary, recommendations for action to deal with these risks.”

Ideally, the leadership and staff of such an agency would be individuals who are not directly affiliated with the institutions that breed intellectual hazard. To date, unfortunately, the proposals fail to accomplish such a desirable separation. The personnel of the agencies charged with monitoring systemic stability are often incumbent government officials. The Obama Administration’s proposed systemic risk council would be made up of the main financial regulators in a consultative role, with a single, accountable authority that can act quickly in a crisis (the current proposal places the Treasury Secretary in this role). The proposed European Systemic Risk Board would include a “significant representation of central Banks” and would operate with a secretariat provided by the European Central Bank. The Financial Stability Board, likewise, is staffed by government officials and chaired by Mario Draghi, Governor of the Bank of Italy.

Experience suggests that the problem of intellectual hazard will not be effectively addressed if the personnel in the agency charged with identifying systemic threats to financial stability are simply recycled regulators and central bankers. They will not bring new ideas to the table; on the contrary, they will

80. See Chan, supra note 76.
come as advocates for their agency’s positions and as defenders of their agency’s turf and power. These people will suffer from the forms of intellectual hazard we have already observed in regulators: asymmetry bias embodied in fixed positions on policy questions, self-serving bias in the form of turf protection and blame avoidance, and authoritarian bias in the form of deference to the agencies that delegate personnel to these new monitoring bodies.⁸³

A preferable solution would be to establish financial stability boards not dominated by existing regulators. A truly independent board, composed largely of people from outside the government, selected according to some principle of merit rather than political connections, and adequately funded and protected against retaliation for expressing unpopular views, would offer a potentially more efficacious approach to the problem of impartially and objectively identifying systemic threats to the financial system and proposing possible remedies or solutions.

E. Stress Tests

In the wake of the Crisis of 2008, the Fed subjected large banks to “stress tests” to assess whether their levels of capital were adequate to cope with serious downturns in economic conditions.⁸⁴ It might be possible to manage intellectual hazard by mandating a different kind of stress test. Systemically important institutions (large banks, insurance companies, and investment firms) could be required to identify models or policies that, if erroneous, could have a materially adverse effect on their safety or soundness. In such cases, the institution could be required to subject the model or policy to a stress test to evaluate how it would function if the basic assumptions on which it is based no longer hold. The institutions would not have to re-

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⁸³. It is noteworthy that the predecessor of the Financial Stability Board, the Financial Stability Forum, had a similar mandate of monitoring for systemic risks in the financial system. It egregiously failed in that function, never identifying the looming threat to the world’s financial markets posed by the U.S. subprime securities until it was much too late to take action. There is, unfortunately, little reason to believe these new agencies will do a better job. See Cally Jordan, Does ‘F’ Stand for Failure: The Legacy of the Financial Stability Forum (Univ. of Melbourne Law Sch., Legal Studies Research Paper No. 429, 2009), available at http://ssrn.com/abstract=1478527.

⁸⁴. The stress tests evaluated how the banks would respond under two scenarios, one being the consensus forecast at the time of the test and the other being a much worse scenario. See HAL S. SCOTT, THE GLOBAL FINANCIAL CRISIS 52 (2009).
port proprietary information about their models, but would have to disclose how the models or assumptions performed under different and less favorable economic conditions.

CONCLUSION

This Article has proposed the idea of intellectual hazard as an organizing principle for the conceptual biases that affect all complex organizations and systems of complex organizations. Intellectual hazard, as we define it, is the tendency of behavioral biases to interfere with accurate thought and analysis within complex organizations. Intellectual hazard impairs the acquisition, analysis, communication, and implementation of information within an organization and the communication of such information between an organization and external parties.

We have argued that intellectual hazard is a particular problem during times of economic stress, including asset-price bubbles and financial crises. Because of its importance during these times, intellectual hazard, like moral hazard, poses systemic risks to the financial system as a whole. We identified a variety of forms of intellectual hazard, falling in three “baskets” or categories: complexity bias, incentive bias, and asymmetry bias. We illustrated how different institutions in financial markets—banks, the Fed, rating agencies, the Basel Committee on Banking Supervision, and bank regulators—appear to have manifested intellectual hazard in connection with the Crisis of 2008. We concluded with possible reforms to mitigate intellectual hazard: corporate governance reforms, reforms to government supervision and oversight, stress tests to assess the robustness of models, and changes in education of financial market personnel. Overall, the purpose has been to stimulate thought and discussion about an important and interesting issue of regulatory policy in the financial services sector.
NOTE

PUBLICITY RIGHTS, FALSE ENDORSEMENT, AND THE EFFECTIVE PROTECTION OF PRIVATE PROPERTY

INTRODUCTION

Publicity rights, though lacking a physical manifestation, are of high social benefit. These rights protect the commercial value in an individual's name. As with other forms of property rights, the state should enforce them vigorously and effectively. In theory, these rights are currently protected, an implicit recognition of their value. In practice, however, two concerns are emerging: the devaluation of wealthier individuals' claims for protection and the use of an overly complex test that fails to provide adequate predictability or expedience. Indeed, the intellectual property protected by publicity rights—essentially the right to exploit a well-known reputation commercially—is particularly fragile because its value, though real and substantial, is embedded in public perceptions and can be easily damaged by undesired associations.¹ This Note proposes a revision of the publicity rights test and suggests that courts import the "Endorsement Test" from First Amendment doctrine to remedy these two issues while operating within the familiar framework of its existing jurisprudence. Guided by the rationale for the right, as demonstrated by its theoretical justifications, false endorsement claims should be evaluated under the following standard: In light of the context, would it appear to a reasonable observer that the disputed message constitutes an endorsement?

Dating to Adam Smith's publication of the Wealth of Nations, theorists have long recognized that a myriad of societal benefits

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¹ Recent events have only reinforced the gap that may exist between a public endorsement persona (the intellectual property "Tiger Woods") and an individual's actual personality (Eldrick "Tiger" Woods). These events have also reinforced the fragility of such personas. See Ken Belson, AT&T Is the Latest to Drop Woods, N.Y. TIMES, Jan. 1, 2010, at B11.
flow from the protection of personal property. As with physical property, courts have acknowledged the right of an individual to the intangible goodwill associated with his name. Today, this recognition is represented by the common-law right of publicity and its statutory counterpart, the federal Lanham Act.

There are, however, twin assaults on this element of personal property. First, a recent circuit court decision suggested that the individuals who most often bring suits to protect their publicity rights—wealthy celebrities—are less deserving of such property rights than the often poorer individuals who attempt to trade on their names and images. Even if this position represented a sensible policy, it ignores the reality that many of these individuals likely generated much of that wealth through the savvy development of an endorsement persona, all the while destroying their ability to continue to control or develop such a persona. Second, even where relief is eventually granted, the courts’ doctrine creates delays and uncertainty. Indeed, courts often deploy complex balancing tests, evaluating the relevant question as one of fact. This method makes it difficult to offer the protections that the law should afford expeditiously and creates pressures for settlement even where no legal defense should exist.

In light of the importance of these property rights, an effective and expedient means of resolution is needed. The test must be effective at determining whether a false endorsement exists, because overprotection of property rights may be just as socially deleterious as underprotection.

3. See, e.g., Abdul-Jabbar v. Gen. Motors Corp., 85 F.3d 407 (9th Cir. 1996) (reversing the lower court’s summary judgment dismissal of a right of publicity claim, noting that the use of celebrity athlete Kareem Abdul-Jabbar’s former name in a car commercial could constitute a violation); Midler v. Ford Motor Co., 849 F.2d 460 (9th Cir. 1988) (finding that use of a “sound alike” in a commercial could constitute a violation); Haelan Labs., Inc. v. Topps Chewing Gum, Inc., 202 F.2d 866 (2d Cir. 1953) (holding that an athlete could provide an exclusive license to his likeness).
4. 15 U.S.C. § 1125(a)(1)(A) (2006) (creating a cause of action for persons injured by commercial depictions “likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of [the defendant] with another person, or as to the origin, sponsorship, or approval of [the defendant’s] goods, services, or commercial activities by another person”).
5. See White v. Samsung Elecs. Am., Inc., 989 F.2d 1512, 1513 (9th Cir. 1993) (Kozinski, J., dissenting from order rejecting request for rehearing en banc) (“Overpro-
analyzing how individuals process information offers perspective on how best to protect this intellectual property. Indeed, some existing case law is already consistent with this research.

A review of case law in other realms reveals that there is already a test that can provide the robust protections required. The Endorsement Test from First Amendment case law would ask whether a reasonable person would think that the challenged material suggests that the plaintiff was either endorsing or disapproving the defendant’s message. Moreover, the relevant prong of this test already functions as a question of law, allowing judges to dispose of the matter without lengthy trials where the issues are clear-cut. It is also consistent with the leading cases and research in the field. In short, this test, guided by the justifications for publicity rights, would allow individuals to capitalize on their own success, regardless of wealth, and avoid the risk of having their successes damaged through undesirable associations.

Part I of this Note traces the theoretical justifications for publicity rights. Part II then introduces the two main threats to their effective enforcement. Finally, Part III proposes a novel formulation that contemplates the reality of human information processing in seeking an effective legal standard.

I. THE ROLE OF PROPERTY RIGHTS IN THE AMERICAN EXPERIENCE

Property rights have long been recognized as a crucial impetus to labor in Western political and social philosophy. This Part traces this recognition among theorists from Adam Smith to the modern academy, and finally to existing jurisprudence. Any proposed test should be guided by these rationales.

A. Intellectual Foundations

It is far from novel to suggest that protection of personal property is necessary to induce individuals to labor. Adam Smith argued that labor, and the fruits thereof, are the essence of property: “The property which every man has in his own
labour, as it is the original foundation of all other property, so it is the most sacred and inviolable.” 8 Then, through the exchange of one man’s surplus for that of another, “the society itself grows to be what is properly a commercial society.” 9 Indeed, it is a commercial society that Smith famously suggested could, through market function, provide for the needs of its members. 10 That is, no one could specialize in a single field and develop excellence therein without the knowledge that he could later exchange the fruits of his labor with others. For instance, a sculptor’s art on its own will not provide sustenance. Through exchange with the farmer, however, both can focus upon their chosen field. Modern theorists also have noted the vital role of property rights in an effective market economy. Professor Dani Rodrik, for instance, stated that as “many others have argued, the establishment of secure and stable property rights has been a key element in the rise of the West and the onset of modern economic growth.” 11 A prerequisite, then, for a modern economy, and indeed a society of learning (since academic research and education as currently constituted would be impossible without a division of labor), is strong property rights.

The logic underlying this protection is just as applicable to intellectual property as to physical property. Professor Rodrik correctly argues that property rights are necessary to induce individuals to labor because “an entrepreneur would not have the incentive to accumulate and innovate unless s/he has adequate control over the return to the assets that are thereby produced or improved.” 12 Moreover, property rights are necessary to promote the entrepreneurial spirit that some have associated with the global successes of the United States. 13 Thus, much hinges on the right.

As with physical property, intellectual property can have real value and require assiduous efforts to generate. According
to the logic of Smith and Professor Rodrik, when someone creates something of value, it should, in the absence of other contractual arrangements, belong to the individual who generated the value. For instance, assume a final element can be added to a product, such as a car, to increase sales. The element positions the car as a "luxury" good and serves as a heuristic for the buyer that the automobile is worth the purchase price. This element adds value to the manufacturer, whether the element is leather seats or an endorsement by a trusted public figure. Because the value of an endorsement is real, it is socially beneficial for individuals to create such public images: The endorsement creates tax revenue both directly from income earned by the endorser and indirectly through economic activity generated by the endorsement.

These valuable public images are just such a commodity. Such images do not occur through happenstance, but rather are often the result of careful planning undertaken by the public figure and a team of skilled advisors. For example, Arnold Palmer, the golfer, is still able to generate revenue from endorsements because of a concerted effort to brand himself not as a "winner," but rather as a man of integrity who came through in the clutch. Although it would have been easy to present him to the public as a "winner," his advisors counseled him otherwise. Palmer recalled that one advisor was adamant on this point: "'Win ads' were about winning or losing, and his aim was never to position me as a 'winner' because there always comes a day when a winner no longer wins." In fact, perhaps the best indicator of the value of celebrity endorsements is that many of the highest-paid athletes in professional sports nonetheless earn more from their endorsements and similar activities than from actually competing in the sport.

B. Legal Foundations

Courts have previously recognized the real value and need for protection for this form of intellectual property. The seminal case, *Haelan Laboratories, Inc. v. Topps Chewing Gum, Inc.*, focused on a dispute between rival companies, one of which had secured an exclusive right to depict athletes' likenesses on

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15. *Id.* at 65.
trading cards. The U.S. Court of Appeals for the Second Circuit held that the athlete had a cognizable “right of publicity,” a decision that served as the turning point in judicial treatment of publicity rights. The Second Circuit suggested that what it termed the “right of publicity” includes the right to exclusivity, because this right “would usually yield [celebrities] no money unless it could be made the subject of an exclusive grant which barred any other advertiser from using their pictures.” That is, consistent with Adam Smith, the right of publicity would otherwise have no value and celebrities would lack sufficient incentive to cultivate their public images.

Prior to Haelan Labs, recognizable individuals had no such protections. As Professor Melville Nimmer discussed in his contemporaneous article, the predecessor “right of privacy” offered little protection to individuals who were in the public eye. For instance, twelve years before Haelan Labs extended protection to celebrity publicity rights, the U.S. Court of Appeals for the Fifth Circuit in O'Brien v. Pabst Sales Co. rejected a celebrity football player’s right of privacy claim in analogous circumstances. There, the Pabst Brewery had produced a promotional calendar featuring a photo of famous football player David O'Brien next to a photo of a Pabst beer. The Fifth Circuit affirmed the lower court’s dismissal of O'Brien’s claim, explaining that privacy is the right of a private person and the “plaintiff is not such a person and the publicity he got was only that which he had been constantly seeking and receiving.”

Other courts would later adopt the Second Circuit’s Haelan Labs framework, including the Supreme Court in Zacchini v.
Scripps-Howard Broadcasting Co. Zacchini, an entertainer, sued a news organization that had recorded and replayed his entire "human cannonball" act on local television news without Zacchini's consent. Noting that "this act is the product of petitioner's own talents and energy, the end result of much time, effort, and expense," the Court held that the broadcast had violated the performer's rights because broadcasting the "entire act poses a substantial threat to the economic value of that performance."

Upon further examination, Zacchini provides a far-reaching mandate for the right of publicity. In fact, the Court found Zacchini's right sufficiently strong to overcome the First Amendment interests of the press, a potent right itself. Moreover, the Court conceptually severed the performer's publicity interests into distinct spheres, each of which may receive independent protection. The Court termed the broadcast a "substantial threat to the economic value of the performance" that "goes to the heart of petitioner's ability to earn a living as an entertainer."

Consequently, it awarded the petitioner damages. Yet this individual broadcast cut to "the heart" of the performer's ability to earn a living in only that one particular media market. The Court would have been aware of Zacchini's mobility, as the Scripps-Howard reporter had filmed him performing at a fairground. Thus, the Court implicitly recognized a right to publicity in individual media markets; broadcasting the act only in New York, for example, would have no effect on attendance elsewhere and cut to the heart of the entertainer's earning power only in New York itself. By protecting each limited sphere of publicity rights, the Court provided a more expansive mandate than if it had required Zacchini to show a serious injury to his publicity rights as a whole.

25. Id. at 563–64.
26. Id. at 575.
27. See, e.g., Potter Stewart, "Or of the Press", 26 HASTINGS L.J. 631, 634 (1975) (arguing that the Constitution guarantees a free press to serve as a "check on the three official branches" of the government).
29. Id. at 578–79.
30. Id. at 563.
31. Indeed, later courts have recognized that conceptual spheres of publicity rights also may be violated, further demonstrating the potency of the right. Wendt v. Host International, Inc., for example, involved a dispute between restaurateur Host, using
Moreover, although Zacchini's claim was in some ways stronger than a false endorsement claim at the time—because broadcasting the entire act "goes to the heart of [the] petitioner's ability to earn a living"—modern-day celebrities can be seriously harmed by false endorsements. Courts interpreting modern publicity rights have acknowledged the efforts necessary to cultivate public images, observing that celebrities "actively cultivate[] the popularity of their names" for endorsement purposes. As noted above, many entertainers earn more from endorsements than from their underlying forms of employment. Thus, today, false endorsements can go to the heart of one's ability to earn a living as an entertainer.

II. THE PROBLEM: JUDICIAL ACTIVISM AND TEST COMPLEXITY THREATEN PUBLICITY RIGHTS

Two recent threats to this right have appeared in the case law. First, at least one court has indicated, counterintuitively, that the publicity rights of wealthier individuals may be less deserving of protection. Second, when evaluating these claims, many courts deploy overly complex tests that lack predictability and expedition. Both of these issues pose serious threats to reliable judicial protection for the right of publicity.

a license to operate theme bars based on the television show Cheers, and actors George Wendt and John Ratzenberger, former stars of the show who played the fictional bar's patrons. 125 F.3d 806 (9th Cir. 1997). The actors claimed that they had been depicted without license by Host's animatronics robots. Id. at 809. Among the factors noted by the Ninth Circuit in reversing the lower court's dismissal of the actors' action was Ratzenberger's investigation of endorsement opportunities in the "beer" sphere. See id. at 814. The court found this factor favored the actors' claim, owing to the likelihood of confusion and diminution in value of a future endorsement by Wendt or Ratzenberger in that sphere. See id. Thus, the right was sufficiently potent to merit protection not only for a geographical sphere of endorsement in the present, but also for a future conceptual sphere.


33. See Bi-Rite Enters., Inc. v. Button Master, 555 F. Supp. 1188, 1199 (S.D.N.Y. 1983) (right of publicity could protect celebrities against their depiction on unlicensed novelty items).

34. See CARFAGNA, supra note 14, at 65.
A. Denying Individuals Full Protection of the Law
Because of their Economic Status

Most troublingly, some judges have recently suggested that wealthy individuals may be entitled to less protection from violations of their publicity rights. ETW Corp. v. Jireh Publishing, Inc. involved celebrity golfer Eldrick "Tiger" Woods's allegations of false endorsement against Jireh, a company that had published painted depictions of Woods playing at the Masters Tournament. Jireh sold prints in white envelopes featuring the title "Masters of Augusta" and, in slightly smaller letters, the words "Tiger Woods." The U.S. Court of Appeals for the Sixth Circuit ultimately upheld the lower court's grant of summary judgment for Jireh, but its discussion additionally included a strand of alarming reasoning. Losing sight of the rationales underpinning publicity rights, the court's opinion twisted Woods's professional success against him. In dismissing Woods's claim, the court "note[d] that Woods, like most sports and entertainment celebrities with commercially valuable identities, engages in an activity, professional golf, that in itself generates a significant amount of income which is unrelated to his right of publicity." Whether Woods possesses other property rights, though, should not impact the unrelated question of whether Jireh infringed Woods's publicity rights. Indeed, the rationale for the right—encouraging entrepreneurial efforts—provides little support for such a conclusion.

Moreover, there is an unmistakable tension between the Sixth Circuit's emphasis on Woods's wealth—which it termed similar to that of "most sports and entertainment celebrities"—and the acknowledgment by other courts that publicity rights generally are relevant only where an individual has achieved celebrity.

35. See id. at 90 (observing that owing to the financial disparity between celebrity and infringer, "courts will often feel less sympathy towards a celebrity than to an apparently hard-working entrepreneur").
36. 332 F.3d 915, 918 (6th Cir. 2003).
37. Id. at 918-19.
38. Id. at 937-38 (the court stated that it relied on the strength of a First Amendment defense).
39. Id.
Thus, what Jireh depicts as a minor exception to a general rule could, pursuant to its own logic, subsume the doctrine of publicity rights in its entirety. Such affluence is common to almost all individuals whose broadly recognizable public images require judicial protection. Jireh's reasoning thus threatens nothing less than the total evisceration of the right of publicity.

The Jireh opinion also misread the practical implications of such a decision when it stated, "[e]ven in the absence of his right of publicity, [Woods] would still be able to reap substantial financial rewards from authorized appearances and endorsements." There are two problems with this statement. First, the court suggests, without support, that it will only allow certain levels of infringement of Woods's rights. But even low levels of infringement can harm a celebrity's property interests. Moreover, it is unclear why the court's logic could not be applied to every successive iteration of expropriation of Woods's image. Second, as noted above, marketable celebrity images do not occur by happenstance. They are the work of careful cultivation to provide revenue streams, not the vagaries of luck. If a product appears to a reasonable individual to be associated with Woods, it could do serious damage to the golfer's marketing plan by distorting his public image. Thus, an unauthorized endorsement could have a significant negative impact on Woods's ability to "reap substantial financial rewards" from his image. Ignoring the reasoning of previous decisions, Jireh briskly dismissed such concerns: "It is not at all clear that the appearance of

41. See Motschenbacher v. R. J. Reynolds Tobacco Co., 498 F.2d 821, 824 n.11 (9th Cir. 1974) ("Generally, the greater the fame or notoriety of the identity appropriated, the greater will be the extent of the economic injury suffered.").

42. In reality, recognizable individuals will exist across the wealth spectrum. In a world taking Jireh to its logical extreme, conceivably only a handful of bankruptcy-filing celebrities, such as Burt Reynolds and Stanley "MC Hammer" Burrell, would retain their publicity rights, whereas other celebrities would have no such protections. See Eric Tyson, Sticking with the Basics Still Serves when the Affluent Need to Manage the Big Bucks, SEATTLE POST-INTELLIGENCER, Mar. 2, 1998, at C3. Putting aside the perverse incentives such a system would propagate (celebrities would do best by spending money as quickly as they earn it, since they could then argue they need the endorsement money), it is wholly inconsistent with the motivating rationales for having such protections in the first place.

43. Jireh, 332 F.3d at 938.

44. See CARFAGNA, supra note 14, at 107.

45. See Haelan Labs., Inc. v. Topps Chewing Gum, Inc., 202 F.2d 866, 868 (2d Cir. 1953); Ali, 447 F. Supp at 729 (upholding the right of publicity to protect the "marketable reputation" of an athlete).
Woods’s likeness in artwork prints which display one of his major achievements will reduce the commercial value of his likeness.\textsuperscript{46} At the very least, cognizant of the functioning of publicity rights, a violation of Woods’s rights in the “artistic” sphere could well have detrimental ripple effects in other commercial spheres. Moreover, permitting such infringing conduct encourages other individuals to create similar unauthorized Woods products and necessarily weakens the branding that Woods and his advisors have endeavored to create.\textsuperscript{47}

B. A Multifactor Test Does Not Provide the Predictability or Expedience Necessary in this Time-Sensitive Sphere

As currently evaluated, the availability of the Lanham Act’s\textsuperscript{48} statutory protections often depends upon the application of a multifactor test. For instance, in 2008 the U.S. Court of Appeals for the Third Circuit reaffirmed its reliance on an eight-factor test to determine whether a defendant has infringed upon a trademark, including protected celebrity images.\textsuperscript{49} The Sixth Circuit in \textit{Jireh} conformed its inquiry to a similarly complex eight-factor test.\textsuperscript{50}

\begin{itemize}
\item \textsuperscript{46} \textit{Jireh}, 332 F.3d at 938.
\item \textsuperscript{47} Cf. supra text accompanying notes 14–15 (discussing Arnold Palmer’s commercial “branding” decisions).
\item \textsuperscript{48} 15 U.S.C. § 1125(a) (2006) (creating a cause of action for commercial depictions “likely to cause confusion, or to cause mistake” as to an individual’s sponsorship thereof).
\item \textsuperscript{49} Facenda v. N.F.L. Films, Inc., 542 F.3d 1007, 1019 (3d Cir. 2008). The eight factors are:
\begin{itemize}
\item (1) the level of recognition that the plaintiff has among the segment of the society for whom the defendant’s product is intended;
\item (2) the relatedness of the fame or success of the plaintiff to the defendant’s product;
\item (3) the similarity of the likeness used by the defendant to the actual plaintiff;
\item (4) evidence of actual confusion and the length of time the defendant employed the allegedly infringing work before any evidence of actual confusion arose;
\item (5) marketing channels used;
\item (6) likely degree of purchaser care;
\item (7) defendant’s intent [in] selecting the plaintiff; and
\item (8) likelihood of expansion of the product lines.
\end{itemize}
\item \textsuperscript{50} \textit{Jireh}, 332 F.3d at 940. The eight factors here are:
\begin{itemize}
\item (1) strength of plaintiff’s mark;
\end{itemize}
\end{itemize}
Such complex tests, deployed as questions of fact, will likely engender lengthy and complex trials. Under the existing regimes, parties could conduct extensive discovery merely upon one of the factors, to say nothing of the Herculean task of balancing the factors' relative merits in the aggregate. For example, *Facenda v. N.F.L. Films, Inc.* involved the estate of a legendary sports announcer whose contract stated that recordings of his work could not be used for any endorsement purposes. The estate sued N.F.L. Films when the company used the recordings in a video linked to the release of a video game. N.F.L. Films "executives testified that the program was a documentary and denied that it was a commercial," whereas the estate characterized the use as an endorsement of the game. The Third Circuit remanded the case to the lower court for a resolution of issues of material fact in the multifactor balancing analysis. Though both parties agreed that sufficient evidence had been collected, the court held that "parties may not stipulate to forgoing a trial when genuine issues of material fact remain." That is, even in a case where both parties seek finality and predictability, the complexity of the test may preclude timely resolution. This concern is compounded in the alternative case, where, contrary to appearances in *Facenda*, a party has intentionally infringed the rights of another and seeks to draw out a trial to induce settlement. Lengthy trials have real economic costs, both for the parties (in the form of lawyers' fees and opportunity costs) and for the judicial system (in docket time).

These multifactor tests are also unpredictable. It is far from a novel insight to express dissatisfaction with such tests. For instance, Chief Judge Posner expressed serious dissatisfaction with such tests in *Exacto Spring Corp. v. Commissioner of Internal Revenue*, as detailed below:

(2) relatedness of the goods;
(3) similarity of the marks;
(4) evidence of actual confusion;
(5) marketing channels used;
(6) likely degree of purchaser care;
(7) defendant's intent in selecting the mark;
(8) likelihood of expansion of the product lines.

Id. 51. *Facenda*, 542 F.3d at 1012.
52. Id.
53. Id. at 1023.
54. Id.
In a tax dispute regarding whether the salary paid to Exacto’s CEO was deductible, all seven factors in the relevant test either favored the company or were neutral. Thus, Chief Judge Posner termed the tax court’s finding against the company “stunning,” because it appeared that even knowing how the factors would cut provided little insight into the result. Similarly, the Third Circuit’s Facenda formulation is silent on how to balance its factors. There is a great danger lurking in such a test. As Chief Judge Posner observed, “since the test cannot itself determine the outcome of a dispute because of its nondirective character, it invites the making of arbitrary decisions based on uncanalized discretion or unprincipled rules of thumb.” That is, the multiplicity of factors combined with the absence of guidance may allow for disparate outcomes arising from identical fact patterns.

Given the fragility of the assets that publicity rights protect (recall the discussion of the efforts underpinning Arnold Palmer’s public image), allowing an interloper to imply an endorsement could have seriously injurious effects. As noted above, the current structures of judicial inquiries can have the effect of encouraging socially inefficient settlements by parties whose rights have been infringed and who cannot predict with confidence the outcome of the appropriate balancing test. A far more useful approach would focus upon the desired end, whether that end is protecting intellectual property and encouraging its development or reducing compensation to a reasonable level. Indeed, at least one commentator has previously suggested that publicity rights tests should be streamlined towards their core purpose. In light of that recognition, any effective test must be recentered around the right’s essence: Has an individual, without his consent, been stripped of ownership rights in his public persona?

55. 196 F.3d 833 (7th Cir. 1999).
56. Id. at 837.
57. Id.
58. For instance, how does the court resolve the case where the intent of the defendant was to imply an endorsement, yet the price of the good is consistent with a relatively high level of care in purchasing? See Facenda, 542 F.3d at 1019 (factors five and three).
59. Exacto Spring Corp., 196 F.3d at 835.
60. See CARFAGNA, supra note 14, at 107.
III. THE SOLUTION: A SIMPLER TEST THAT IS FAIR TO ALL

Judicial reasoning—in the context of false endorsement claims and First Amendment disputes—may offer useful guideposts for protecting publicity rights. First, however, it is sensible to review the academic literature of social scientists who seek to understand how mental associations are formed. That literature concludes that such associations are contextual. Thus, to craft a test that effectively protects publicity rights, one must recognize not only that the underlying intellectual property is malleable, but also how it can be shifted.

A. Associations Are Inherently Contextual

The academic literature indicates that individuals process information contextually. Research conducted by Amos Tversky and Daniel Kahneman indicates that individuals are highly susceptible to suggestion by context when evaluating uncertain information. Indeed, so strong is this predilection that it is evinced even where individuals should recognize that the contextual information is useless.

This finding is particularly relevant to evaluating judicial treatment of false endorsement and publicity rights. Short of political advertisements, questions of endorsements often will fall into the category of uncertain information. Few individuals see an advertisement and ponder the precise nature of the relationship between the product and its apparent endorser. If the context indicates that the apparent endorser is associated with the product, audiences generally will associate him with the depiction. This association, in turn, becomes an element of the context in which the apparent endorser’s actual endorsements are understood and may thus affect the manner in which he is viewed in the future. After all, most members of the public are not familiar with the actual character of most celebrities. For example, the target audience for product endorsements does not know Palmer or Woods personally. Thus, the apparent endorsement, by insinuating itself into the background assump-

63. Id. at 1125 (noting that survey participants performed worse when given contextual information than when not).
64. For example, the statement “I am Candidate X, and I approved this message.”
tions that the public holds regarding the "endorser," shifts how he is viewed.65 This alteration of his persona may cause a diminution in its value by deviating from the apparent endorser's carefully developed publicity plan.

Thus, to protect publicity rights effectively, the judicial inquiry into alleged false endorsements must holistically and contextually examine the message propagated by the disputed depiction. Because endorsements generate their value only within a web of socially constructed meaning, it would be counterproductive to evaluate false endorsement claims against an abstract standard. Simply banning the use of "magic words" ("Arnold Palmer uses this product") for example, would fail to account for the myriad of other ways that a defendant can infringe on a celebrity's publicity rights. Yet even the use of an individual's name in some contexts,66 such as in a news story, might not imply an endorsement. Instead, a balance must be struck. As Chief Judge Kozinski of the U.S. Court of Appeals for the Ninth Circuit has noted when discussing publicity rights, "[o]verprotecting intellectual property is as harmful as underprotecting it."67 In publicity rights cases, the intellectual property at issue is a marketable reputation, used for that purpose. Thus, the central question is whether this depiction misleads the public into believing that the plaintiff is involved with the product in question. If the answer is no, protection should not attach under the right of publicity.

B. Exemplar Opinions to Be Incorporated into Any Future Standard

The most effective opinions in this arena have recognized the importance of a test eschewing a formalistic "magic words" requirement. These opinions have maintained that the most effective approach to protect publicity rights focuses instead on the association between the individual claiming infringement and the allegedly infringing product. In Carson v. Here's Johnny

65. See Tversky & Kahneman, supra note 62, at 1125.
Portable Toilets, Inc., for instance, the dispute involved famed talk show host Johnny Carson and a toilet seat maker using the product name “Here’s Johnny” and the catchphrase, “The World’s Foremost Commodian” to market its products. The U.S. Court of Appeals for the Sixth Circuit reversed the lower court’s dismissal of Carson’s suit. It held that there had been an appropriation of Carson’s identity, owing to the association between the phrases and Carson. The toilet seat maker had infringed Carson’s right of publicity even though it never used the talk show host’s formal name in its marketing scheme. By contrast, the Sixth Circuit noted, owing to the lack of resonance in the public mind, there would have been no infringement had the product been named the “J. William Carson Portable Toilet.” Regardless of the presence of magic words, the court explained that “Carson’s achievement has made him a celebrity which means that his identity has a pecuniary value which the right of publicity should vindicate. Vindication of the right will tend to encourage achievement in Carson’s chosen field.”

Carson’s claim turned on the mental connection between Carson and the product, regardless of the literal accuracy or specificity of the statement in question. This eminently reasonable formulation, consistent with the theoretical underpinnings of the right of publicity, should be the baseline for any approach to resolving comparable disputes.

The U.S. District Court for the Southern District of New York in Ali v. Playgirl, Inc. took a similar holistic approach to evaluating whether a picture published in Playgirl Magazine infringed Muhammad Ali’s right of publicity. It addressed a depiction of a male in a boxing ring, captioned “Mystery Man,” but bearing a distinct resemblance to boxer Muhammad Ali. The picture also “refer[red] to the figure as ‘the Greatest,’” Ali’s well-known moniker. In light of these facts, the court declared that the defendants could not “seriously dispute the assertion that the of-
fensive drawing is in fact Ali's portrait or picture." That is, the court recognized from the picture's context that Ali was the referent, even though he was never explicitly named. The inquiry did not turn on the presence or absence of magic words. Simply, given the picture's context, viewed as a whole, viewers would still reasonably process the information as "Ali."

Yet the Ali court went further. It noted that "defendants appear not only to be usurping plaintiff's valuable right of publicity for themselves but may well be inflicting damage upon this marketable reputation." Indeed, it recognized that injury in one sphere of publicity rights could affect the value of other endorsement opportunities. The intellectual property protected by enforcing rights of publicity—an individual's marketable reputation—does not exist in a vacuum. Rather, a celebrity's reputation is malleable. By publicly tying Ali to unsavory activities, Playgirl could damage his ability to secure even endorsements that have little connection, on their face, to Playgirl's products. The public might conceptualize Ali differently than it had before. In this way, the Ali court acted consistently with the insights of academic researchers and practitioners who craft marketable public images. False endorsements simultaneously threaten to deprive a celebrity of endorsement opportunities and weaken his cultivated brand as a whole. As discussed in Part I.A, Arnold Palmer sought assiduously to avoid advertisements depicting him as a winner, though these opportunities would be lucrative (both for Palmer and for the company seeking to leverage Palmer's reputation as a "winner"). He recognized that there was greater long-term value in nurturing his "sportsmanlike" image. Similarly, the Ali court recognized that Ali's image was malleable and that Ali should retain the exclusive right to choose with which products to associate.

In light of Tversky and Kahneman's analysis of contextual processing, and the reasoning in Carson and Ali, the contours of a
practical inquiry begin to take shape. The test must protect personal property and create strong incentives for economic entrepreneurialism that generate value where previously none had existed. The test must therefore have the sensitivity to capture false endorsements without being unduly overprotective. Yet it must also treat all individuals fairly and equally, regardless of income or wealth, and provide for the expedient resolution of claims.

C. The Endorsement Test

There is an existing test that, if framed by the guideposts discussed above, will more effectively secure publicity rights: the Endorsement Test, developed in the context of the First Amendment. In evaluating whether government action constitutes an impermissible establishment of religion, the Supreme Court has employed a contextual inquiry into “the message that the government’s practice communicates: the question is ‘what viewers may fairly understand to be the purpose of the display.’” Adapted to publicity rights claims, this inquiry calls for a contextual examination of the message fairly understood to be communicated by the item in question. If it is an implied endorsement, the implied endorser’s right to publicity is implicated. Additionally, because this test already has preexisting case law, its interpretation should be more predictable and streamlined.

The Endorsement Test is well-suited to this context for two further reasons. First, the inquiry is based on the perspective of a reasonable observer, not the vagaries of any particular individual’s interpretation. This distinction is important because one can easily imagine the naïve individual who associates golf with Tiger Woods and therefore believes Woods has endorsed any product sold with golf imagery. This individual’s testimony should not secure Woods a publicity rights victory where the product has been associated only with golf, but not with him. The reasonableness standard protects against such an error.

81. In reality, of course, no test can offer perfect protection. Instead, what is sought is a test that comes as close as possible to the goal.
83. See Capitol Square Review & Advisory Bd. v. Pinette, 515 U.S. 753, 779–80 (1995) (O’Connor, J., concurring in part and concurring in the judgment) (stating that the proper standard is not the view of any person, but rather the view of a reasonable person, the “personification of a community ideal of reasonable behavior, determined by the [collective] social judgment” (internal citations omitted)).
Additionally, the Endorsement Test operates as a question of law, rather than fact, allowing for more expedient resolution of clear-cut disputes. Indeed, the test will allow courts to resolve publicity rights issues more easily on the pleadings alone. By contrast, the current complex tests frequently force courts to engage in extensive fact finding, even where the parties seek to stipulate that no further discovery is necessary. Expediting the resolution of these issues offers twin social benefits. First, eliminating the cost of lengthy trials will reduce strain on the courts. It also lessens the economic pressures on the parties to agree to socially inefficient settlements where settling is worth less than the cost of a lengthy trial. Second, by hastening resolutions, the Endorsement Test limits the risk posed by judgment-proof defendants and the accompanying pressure to settle. Consider, for instance, the buttons and other novelty items emblazoned with celebrity images found to have violated rights of publicity in *Bi-Rite Enterprises, Inc. v. Button Master.* Such simple-to-produce items could clearly be the work of judgment-proof individuals, and expedient resolution of such claims would limit the losses stemming from the impossibility of recouping such costs.

How would the Endorsement Test operate in practice? Consider the facts in *Carson.* The phrases “Here’s Johnny” and “The World’s Foremost Commodian” were both designed to make consumers think of Carson. Indeed, the toilet seat maker stipulated to an attempted association with Carson at trial. What, then, would a reasonable observer assume was the meaning of these phrases? It seems only reasonable to assume that they would associate the product with Carson. Reading each statement within the context of the other makes this clear. Although referring to the seat as the “Foremost Commodian” alone would not evoke Carson, because many celebrities could be the world’s foremost comedian, the interplay of the two phrases makes it clear that Carson, owing to the presence of his catchphrase, is the intended referent. Under the Endorsement Test, then, *Carson*

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84. See, e.g., O’Connor v. Washburn Univ., 416 F.3d 1216, 1231 n.7 (10th Cir. 2005) (“The effect prong of the endorsement test . . . is a question of law that this court decides without reference to the reactions of individual viewers.”).
seems to be a case that could quickly be resolved on the pleadings, saving Carson the costs of a lengthy trial.

This result is also consistent with the underlying basis for publicity rights. The defendant intended its implied endorsement to associate the product with Carson, and thus to increase profits. To encourage the development of marketable personas, the right of profit should belong to Carson alone, not to the toilet-seat maker.

The Endorsement Test would also protect socially desirable works that might cursorily appear tangential to publicity rights. For instance, it would protect parody rights, as in Cartoons, L.C. v. Major League Baseball Players Ass'n, featuring unlicensed cartoon depictions of Major League Baseball players. There, the Tenth Circuit explained that parody touches core concerns of the First Amendment as one of the key methods of social criticism. In evaluating the involved parody trading cards, no reasonable observer would imagine that they reflected a product endorsement by the named baseball player. For instance, the court noted that highly paid player Barry Bonds was termed “Treasury Bonds,” and the cards described him as having a “24-karat Gold Glove,” given his compensation. This is clear social criticism, rather than endorsement. The Endorsement Test would adequately protect parody because a reasonable observer would recognize that statements such as those in Cartoons are not purported declarations of fact (no one would play with a 24-karat glove) but rather exaggerations meant as social criticism.

The Endorsement Test would also protect genuine transformation. In evaluating a claim under the right of publicity, the California Supreme Court examined “whether a product containing a celebrity's likeness is so transformed that it has become primarily the defendant’s own expression rather than the celebrity’s likeness.” Given the contextual nature of the Endorsement Test inquiry, and the insights of Tversky and Kahneman, genuine transformations should be protected. In fact, the Endorsement Test’s contextual nature was highlighted by the Supreme Court’s analysis in County of Allegheny v. ACLU,

88. 95 F.3d 959 (10th Cir. 1996).
89. Id. at 972.
90. Id. at 962–63. The “Gold Glove” is a baseball award recognizing defensive achievement.
where it held that the display of a crèche on the courthouse steps was a religious endorsement, but a display of a Christmas tree, a menorah, and a "Salute to Liberty" sign did not constitute an endorsement of religion. The result in County of Allegheny seems consistent with the academic research on how individuals interpret messages. Although a single religious symbol standing alone on the courthouse steps might contextually suggest a connection between the judicial system and the religion symbolized by the symbol, it is also reasonable to find that there is no suggestion of a favored religion where multiple religious symbols and a secular symbol are comingled. The context as a whole affects the way in which viewers see the display—recall, this method of evaluation is so ingrained that even where survey participants knew they should not rely on proffered contextual information, they still did so. Similar logic would protect a news story that legitimately reports on the activities of an individual, while preventing "news" stories that, in reality, are the activities of an individual as in Zacchini.

In short, the Endorsement Test would far more effectively balance the competing interests in this important sphere.

CONCLUSION

There are compelling social reasons for protecting the property rights encompassed within the right of publicity. These rationales have been recognized by theorists and courts alike. At present, the right of publicity is underprotected by virtue of the threat of unequal treatment based on economic status and the complexity of the test applied. Although no test is perfect, the better the guidance provided to the court, the more likely that it will reach the desired result. Given the underlying goals of the right of publicity, importing the Endorsement Test would provide a more effective analytical framework than the current patchwork of tests. The Endorsement Test, as developed here, guided by the theoretical literature, would cut to the core of the relevant inquiry: In light of a disputed message's context, does it appear to a reasonable observer that the plain-

93. Id. at 619.
94. See Tversky & Kahneman, supra note 62, at 1125.
95. See supra text accompanying notes 24–34.
tiff has endorsed the defendant’s message? Such a test would appropriately vindicate the underlying goals of the right of publicity and promote the socially beneficial entrepreneurial spirit. In so doing, courts can better provide a remedy that promotes the underlying ends of publicity rights and spares litigant and court resources.

Michael A. Cooper
NOTE
AN INTERPRETIVE FRAMEWORK FOR NARROWER IMMUNITY UNDER SECTION 230 OF THE COMMUNICATIONS DECENCY ACT

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INTRODUCTION

For well over a decade, courts and commentators have struggled to apply and interpret Section 230 of the Communications Decency Act of 1996 (CDA). Section 230 was designed to accomplish two objectives: First, Congress sought to protect children from Internet pornography by encouraging Internet Service Providers (ISPs) and websites to censor content voluntarily; second, Congress sought to promote freedom of expression on the Internet. To accomplish these two divergent goals, Section 230 grants immunity from tort liability to all websites and ISPs that are not themselves responsible for the creation or development of tortious content. Almost all courts have interpreted Section 230 immunity broadly, covering even publishers who take an active role in the production of controversial content, so long as
they are not the authors. Although this broad interpretation affects the basic goals of the statute, it ignores several serious textual difficulties and mistakenly extends protection too far by immunizing even direct participants in tortious conduct. A proper reading of the statute—one that accounts for the background common law principles of vicarious tort liability upon which Section 230 was enacted—would correct both problems.

Part I introduces Section 230’s history and purpose. Part II reviews the courts’ broad interpretation of the statute. Part III examines several textual difficulties that this broad interpretation raises. Finally, Part IV attempts to solve these difficulties by interpreting Section 230 in light of the relationship between two strains of pre-Internet vicarious liability defamation doctrine and Stratton Oakmont, Inc. v. Prodigy Services Co., the defamation case that prompted Congress to pass Section 230. The analysis indicates that although the immunity provision of Section 230 is broad, Congress did not intend to abrogate traditional common law notions of vicarious liability. Some bases of vicarious liability remain, and their continuing validity both explains the interpretive difficulties and undergirds courts’ recent push to narrow Section 230 immunity.

I. SECTION 230: TEXT AND BACKGROUND

Congress enacted Section 230 of the CDA to achieve two objectives: to address the problem of children accessing pornography and other offensive material on the Internet, and to promote freedom of expression on the Internet, a then-new and potentially fragile communications medium. To accomplish

3. See 47 U.S.C. § 230(b) (2006) (“It is the policy of the United States . . . to remove disincentives for the development and utilization of blocking and filtering technologies . . . .”); Zeran, 129 F.3d at 331 (“Another important purpose of § 230 was to encourage service providers to self-regulate the dissemination of offensive material over their services.”); 141 CONG. REC. 15,503 (1995) (statement of Sen. Exon) (“[T]he worst, most vile, most pernicious pornography is only a few click-click-clicks away from any child on the Internet.”).
these goals, Section 230 grants immunity from tort liability to computer service providers such as websites and ISPs that provide access to defamatory content created by third parties:

§ 230(c) Protection for "Good Samaritan" blocking and screening of offensive material

(1) Treatment of publisher or speaker

No provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider.

(2) Civil liability

No provider or user of an interactive computer service shall be held liable on account of—

(A) any action voluntarily taken in good faith to restrict access to or availability of material that the provider or user considers to be obscene, lewd, lascivious, filthy, excessively violent, harassing, or otherwise objectionable, whether or not such material is constitutionally protected;

§ 230(f)(3) Information content provider

The term "information content provider" means any person or entity that is responsible, in whole or in part, for the creation or development of information provided through the Internet or any other interactive computer service.  

It is easy to see how Congress's grant of immunity promotes freedom of speech: Internet-based publishers are enabled to relay and distribute controversial and even defamatory third-party-created content without fear of tort liability. So long as they are not the authors of the material, "information content providers"—websites and other service providers—will not be liable. As a result, Comcast and Verizon can provide unfettered access to the entire Internet, blog-hosting sites such as WordPress and Blogger can make available the enlightening and sometimes less-enlightening musings of the Internet community at large, and Wikipedia can provide user-authored, encyclopedic coverage of

nearly every topic imaginable—all free from the threat of liability should some user-submitted content prove to be defamatory.  

Section 230’s effect on children’s access to objectionable content is slightly more roundabout. Rather than creating a positive incentive to censor content, the provision operates by removing a major disincentive to censorship: the threat of defamation liability. In *Stratton Oakmont, Inc. v. Prodigy Services Co.*, a New York state court held Prodigy, a then-popular ISP, liable for defamatory content posted by a third party to one of the service’s message boards. The court reasoned that because Prodigy held itself out to the public as a family-friendly, carefully controlled and edited Internet provider, and took steps to screen offensive content, the ISP had taken on the role of a newspaper-like publisher rather than a mere distributor and could therefore be held liable. By filtering some objectionable content, the court reasoned, Prodigy had taken ownership of all of it. Congress rejected this line of reasoning in Section 230 and instead immunized computer service providers from liability “on account of any action voluntarily taken...to restrict access to or availability of [objectionable content].” As a result, censorship of third-party-created content can now proceed freely. Without fear of incurring liability, filtered Internet services can protect homes and workplaces from pornography and other objectionable material, message board administrators can remove obscene or simply off-topic posts from their sites, and bloggers can remove or censor objectionable visitor comments to their postings.

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6. As mere hosts of content created by others, blog-hosting sites are immune from defamation liability under a straightforward application of Section 230. For a thoughtful discussion of the slightly more difficult question of the applicability of Section 230 immunity to Wikipedia, see Ken S. Myers, *Wikimmunity: Fitting the Communications Decency Act to Wikipedia*, 20 HARV. J.L. & TECH. 163 (2006).


8. Distributors, such as libraries, bookstores, and telephone companies, who “deliver, transmit, or facilitate defamation [but] have only the most attenuated or mechanical connection with the defamatory content” are not liable “unless [they] know[] or should know of the defamatory content.” Publishers and republishers, such as book presses and newspapers, on the other hand, are responsible for all harms caused by their defamatory publications. DAN B. DOBBS, THE LAW OF TORTS § 402 (2000).


II. ZERAN, DRUDGE, AND THE MAJORITY VIEW

Section 230 operates straightforwardly: Computer service providers such as ISPs and websites are granted immunity from defamation liability for third-party-created content in order to promote free speech and to allow them to protect children from objectionable content. Courts have struggled, however, to define the precise contours of the statute's immunity provisions. What qualifies as an interactive computer service? Can a business or website simultaneously be both a computer service and a content provider? Can a website or other service provider ever edit content so heavily as to transform itself into a content provider and thereby lose its immunity?

Courts have, from the beginning, adopted a broad view of Section 230 immunity.11 In Zeran v. America Online, Inc.,12 the U.S. Court of Appeals for the Fourth Circuit, the first circuit to interpret the statute, held that even if a service provider exercised significant editorial control over the content in question, it was immune so long as it was not the content's author.13 Later courts gradually expanded Section 230 immunity to cover an increasingly broad range of potential defendants.14 In Blumenthal v. Drudge,15 for ex-

11. See Mark A. Lemley, Rationalizing Internet Safe Harbors, 6 J. TELECOMM. & HIGH TECH. L. 101, 103 (2007) ("[Section 230] has been interpreted quite broadly to apply to any form of Internet intermediary, including employers or other companies who are not in the business of providing Internet access and even to individuals who post the content of another. And it has been uniformly held to create absolute immunity from liability for anyone who is not the author of the disputed content, even after they are made aware of the illegality of the posted material and even if they fail or refuse to remove it." (footnotes omitted)).
12. 129 F.3d 327 (4th Cir. 1997).
13. See id. at 330 ("[L]awsuits seeking to hold a service provider liable for its exercise of a publisher's traditional editorial functions—such as deciding whether to publish, withdraw, postpone or alter content—are barred."). The plaintiff in Zeran alleged that America Online had unreasonably delayed in retracting defamatory messages posted by a third party, refused to post retractions to those messages, and failed to screen for and prevent similar future postings. Id. at 328. The court rejected these arguments, interpreting the text of Section 230 to preclude liability even where a service provider is on notice of and in a position to prevent or remove potentially defamatory content. The entire inquiry turned on the identity of the content's author. Id. at 330–32 ("By its plain language, § 230 creates a federal immunity to any cause of action that would make service providers liable for information originating with a third-party user of the service.").
14. For a useful table of cases illustrating the expanding scope of Section 230 immunity, see Myers, supra note 6, at 205–08. See also H. Brian Holland, In Defense of Online Intermediary Immunity: Facilitating Communities of Modified Exceptionalism, No. 21
ample, the U.S. District Court for the District of Columbia found an ISP eligible for Section 230 immunity even though it had contracted for the development of the unverified gossip column that was at issue in the suit. Thus, even when defamatory content is developed at a service provider’s request, the provider is immune from liability so long as it is not the author of the material.

Almost all courts considering Section 230’s scope have followed Zeran and Drudge, and the Ninth Circuit has formalized the holdings of the cases into a three-part inquiry: (1) is the defendant an “interactive computer service” within the meaning of Section 230; (2) does the plaintiff’s cause of action treat the defendant as a publisher; and (3) was the content at issue in the suit “provided by another information content provider?” If a plaintiff’s cause of action against a website or other computer service treats that service as a publisher of third-party-created content, the defendant will be immune from liability—end of story.

56 U. KAN. L. REV. 369, 374 (2008) ("Following Zeran, and building on that court’s reading of both the statute and the policies sought to be effected, courts have consistently extended the reach of § 230 immunity along three lines: (1) by expanding the class who may claim its protections; (2) by limiting the class statutorily excluded from its protections; and (3) by expanding the causes of action from which immunity is provided."); Brandy Jennifer Glad, Comment, Determining What Constitutes Creation or Development of Content Under the Communications Decency Act, 34 Sw. U. L. REV. 247, 253–58 (2004) (individually discussing several cases in the “series of decisions that offered increasingly broader immunity for ISPs”).

16. Id. at 47, 50.
17. See Universal Commc’n Sys., Inc. v. Lycos, Inc., 478 F.3d 413, 418 (1st Cir. 2007); Batzel v. Smith, 333 F.3d 1018, 1027 (9th Cir. 2003); Green v. AOL, Inc., 318 F.3d 465, 471 (3d Cir. 2003); Ben Ezra, Weinstein, & Co. v. AOL, Inc., 206 F.3d 980, 986 (10th Cir. 2000). But see Chi. Lawyers’ Comm. for Civil Rights Under Law, Inc. v. Craigslist, Inc., 519 F.3d 666, 670 (7th Cir. 2008). Judge Easterbrook reasons in Craigslist that other circuits have extended immunity too far by “treating § 230(c)(1) as a grant of comprehensive immunity from civil liability for content provided by a third party” and urges instead immunity only for publication-based torts. Id. Because publication is not an element of copyright infringement, Judge Easterbrook’s interpretation would allow, for example, computer service providers to be held liable for contributory copyright infringement if their systems were designed to help people steal music.
18. See Batzel, 333 F.3d at 1037 (Gould, J., concurring in part and dissenting in part).
The prevailing approach to Section 230 serves Congress's dual goals quite well. The broad service provider immunity of Zeran and Drudge promotes freedom of speech on the Internet while simultaneously removing a major disincentive to censorship. Zeran and Drudge, along with later cases, however, failed to resolve several serious interpretive difficulties.

A. Subsections 230(c)(1) and (c)(2): Giving Meaning to "Good Samaritan"

Chief among these difficulties is the relationship between subsections (c)(1) and (c)(2). Subsection (c)(1) provides that "[n]o provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider."19 As noted in Part II above, Zeran and later courts quite reasonably interpreted this language to immunize websites and other service providers from tort liability for any third-party-created content regardless of whether they make any editorial changes to the content.20 If this reading is proper, however, then subsection (c)(2), which provides immunity to computer service providers that do choose to censor objectionable third-party-created content, appears to be superfluous.21 If providers who choose to censor third-party-created content are already immune under subsection (c)(1) because the content is not their own, then what can be the purpose of subsection (c)(2), which grants immunity if they choose to censor? The rule against surplusage,22 which would apply with particular force here where the two subsections are textual neighbors, thus militates against the majority view of Zeran and Drudge. Similarly, the very heading of Section 230 and the title of the act of which it is a part coun-

20. See Batzel, 333 F.3d at 1037.
21. Subsection (c)(2) reads: "No provider or user of an interactive computer service shall be held liable on account of—(A) any action voluntarily taken in good faith to restrict access to [objectionable content]." 47 U.S.C. § 230(c)(2) (2006).
22. The rule against surplusage presumes that Congress does not include redundant or otherwise unnecessary language in statutes. WILLIAM N. ESKRIDGE, JR. ET AL., LEGISLATION AND STATUTORY INTERPRETATION 266 (2000); see also Kungys v. United States, 485 U.S. 759, 778 (1988) (calling it the "cardinal rule of statutory interpretation that no provision should be construed to be entirely redundant").
sel against the majority view: “§ 230(c)—which is, recall, part of the ‘Communications Decency Act’—bears the title ‘Protection for ‘Good Samaritan’ blocking and screening of offensive material’, hardly an apt description if its principal effect is to induce ISPs to do nothing about the distribution of indecent and offensive material.” 23 The majority view reads subsection (c)(2) entirely out of the text and in the process renders the Section powerless to achieve its stated objective—encouragement of self-censorship. 24

B. Subsections 230(c)(1) and (f)(3): Defining Information Content Providers

The language of Section 230 implies a world composed of two distinct categories of entities: information content providers and computer service providers. Information content providers are liable in tort for the damages their content causes, whereas computer service providers such as ISPs and websites are immune. But what happens when the distinction between service provider and content provider becomes blurred? Is it possible for multiple individuals to be collectively responsible for content? Could an ISP or website be simultaneously both a service provider and a content provider? Without clear statutory guidance, courts 25 and commentators 26 have struggled mightily to discover

24. See id. (noting that if the majority approach is correct, “then § 230(c) as a whole makes ISPs indifferent to the content of information they host or transmit: whether they do (subsection (c)(2)) or do not (subsection (c)(1)) take precautions, there is no liability under either state or federal law” (emphasis added)).
25. See, e.g., Fair Hous. Council of San Fernando Valley v. Roommates.com, LLC, 521 F.3d 1157, 1184 (9th Cir. 2008) (searching dictionaries, case law, and the text of the statute for the “ordinary meaning” of “development”); Batzel, 333 F.3d at 1031 (“The ‘development of information’ therefore means something more substantial than merely editing portions of an e-mail and selecting material for publication.”); Ben Ezra, Weinstein & Co. v. AOL, Inc., 206 F.3d 980, 984–86 (10th Cir. 2000) (holding defendant not liable when plaintiff alleged defendant was acting as both computer service and content provider); Anthony v. Yahoo!, Inc., 421 F. Supp. 2d 1257, 1262–63 (N.D. Cal. 2006) (stating that even when Yahoo! did not create the online material, the CDA “[did] not absolve Yahoo! from liability for any accompanying misrepresentations” they made that the material was genuine); MCW, Inc. v. Badbusinessbureau.com, L.L.C., No. Civ. A:3:02-CV-2727-G, 2004 WL 833595, at *8 (N.D. Tex. Apr. 19, 2004) (“The distinction between merely publishing information provided by a third-party as an interactive computer service and actually creating or developing any of the information posted as an information content provider is critical [and] determines whether the CDA provides immunity.”); Carafano v. Metrosplash.com, Inc., 207 F. Supp. 2d 1055, 1066–68 (C.D. Cal. 2002) (finding that defendant, although a computer service, was also an in-
Narrower Immunity

the precise distinction between a mere service provider that exercises traditional editorial discretion and an information content provider, receiving no immunity under Section 230.27

Consider the facts before the court in MCW, Inc. v. Badbusinessbureau.com, L.L.C.28 In MCW the U.S. District Court for the Northern District of Texas considered a claim against Badbusinessbureau.com (BBB),29 a web-based forum that allows consumers to post business complaints and vent their frustrations to the Internet-browsing public.30 MCW, the target of several negative user-submitted reviews, brought an action against BBB, alleging a variety of common law and statutory violations.31 BBB sought dismissal, claiming immunity under Section 230.32 If BBB were a mere conduit through which customers could publicize their grievances, the case would have been simple. Such conduits clearly are immune as service providers un-


27. Zeran and later decisions have made it quite clear that a computer service provider need not be a mere conduit in order to qualify for immunity. So long as its actions do not take it out of the traditional realm of editorial discretion and into the realm of authorship, a computer service will retain its Section 230 immunity. Zeran v. AOL, Inc., 129 F.3d 327, 330 (4th Cir. 1997) ("[Section] 230 precludes courts from entertaining claims that would place a computer service provider in a publisher's role. Thus, lawsuits seeking to hold a service provider liable for its exercise of a publisher's traditional editorial functions—such as deciding whether to publish, withdraw, postpone or alter content—are barred."). Of course, at the extreme, the exercise of traditional editorial functions can start to look very much like co-authorship.


31. The plaintiff alleged, among other violations, unfair competition, business disparagement, and trademark infringement. Id. at *2.

32. Id. at *7.
der Section 230. But the site was much more than a conduit. After receiving complaints, the site operators categorized them by geographic region and often added disparaging titles. On some occasions the site had actively solicited the negative content submissions from its users, further blurring the line between service provider and content provider.

The court was forced to decide whether BBB was merely a service provider that had chosen to exercise a rather broad degree of editorial discretion or whether it had crossed the provider-creator line and become responsible for the content in question. This line is difficult to draw. Unfortunately, the text of Section 230 provides little guidance. Section 230(f)(3) defines an information content provider as “any person or entity that is responsible, in whole or in part, for the creation or development of information provided through the Internet or any other interactive computer service.” Does soliciting content make one “responsible for its creation”? Does adding a title to another’s content make one a partial creator of that content? Perhaps, but perhaps not.

The Zeran line of cases does little to clarify the standard, for they simply restate the statutory language while ignoring the potential for ambiguity at the margins. When confronted with facts that force a resolution of the ambiguous distinction between service provider and content provider, courts almost un-

33. Id. at *1, *9 nn.10-11.
34. Id. at *10.
35. Id. at *7-8 (“The CDA requires courts to determine . . . when content provided by third-parties is somehow transformed into content created or developed by an interactive computer service. The distinction between merely publishing information provided by a third-party as an interactive computer service and actually creating or developing any of the information posted as an information content provider is critical.” (citation omitted)).
37. The MCW court ultimately concluded that BBB was not entitled to protection under Section 230. Id. at *10. Its conclusion was based in part on the argument that even if BBB was not literally the creator or developer of the content at issue, it was at the very least “responsible . . . for the creation or development” of that content. Id. at *10 n.12. This interpretation of Section 230(f)(3)'s definition of information content provider is broader than the majority view, narrowing Section 230 immunity. It provides, however, no more guidance than does the majority view for determining where to draw the line between mere service providers and content providers. It simply moves that line in a direction less favorable to immunity.
38. Zeran v. AOL, Inc., 129 F.3d 327, 330 (4th Cir. 1997) ("[Section] 230 creates a federal immunity to any cause of action that would make service providers liable for information originating with a third-party user of the service.").
failingly resolve the issue in favor of immunity. Unless a service provider literally and unambiguously pens the words of the content in question, it will be immune from liability.

Followed to its logical conclusion, this view would immunize parties surely not within the intended scope of Section 230. Imagine, for example, a hypothetical website, harassthem.com. Visitors to the site are encouraged to get even with others by publicly posting a target’s name, address, credit card information, and so forth, along with embarrassing facts or stories about him. The site instructs users that the information need not be confirmed and can be based on rumor, conjecture, or fabrication. Such a site, by providing a forum for and encouraging defamation, can be quite reasonably considered “responsible... in part, for the creation or development” of the resulting tortious content, rendering it ineligible for Section 230 immunity. Yet the content is not authored by harassthem.com. It “originat[es] with a third-party user of the service,” which, under Zeran, is all that is necessary for service provider immunity. Zeran fails to account for those circumstances in which immunity should be cut off even absent full authorship. Consequently, its framework is of little use in drawing the appropriate line between mere service providers and those responsible for tortious content.

C. Now-Undesirable Policy Outcomes

The Zeran line also suffers from a flaw not of its own creation. Section 230 takes as an explicit objective the “continued development of the Internet...[and preservation of] the vibrant and competitive free market that presently exists for the Internet.”


40. This example is from Fair Housing Council of San Fernando Valley v. Roommates.com, LLC. 489 F.3d 921, 928 (9th Cir. 2007).

41. The scenario is, unfortunately, not all that far-fetched. Consider sites such as DontDateHimGirl.com, ManHaters.com, and TrueDater.com that offer disgruntled lovers the opportunity to vent their frustrations and warn future victims of their ex-partners’ faults, mixing public service and sweet revenge. See Lizette Alvarez, (Name Here) Is a Liar And a Cheat, N.Y. TIMES, Feb. 16, 2006, at G1.


43. Zeran, 129 F.3d at 330.

Congress recognized the enormous potential of the Internet and feared that unchecked tort liability might decrease its value as a facilitator of free speech. But, as some have noted, "the Internet is no longer in its infancy." Internet publications have matured to the point where, at least in certain instances, they are robust enough to face the same exposure to liability as their print counterparts. For example, it no longer serves any coherent purpose to treat defamatory content in the print edition of the New York Times differently than that in the online version. This is not to say, of course, that the Internet has no need for protection. Certain contexts may very well warrant special protections. Many continue to defend vigorously the special protection that Section 230 currently affords Internet publications because of the Internet's unique status as a facilitator of free individual expression. Still, the Internet landscape has changed dramatically since Zeran was decided, and its extremely broad immunity seems slightly out of step with modern policy objectives. The Internet continues to serve as a valuable facilitator of free expression, but it has now become such a robust and integral part of modern life that it can safely be subjected to at least minimal regulation. Indeed, the ubiquity of modern Internet-based communication suggests that such regulation is not only feasible but normatively desirable. As an increasing percentage of human interaction and communication is transferred to the digital realm, legal remedies must follow, lest familiar wrongs be left without familiar remedies.

45. Zeran, 129 F.3d at 330.


47. See Magee & Lee, supra note 26 (arguing that the same defamation standard should apply to both print and web-based news portals).

48. Newspapers author most of their material and so are not in a position to benefit from Section 230 immunity. Third-party-authored advertisements, though, are the exception. In the print context, courts have held primary publishers like newspapers responsible even for advertisements prepared by others. See DOBBS, supra note 8, § 402 (citing Triangle Pubs., Inc. v. Chumley, 317 S.E.2d 534 (Ga. 1984)). Online newspapers, however, would be immune from liability under Section 230.

49. See, e.g., Holland, supra note 14, at 391–404.

IV. A NARROWER VIEW OF SECTION 230 IMMUNITY

The search for coherence and the desire to achieve sensible policy outcomes have led a growing number of courts to apply Section 230 immunity more narrowly. By interpreting “content development” to encompass more than mere literal authorship, some courts have allowed plaintiffs’ claims to go forward against websites even where a third party created the content at issue.

For example, in *Fair Housing Council of San Fernando Valley v. Roommates.com, LLC*, the Ninth Circuit considered a discrimination claim against the website Roommates.com. The site was designed to match people renting spare rooms with people looking for housing. A user posting an available housing opportunity on the site was required to provide not only basic identificatory information but also more personal and controversial information such as his sex, sexual orientation, and whether he would bring children to the household. The user was asked to provide this data by selecting from a limited set of answer choices. The Fair Housing Councils of San Fernando Valley and San Diego

swath of online speech is not the right general approach. Nor do I favor a set of rules that apply only in cyberspace and not in offline life. The rules should, to the greatest extent possible, be the same in the online context as offline. We should strive to apply rules of general applicability to the Internet context.”; JOHN PALFREY & URS GASSER, BORN DIGITAL: UNDERSTANDING THE FIRST GENERATION OF DIGITAL NATIVES 106-07 (2008) (“The scope of the immunity the CDA provides for online service providers is too broad... There is no reason why a social network should be protected from liability related to the safety of young people simply because its business operates online.”); see also Susan Freiwald, Comparative Institutional Analysis in Cyberspace: The Case of Intermediary Liability for Defamation, 14 HARV. J.L. & TECH. 569, 654 (2001) (“[T]otal immunity for intermediaries rather than distributor liability represents a failure of public policy and the poor resolution of a legal conflict.”); Lemley, *supra* note 11, at 101-02 (arguing that Section 230’s immunity provision is inconsistent with and less desirable than other federal Internet intermediary safe harbors); Melissa A. Troiano, Comment, The New Journalism? Why Traditional Defamation Laws Should Apply to Internet Blogs, 55 AM. U. L. REV. 1447, 1475 (2006) (“Because many bloggers utilize their blogs to attract a large public audience in a way that resembles the function of traditional print journalism, bloggers should not be immune from suit simply because they publish their work on the Internet. Instead, bloggers who choose to share their views with the public, and who individually monitor their content, should be responsible for ensuring the legality of their content prior to publication.”).

51. 521 F.3d 1157 (9th Cir. 2008).
52. *Id.* at 1161.
53. *Id.* at 1161–62.
54. *Id.* at 1166.
sued, alleging that the site violated the federal Fair Housing Act and California housing discrimination laws.\textsuperscript{55}

Writing for a divided Ninth Circuit panel, Chief Judge Kozinski rejected the defendant's Section 230 immunity defense. The court reasoned that a website "can be [simultaneously] both a service provider and a content provider"\textsuperscript{56} and that "[b]y requiring subscribers to provide the information as a condition of accessing its service, and by providing a limited set of pre-populated answers, Roommate be[came] much more than a passive transmitter of information provided by others; it bec[ame] the developer, at least in part, of that information."\textsuperscript{57} In so holding, the court departed slightly from Zeran's extremely narrow articulation of what constitutes "content development." Instead, the court recognized that the range of potential liability must extend somewhat further than literal authorship to other parties who are also directly responsible. Roommates.com was responsible because it solicited and aided the content's development. That the user posting to the site was the last in the chain to push a button or click a mouse was insignificant because the content was the product of a collaborative effort.\textsuperscript{58}

Cases such as Roommates.com are rare but not unheard of.\textsuperscript{59} They represent a push against the broad immunity of the majority view and make some effort to address the interpretive difficulties that courts have faced in applying Section 230.\textsuperscript{60}

What these courts have failed to do, however, is to provide a theoretical foundation that explains their deviations from the

\textsuperscript{55} Roommates.com, 521 F.3d at 1162. The Fair Housing Act prohibits discrimination on the basis of "race, color, religion, sex, familial status, or national origin," 42 U.S.C. § 3604(c) (2006), and the California fair housing law prohibits discrimination on the basis of "race, color, religion, sex, sexual orientation, marital status, national origin, ancestry, familial status, source of income, or disability." CAL GOV'T CODE § 12955 (West 2005).

\textsuperscript{56} Roommates.com, 521 F.3d at 1162.

\textsuperscript{57} Id. at 1166.

\textsuperscript{58} Id. at 1166-67.

\textsuperscript{59} See, e.g., MCW, Inc. v. Badbusinessbureau.com, L.L.C., No. Civ. A.3:02-CV-2727-G, 2004 WL 833595 (N.D. Tex. Apr. 19, 2004); see also Chi. Lawyers' Comm. for Civil Rights Under Law, Inc. v. Craigslist, Inc., 519 F.3d 666, 670-71 (7th Cir. 2008) (rejecting majority view of Section 230 immunity and instead interpreting Section 230 immunity to apply only to publication-based torts); Batzel v. Smith, 333 F.3d 1018, 1033 (9th Cir. 2003) (reasoning that a defendant would not be immune under Section 230 where, though the content was provided by a third party, it was not provided with the expectation that it would be posted to the Internet).

\textsuperscript{60} See supra Part III.
majority view and that defines the precise boundaries of the exceptions they create to the general rule of immunity for providers of third-party-created content. They announce "no immunity here" without providing a satisfactory account of how Section 230 should now be understood.

This Part attempts to provide that missing framework by analyzing Section 230 in light of the relationship between two strains of pre-Internet vicarious liability defamation doctrine and Stratton Oakmont, Inc. v. Prodigy Services Co., the defamation case that prompted Congress to enact Section 230. The analysis indicates that although the immunity provision of Section 230 is broad, Congress did not intend to abrogate entirely traditional common law notions of vicarious liability. Some bases of vicarious liability remain, and their continuing validity produces a cogent distinction between "content providers" and "content developers." It also resolves the tension between Section 230's encouragement of "Good Samaritan" screening and its simultaneous provision for sweeping immunity regardless of any censorial action.

A. Pre-Internet Precursors: Ratification and Concert of Action

The common law of defamation provides two relevant lenses through which to interpret Section 230 immunity. First, consider the pre-Internet theory of defamation by ratification. Under that doctrine, "[o]ne who intentionally and unreasonably fails to remove defamatory matter that he knows to be exhibited on land or chattels in his possession or under his control is subject to liability for its continued publication." These cases typically involve a defendant who, though not the author of the defamatory statement in question, has implicitly ratified that statement by his failure to remove it from a place of prominence on his property. In Tacket v. General Motors Corp., for example, the Court of Appeals for the Seventh Circuit considered the defamation claim of Thomas Tacket, a General Motors employee, against that company for its eight-month failure to remove an unauthorized and allegedly defamatory stenciling from its factory walls. Tacket had been im-

62. See supra Part III.B.
63. See supra Part III.A.
64. See RESTATEMENT (SECOND) OF TORTS § 577(2) (1977).
65. 836 F.2d 1042 (7th Cir. 1987).
plicated in a scheme in which he, in his managerial capacity with General Motors, had approved a contract to purchase wooden boxes from a firm located in his friend’s garage.66 Upon learning of the scheme, Tacket’s fellow employees expressed their displeasure by inscribing the phrase “TACKET TACKET WHAT A RACKET” on a highly visible area of a factory wall.67 The Seventh Circuit held that the message could not have remained on the wall for eight months without approval of the company’s management and that the company had therefore adopted the statements as its own.68 Though somewhat rare, defamation by ratification is a natural extension of basic defamation principles. By adopting statements of a third party as his own and continuing to publish them on his property, a defendant has taken individual ownership of these statements. They belong as much to him as if directly spoken, and they are no less damaging.

Second, consider defamation by concert of action.69 As in criminal law, defendants who cooperate to pursue a tortious goal may be held liable together, even though each has not individually committed every element of the offense. If two parties target a plaintiff’s house for robbery, and one breaks down the door while the other beats the plaintiff, each is liable for his own acts as well as those of his coconspirator.70 Similarly, in the defamation context, if several actors join together to create and disseminate defamatory material, all may be held liable. For example, in Gosden v. Louis,71 the Court of Appeals of Ohio considered the defamation claim of a construction company against seventeen residents of an apartment complex where the company had performed work.72 One of the residents had drafted a letter, later signed by the other residents, alleging that while working at the complex, employees

66. Id. at 1044.
67. Id. at 1045, 1047.
68. Id. at 1047.
69. For a general treatment of contributing tortfeasor (or “civil conspiracy”) liability, see RESTATEMENT (SECOND) OF Torts § 876: “For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) does a tortious act in concert with the other or pursuant to a common design with him, or (b) knows that the other’s conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . .”
Id.
70. See DOBBS, supra note 8, § 340; see also Drake v. Keeling, 299 N.W. 919 (Iowa 1941); Smithson v. Garth, 3 Lev. 323, 83 Eng. Rep. 711 (1691).
72. Id. at 486–87.
of the company had driven their vehicles recklessly, harassed neighborhood residents, used profane language, engaged in lewd and voyeuristic acts, and violated a county noise ordinance. Each of the defendants freely admitted to having signed the letter, and the court held these admissions sufficient to support a jury finding of conspiracy to defame the plaintiff. Like ratification torts, concert of action torts are relatively rare. Nonetheless, the category is a logical expansion of the tort doctrine that holds all participants in tortious schemes equally liable. Tortfeasors should not escape liability simply because they choose to work in groups.

B. A Narrower Interpretation of Section 230

The tort theories of ratification and concert of action help to explain the perplexing relationship between subsections (c)(1) and (c)(2) of Section 230. Subsection (c)(1) provides that “[n]o provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider.” Because this language seems to provide complete immunity to service providers regardless of whether they choose to censor content or not, the subsection appears inconsistent with (c)(2), which provides immunity only to service providers that do choose to censor content.

Ratification and concert of action relieve the tension between the two subsections. Despite its strong language, subsection (c)(1) cannot have been intended to immunize service providers from liability for third-party-created content in every context. Such an interpretation would yield nonsensical results. Congress could not have intended, for instance, to immunize a website run by a political organization that conspires with a third-party author to defame an opposing candidate viciously. The strict application of subsection (c)(1)’s language appears to confer such immunity, but that language must be interpreted in light of the background principles of tort law. Something remains of

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73. Id.
74. Id. at 498.
75. See supra Part III.A.
77. See supra Part III.A.
78. Apart from the absurd results that follow an interpretation providing immunity in absolutely every instance of third-party-created content, an interpretation that preserves traditional common law bases of vicarious liability can be justi-
liability for third-party-created content even after subsection (c)(1): liability where a website either ratifies content created by a third-party or is a coconspirator in its creation. Once it is understood that subsection (c)(1)'s immunity is not absolute—that its language does not abrogate traditional bases of vicarious liability—subsection (c)(2)'s purpose becomes much clearer.

The purpose of subsection (c)(2) is to immunize websites from certain types of vicarious liability. Section 230 was drafted partly in response to Stratton Oakmont, Inc. v. Prodigy Services Co.,80 which found an ISP liable because, despite a stated policy of censoring objectionable content, the company failed to censor statements that falsely accused Stratton Oakmont and its president of crimi-

79. Indeed, no one could reasonably argue that Section 230 was intended to eliminate all bases of vicarious liability. There is no doubt, for instance, that Section 230 left intact the doctrines of respondeat superior and agency liability. A website owner who argued that he should receive immunity because it was his employee, a third party, who posted tortious material would be laughed out of court. All courts to consider the issue have simply assumed that standard principles of agency law remain unchanged by Section 230's immunity provision. See Batzel v. Smith, 333 F.3d 1018, 1035 (9th Cir. 2003) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act. In order for [the defendant] to be held vicariously liable for the torts of [the third party tortfeasor] on a theory of agency, [the defendant] must have had the ability to control [the third party’s] activities." (internal citations omitted)); Higher Balance, LLC v. Quantum Future Group, Inc., No.08-223-HA, 2008 WL 5281487, at *7 (D.Or. 2008) ("[P]laintiff has failed to show that the [website] forum moderators are . . . staff members. Without this evidentiary link, plaintiffs have not shown that the forum moderators are employees or agents . . . ."); Blumenthal v. Drudge, 992 F. Supp. 44, 50 (D.D.C. 1998) ("It is also apparent to the Court that there is no evidence to support the view originally taken by plaintiffs that [the third party tortfeasor] is or was an employee or agent of [the defendant]."). Ratification and concert of action are no different.

The theory of liability in *Stratton* was one of ratification. The court reasoned that "Prodigy had uniquely arrogated to itself the role of determining what [was] proper for its members to post and read" and could therefore be held liable as a publisher of any defamatory material posted to its bulletin board system. By failing to remove defamatory statements from its system, Prodigy had ratified and republished those statements, making it no less liable than the original speaker. With subsection (c)(2), Congress essentially overruled *Stratton*, stipulating that failure to censor never constitutes ratification. Congress recognized that service providers would be discouraged from censoring at all if by doing so they risked incurring liability and so stepped in and disqualified censorship as a ground for ratification liability.

Other avenues for vicarious liability nevertheless remain even after subsection (c)(2). Websites and other service providers can still be liable for third-party-created content if they ratify that content in a manner other than by failure to censor, and they can still be liable if they engage in a tortious concert of action with a third party. As an example, consider the website of the Republican party, gop.com. If an Internet user posts content calumniously accusing President Obama of treason or of piracy on the high seas, gop.com will be immune from defamation liability under subsection (c)(2). Suppose, though, that instead of merely failing to remove the post, gop.com reprogrammed its website such that the post was prominently displayed to every visitor of the site. Alternatively, suppose that the post was part of a larger right-wing conspiracy of which gop.com was a part—that gop.com had acted in concert with the defamer to make his voice heard. Under such circumstances, gop.com's invocation of Section 230 immunity should fail. Though not the creator of the content, gop.com could still be liable as a ratifier or coconspirator of the defamer.

Principles of vicarious liability also clarify another difficulty courts have faced in applying Section 230: the service provider-content provider distinction. What does it mean to be "responsible, in whole or in part, for the creation or development" of

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82. *Id.*
83. *See id.; RESTATEMENT (SECOND) OF TORTS §§ 577(2), 578 (1977)(including failure to remove defamatory materials in the definition of publication).*
84. *See supra Part III.B.*
Internet content, and when do websites cross the line and become content providers? The slight trend toward broader liability is a push in the right direction, but courts have thus far insufficiently articulated the boundaries of expanded liability. The pre-Internet theories of ratification and concert of action liability help to define those boundaries. Responsibility should extend somewhat further than the Zeran line seems to allow. The category of individuals responsible for the creation or development of content is broader than literal content authors. It includes not only the last individual in a chain to press a button or click a mouse but also all of the ratifiers and coconspirators along the way. A few courts have, admirably, moved to narrow Section 230 immunity. But, without a coherent interpretive framework by which to distinguish who is and who is not "responsible in part" for the "creation or development" of content, they leave themselves open to the critique that they have merely carved out exceptions by judicial fiat—that there is no principled way to deny immunity in one case but not another. The common law doctrines of conspiracy and ratification can supply the basis for those distinctions. Their application will allow courts to make principled determinations as to what sorts of conduct take service providers out of the realm of immunity and into the realm of responsibility for objectionable content.

Conclusion

This historical, common law-focused approach to the scope of Section 230 immunity accomplishes several goals. First, by recognizing that two categories of vicarious liability survive subsection (c)(1), it is possible to explain the nagging question of subsection (c)(2)’s purpose given subsection (c)(1)’s seemingly endless breadth. Subsection (c)(2) explicitly eliminates the rationale for ratification liability relied on in Stratton v. Oak-

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86. See Fair Hous. Council of San Fernando Valley v. Roommates.com, LLC, 521 F.3d 1157, 1166–67 (9th Cir. 2008) (“The projectionist in the theater may push the last button before a film is displayed on the screen, but surely this doesn’t make him the sole producer of the movie.”).

87. Excluding, of course, ratification by failure to censor. Such theories of ratification are expressly prohibited by subsection (c)(2).

88. See, e.g., Roommates.com, 521 F.3d at 1183 (McKeown, J., concurring in part and dissenting in part) (“The majority’s definition of ‘development’ would transform every interactive site into an information content provider and the result would render illusory any immunity under § 230(c).”).
Mont, Inc. v. Prodigy Services Co.—ratification by failure to censor. Second, by articulating the ways in which a party who is not the literal author of content may nonetheless be responsible for that content, it is possible to clarify slightly the sometimes difficult distinction between content providers and mere service providers. Finally, by grounding the content provider-service provider distinction in the common law doctrines of ratification and concert of action, it is possible to provide a theoretical underpinning to the nascent trend toward narrower Section 230 immunity. Courts are empowered to apply a more developed framework to questions of responsibility, avoiding accusations that the concept is limitless or a creation of judicial fiat.

Gregory M. Dickinson
NOTE

PUNISHMENT AND STUDENT SPEECH:
STRAINING THE REACH OF THE FIRST AMENDMENT

INTRODUCTION

On April 24, 2007, Avery Doninger referred to officials at her high school as "douchebags" on her private blog. Finding little humor in the reference, the school officials responded by barring Doninger's run for a position on the student council. Doninger challenged the school's decision, alleging that the First Amendment protected her speech and limited the extent of her punishment. The U.S. District Court for the District of Connecticut rejected both claims after finding that the school could suppress her "uncivil and offensive" speech and that the "scope of...punishment lay within [the school's] discretion." In a panel opinion joined by then-Judge Sotomayor, the Second Circuit upheld the lower court's ruling that the speech was unprotected but declined to address the scope of the school officials' discretion to punish Doninger. Instead, the court noted that, "given the posture of this case, we have no occasion to consider whether a different, more serious consequence than disqualification from student office would raise constitutional concerns."

The "constitutional concerns" referenced in the Second Circuit's opinion present novel questions about the First Amendment's application to student speech. Although the Supreme Court has emphasized consistently that school officials deserve

2. Id. at 207–08.
3. Id. at 211.
4. Id. at 216.
5. Id. at 215.
7. Id. at 53 (citing Wisniewski v. Bd. of Ed. of the Weedsport Cent. Sch. Dist., 494 F.3d 34, 40 (2d Cir. 2007)).
deference in regulating student speech,\(^8\) the Court has not decided whether deference extends to a school’s choice of punishment. Supreme Court cases evaluating student speech under the First Amendment have risen and fallen on the suppression issue; that is, the Court has ended its inquiry after determining whether the speech was protected or not.\(^9\) Recent Court of Appeals decisions, including \textit{Doninger}, have gone beyond the Supreme Court’s precedent and created uncertainty about whether courts can use the First Amendment to limit the extent to which schools punish students for their unprotected speech.\(^10\) These cases not only signal an unprecedented level of judicial scrutiny, but also invite a reexamination of the degree of deference courts owe school officials.

Punishment implicates First Amendment values when it induces self-censorship.\(^11\) Unwanted deterrence of valid speech grows when the scope of First Amendment protection is unclear, as is often the case in school settings where the margin of protected speech is particularly blurred.\(^12\) Although the Supreme Court has not examined the issue of punishment in the

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\(^8\) See, e.g., \textit{Morse v. Frederick}, 551 U.S. 393, 396–97 (2007) (quoting \textit{Bethel Sch. Dist. No. 403 v. Fraser}, 478 U.S. 675, 682 (1986)) (ruling that otherwise protected speech received abridged protections in a school setting); \textit{Hazelwood Sch. Dist. v. Kuhlmeier}, 484 U.S. 260, 270 (1988) (upholding principal’s decision to delete student articles from school newspaper because “school officials were entitled to regulate the contents of [the school newspaper] in any reasonable manner”).

\(^9\) See, e.g., \textit{Morse}, 551 U.S. at 397 (concluding First Amendment analysis after determining that school could suppress student speech); \textit{Hazelwood}, 484 U.S. at 273–74 (same); \textit{Fraser}, 478 U.S. at 685 (same).

\(^10\) \textit{Doninger}, 527 F.3d at 53; \textit{Wisniewski}, 494 F.3d at 35 (reviewing disciplinary action against student for allegedly threatening speech); \textit{LaVine v. Blaine Sch. Dist.}, 257 F.3d 981, 992 (9th Cir. 2001) (invalidating school discipline of student speech without specifying level of scrutiny).

\(^11\) Dissenting in \textit{Alexander v. United States}, Justice Kennedy commented that “[t]here can be little doubt that regulation and punishment of certain classes of unprotected speech have implications for other speech that is close to the proscribed line, speech which is entitled to protections of the First Amendment.” 509 U.S. 544, 565 (1993) (Kennedy, J., dissenting).

context of student speech, it has engaged in analogous inquiries in two other areas of First Amendment jurisprudence: defamation and obscenity. In defamation actions, the Court has held that the First Amendment bars the imposition of punitive damages in some circumstances because an award of punitive damages may cause media self-censorship. In obscenity actions, however, the Court has declined to use the First Amendment to limit liability. It remains to be seen where the Court will place student speech between the divergent, yet not necessarily conflicting, strands of defamation and obscenity cases. This Note argues that courts should follow the Supreme Court's reasoning in obscenity cases by refusing to scrutinize the extent of school punishment of unprotected speech.

Part I examines the two lines of cases—defamation and obscenity—in which courts have assessed whether the First Amendment limits the magnitude of punishment of unprotected speech. This Part then highlights recent lower court decisions that note the constitutional concerns associated with punishment of student speech. Part II considers whether courts should adopt intermediate scrutiny or a form of rational basis review in examining school disciplinary measures under the First Amendment. Finally, Part III argues that courts should not construe the First Amendment to limit the extent to which a school may punish unprotected student speech.

I. THE FIRST AMENDMENT FRAMEWORK FOR PUNISHMENT

A. Defamation

The Supreme Court has used the First Amendment to limit punishment of unprotected speech in defamation actions. Defamation precedent for much of the last two centuries permitted awards of punitive damages. In the 1971 decision

13. See infra Part I.A.
14. See infra Part I.B.
Rosenbloom v. Metromedia, Inc., however, the Supreme Court began to shift its approach to damages. There, the Court considered whether the evidentiary standard announced in New York Times v. Sullivan should extend to private individuals involved in matters of public concern. A majority refused to extend the New York Times standard, and the Court splintered on the issue of standards of proof required for "public figures." This divergence prompted debate over the extent of damages available in defamation actions. Justices Stewart and Marshall urged the Court to adopt a negligence standard for actual damages proved, but to bar punitive damages entirely. Justice Harlan disagreed, deeming punitive damages constitutionally permissible to the extent they had a "reasonable and purposeful relationship" to the "actual harm done."

Three years after Rosenbloom, the Supreme Court decided Gertz v. Welch and changed the contours of permissible defamation damages, adopting Justices Stewart and Marshall's view disallowing punitive damages. In Gertz, the Court considered the damages available to a private individual in a defamation suit against a magazine publisher. Because the heightened evidentiary standard of New York Times did not apply to private plaintiffs, the Court cautioned against the discretionary power of juries "selectively to punish expressions of unpopular views." The Court stressed that such punishment would lead to media self-censorship, and held that, on a showing of negligence alone, a private plaintiff could recover compensatory damages but not punitive damages.

the validity of punitive damages was so well established that a contrary claim would “not admit of argument”).

18. Rosenbloom, 403 U.S. at 43–44.
19. Id. at 29.
20. Id. at 82–86 (Marshall, J., dissenting).
21. Id. at 77 (Harlan, J., dissenting).
23. Id. at 350.
24. Id. at 347–49.
circumstances remains binding today,\textsuperscript{25} although the Court later
limited it to matters involving a public concern.\textsuperscript{26}

B. Obscenity

By contrast, the Supreme Court has consistently declined to
limit the extent of punishment for obscene materials.\textsuperscript{27} In \textit{Alexander v. United States}, for example, the Court considered whether
stiff punishment of obscenity under the Racketeer Influenced
and Corrupt Practices Act (RICO) implicated the First Amend-
ment.\textsuperscript{28} The Court acknowledged that RICO's large forfeiture
provision may lead "cautious booksellers to . . . remove margin-
ally protected materials from their shelves out of fear that
those materials could be found obscene and thus subject them
to forfeiture."\textsuperscript{29} But the Court rejected the First Amendment
chilling argument, ruling that the legitimate goal of curtailing
obscenity prevailed over its incidental self-censorship effects.\textsuperscript{30}

The punishment of obscenity, however, has not escaped con-
troversy on the Court. Justice Kennedy dissented in \textit{Alexander
to argue that RICO's forfeiture provision violated the First Amend-
ment. Noting that "the government must use measures that are
sensitive to First Amendment concerns in . . . punishing speech,"
Justice Kennedy took issue with RICO's forfeiture provision be-
because it authorized the government to shut down bookstores that
sold otherwise protected speech after finding a single obscene ar-
ticle.\textsuperscript{31} In his view, the severity of RICO's penalties induced the
"evils" of state censorship and self-censorship beyond constitu-
tionally permissible levels.\textsuperscript{32} Justice Kennedy concluded that the

\textsuperscript{25. Herbert v. Lando, 441 U.S. 153, 162 n.7 (1979) (noting that \textit{Gertz} limited the
entitlement to punitive damages); Patrick v. Cleveland Scene Pub. LLC, 582 F.
58 (1985).
27. See \textit{Alexander v. United States}, 509 U.S. 544, 555 (1993) ("We have in the past
rejected First Amendment challenges to statutes that impose severe prison sent-
ences and fines as punishment for obscenity offenses."); \textit{Fort Wayne Books, Inc.
v. Indiana}, 489 U.S. 46, 60 (1989) (declining to limit the extent of punishment of
obscenity under Indiana law).
30. \textit{Id.} at 556.
31. \textit{Id.} at 574 (Kennedy, J., dissenting) (citations omitted).
32. \textit{Id.} at 572.
“censorial cast” of the forfeiture provision amounted in substance to a prior restraint that violated the First Amendment.33

Sixteen years before *Alexander*, Justice Stevens twice departed from Supreme Court precedent to argue that the First Amendment should limit the punishment of obscenity. In *Marks v. United States*, the Court held that the three-part *Miller v. California*34 test for obscenity could not be applied retroactively to the detriment of the defendant.35 Justice Stevens issued a separate opinion expressing his view that criminal prosecution of obscenity impermissibly conflicts with First Amendment values.36 He dissented from a criminal conviction on similar grounds in a contemporaneous obscenity case, *Smith v. United States*.37 Citing the numerous problems inherent in defining obscenity, Justice Stevens argued again that sexually explicit content should be civilly—not criminally—regulated.38 Justice Stevens failed, however, to persuade a majority of Justices. The Court affirmed the criminal punishment of obscene speech,39 a standard that remains in effect.40

C. School Speech

Without any controlling Supreme Court precedent, lower federal courts have drawn their own conclusions about the extent to which the First Amendment limits punishment of student speech. In *Ponce v. Socorro Independent District*, the Fifth Circuit heard a student’s First Amendment challenge to his high school’s decision to expel him because he had written in his journal about his plans for a “Columbine-style” attack against the school.41 The court held that the writings qualified as threatening speech unprotected by the First Amendment

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33. *Id.* at 566, 575.
34. 413 U.S. 15, 24 (1973).
36. *Id.* at 198 (Stevens, J., concurring in part and dissenting in part).
38. *Id.*
39. *Id.* at 309 (majority opinion).
41. 508 F.3d 765, 766 (5th Cir. 2007).
and declined to consider whether the punishment was excessive. Rather, the court reasoned:

Because we conclude that no constitutional violation has occurred, our inquiry ends here. Our role is to enforce constitutional rights, not "to set aside decisions of school administrators which [we] may view as lacking a basis in wisdom or compassion." Because the journal's threatening language is not protected by the First Amendment, [the school district's] disciplinary action against [the student] violated no protected right.

The Eighth Circuit followed a similar rationale in Doe v. Pulaski County Special School District. There, a middle school student who made vulgar comments expressing a desire to "molest, rape, and murder" his ex-girlfriend challenged his expulsion on First Amendment grounds. As in Ponce, the court held that this language constituted a true threat, and that the school's disciplinary action did not violate the student's First Amendment rights. The court also noted that the expulsion appeared "unnecessarily harsh." Nevertheless, the court declined to review the school's decision, explaining that the court lacked authority to assess the "wisdom" of a particular punishment.

Recent appellate cases have raised new questions about the extent of punishment the First Amendment allows. The Second Circuit's decision in Doninger v. Niehoff marks the latest example. To support the dicta that punishment of student speech may raise "constitutional concerns," Doninger cited a 2007 decision from the same circuit, Wisniewski v. Board of Education of the Weedsport Central School District. Like Doninger, Wisniewski involved school discipline in response to a student's off-campus expression. The school district suspended Martin Wisniewski after he displayed an instant message icon to other students that contained threats against a teacher, and the Second Cir-

42. Id. at 772.
43. Id. (citing Wood v. Strickland, 420 U.S. 308, 326 (1975)).
44. 306 F.3d 616 (8th Cir. 2002).
45. Id. at 619.
46. Id. at 626–27.
47. Id. at 627.
48. Id. (citing Wood, 420 U.S. at 326).
49. 494 F.3d 34 (2d Cir. 2007).
50. Id. at 35–36.
cuit upheld the school's punishment. Wisniewski added that, because the student's parents failed to challenge the extent of the school's punishment specifically, the court "need not determine whether such a challenge would have to be grounded on the First Amendment itself or the substantive component of the Due Process Clause of the Fourteenth Amendment."

In LaVine v. Blaine School District, a student specifically challenged the extent his school punished him for his unprotected speech—the kind of challenge that was never pled in Wisniewski—and the Ninth Circuit Court of Appeals invalidated part of the school's punishment. After James LaVine gave a violent poem to a teacher, LaVine's high school expelled him temporarily and documented the expulsion with a letter in his school file. LaVine claimed his school's expulsion and documentation decisions violated his First Amendment rights. The Ninth Circuit ruled that the First Amendment permitted the expulsion because the school acted with sufficient grounds to avert perceived potential harm. But the Ninth Circuit found no similar grounds for the placement of the letter in LaVine's file and, with sparse reasoning, held that "it went beyond the school's legitimate documentation needs." The court did not, however, specify the level of scrutiny it applied to the school's disciplinary decision.

Doninger, Wisniewski, and LaVine raise striking questions. They suggest that the extent to which a school punishes a student for his unprotected speech may raise constitutional concerns under the First and Fourteenth Amendments. The remainder of this Note explores how these constitutional guarantees should be applied to student speech.

II. ILL-FITTING LEVELS OF SCRUTINY: INTERMEDIATE SCRUTINY AND RATIONAL BASIS

Questions about the extent of punishment enter a First Amendment analysis only in particular settings. The relevant
speech must be unprotected because protected speech cannot be punished.\textsuperscript{57} Courts confronted with a challenge to punishment of unprotected student speech have several potential constitutional tools to evaluate the claim. The First Amendment itself is one of these potential tools, as courts may apply the First Amendment to punishment of student speech through intermediate scrutiny or a form of rational basis review.\textsuperscript{58} This Part explores both of these levels of scrutiny and concludes that neither provides a satisfactory means to assess punishment of unprotected student speech.\textsuperscript{59}

\textbf{A. Intermediate Scrutiny}

Courts may apply intermediate scrutiny to punishment of student speech. Under intermediate scrutiny, a court will uphold a law if it advances some important government interest and is reasonably well tailored to that interest.\textsuperscript{60} Beginning in the 1980s, federal courts gravitated toward intermediate scrutiny as the default level of scrutiny for various strands of First Amendment jurisprudence.\textsuperscript{57} Punishment of speech is distinct from suppression of speech. See Emily Gold Waldman, \textit{Regulating Student Speech: Suppression Versus Punishment}, 85 IND. L.J. 1 (forthcoming 2010). Speech suppression enjoins the speech as expressed, whereas punishment of speech occurs after the speech has occurred. For instance, an injunction prohibits speech itself ex ante, and thus constitutes a suppression of speech. See, \textit{e.g.}, Hazelwood Sch. Dist. v. Kuhlmeier, 484 U.S. 258, 266-67 (1988) (upholding school officials' decision to cut "vulgar and offensive terms" from a school newspaper before it was published). When a speaker violates an injunction or engages in unprotected speech, however, the question of punishment arises.

\textsuperscript{58} The two other First Amendment levels of scrutiny—ad hoc balancing and strict scrutiny—can be immediately rejected for parallel reasons. A balancing test would be inappropriate because it grants judges too much authority to second-guess the expertise and discretion of school officials. Moreover, as ad hoc balancing tests involve the weighing of interests in particular cases, strong public opinion may determine the outcome of the test. See, \textit{e.g.}, Dennis v. United States, 341 U.S. 494, 509-10 (1951) (applying ad hoc balancing test to uphold defendants' convictions for trying to organize a communist political party). Strict scrutiny is similarly inappropriate because it would forbid the government from restricting speech that it has the constitutional prerogative to restrict. Thus, a balancing test and strict scrutiny are not plausible.

\textsuperscript{59} Although these levels of scrutiny developed in Equal Protection cases, the Supreme Court has incorporated each of them into the First Amendment arena. See Turner Broadcasting System, Inc. v. FCC, 512 U.S. 622, 661-62 (1994) (remanding for lower court to apply intermediate scrutiny to content-neutral television programming regulations); Barnes v. Glen Theatre, Inc., 501 U.S. 560, 580 (1991) (Scalia, J., concurring) (applying rational basis review to nude dancing restrictions).

Amendment claims. And in *Gertz v. Welch*, concerns about self-censorship led the Supreme Court to examine defamation awards with heightened scrutiny. There, the Court interpreted the First Amendment to require that "state remedies for defamatory falsehood reach no farther than is necessary to protect the legitimate interest involved." The Court thus indicated that some level of scrutiny less deferential than strict scrutiny, but more rigorous than rational basis review, can be applied to punishment of unprotected speech.

But intermediate scrutiny remains ill-suited to review the extent of school discipline under the First Amendment. Courts have neither explicitly nor consistently extended intermediate scrutiny beyond restrictions on protected forms of speech. Applying intermediate scrutiny to the punishment of unprotected student speech—by definition, speech of less constitutional value—would thus be inconsistent with the entire thrust of First Amendment jurisprudence.

Further, applying intermediate scrutiny to the punishment of unprotected speech would create an unmanageable standard. Lower courts have shirked the Supreme Court's guidance in applying intermediate scrutiny. Professor Ashutosh Bhagwat has reported, for example, that although no challenge to regulation of a sexually oriented business has succeeded in the Supreme Court, 35.3% of such challenges succeed in the courts of appeals. The most plausible explanation for the divergence of lower courts from the Supreme Court's guidance is that intermediate scrutiny implicitly forces courts to balance the asserted policy against constitutional interests. Balancing tests breed disorder among courts because of their inherent uncertainty and because lower courts have shown a "systematic inability to

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61. *Id.* at 801-02 (citing *Turner*, 512 U.S. 622; *Barnes*, 501 U.S. at 566; Bd. of Trs. of the State Univ. of N.Y. v. Fox, 492 U.S. 469, 477 (1989); *Ward v. Rock Against Racism*, 491 U.S. 781, 797-98 (1989); *City of Renton v. Playtime Theatres, Inc.*, 475 U.S. 41, 46-55 (1986)).
63. *Id.* at 349.
64. See Bhagwat, *supra* note 60, at 818. Professor Bhagwat also documented divergence between the lower courts and the Supreme Court in symbolic speech and in time, place, and manner cases. *Id.*
The First Amendment calibrate their constitutional analysis to the relative strengths of the speech and regulatory interests involved."^66

The application of intermediate scrutiny to the discipline of unprotected student speech will produce a similar host of difficult and opaque questions of application. School officials will have to account for the uncertainty of whether their disciplinary decisions involving student speech "substantially relate" to their goal. Given the evolving forms of student speech^67 and the expertise of school officials in meting out discipline to advance school goals, the discrepancies among federal courts will likely multiply. In short, applying intermediate scrutiny to the extent school officials punish unprotected student speech runs counter to the Supreme Court’s guidance and would undermine any coherence imparted by such a level of scrutiny.

B. Rational Basis Review

Rational basis review affords another means to review the extent of punishment. Professor Emily Gold Waldman has argued in favor of implementing a First Amendment "reasonableness" backstop against excessive punishment of student speech. ^68 Other scholars have advocated applying rational basis review to "minimally valued speech." ^69 A reasonableness standard would likely resemble rational basis review in the Equal Protection arena. The rational basis standard is immensely deferential, requiring only that the governmental action be "rationally related" to a "legitimate" government interest. ^70 Ra-

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^66. Bhagwat, supra note 60, at 820.
^68. Waldman, supra note 57 (manuscript at 34). Professor Waldman argues that courts should apply a reasonableness standard to "rectify any abuses of discretion." Id. (manuscript at 35).
^69. See Edward J. Eberle, The Architecture of First Amendment Free Speech 9 (Roger Williams Univ. Sch. of Law Faculty Papers, Paper 14, 2007). Unprotected speech has no necessary "minimal" value. Yet, Justice Scalia has asserted that even unprotected speech implicates First Amendment interests, writing that "constitutionally proscribable content [does not comprise] categories of speech entirely invisible to the Constitution, so that they may be made vehicles for content discrimination." R.A.V. v. City of St. Paul, 505 U.S. 375, 383–84 (1992) (emphasis added) (citations omitted). Hence, a state actor’s treatment of unprotected speech may warrant some degree of judicial scrutiny.
Rational basis is appealing in that it provides a baseline of scrutiny that courts have experience applying.\textsuperscript{71}

Despite its benefits, rational basis review of the extent of school punishment would have fatal drawbacks. The standard provides less clarity in application than its plain language suggests.\textsuperscript{72} Laws subject to rational basis review under the Equal Protection Clause of the Fourteenth Amendment will almost certainly be upheld.\textsuperscript{73} But courts have increasingly taken license to strike down laws that should easily survive the standard form of rational basis review.\textsuperscript{74} Some of these laws may have

\textsuperscript{71} Rational basis review has found some support in First Amendment cases reviewing the extent of punishment of unprotected speech. \textit{Gertz} declared punitive damages invalid under the First Amendment because “punitive damages are wholly irrelevant to the state interest that justifies a negligence standard for private defamation actions.” \textit{Gertz v. Welch}, 418 U.S. 323, 350 (1974). In the school speech context, the Ninth Circuit upheld an emergency expulsion against First Amendment challenge because it was a “reasonable” response to the student’s threatening speech. \textit{LaVine v. Blaine Sch. Dist.}, 257 F.3d 981, 990 (9th Cir. 2001). Hence, in both examples, the courts required a baseline level of scrutiny that resembled rational basis review.

\textsuperscript{72} In his majority opinion in \textit{U.S. Railroad Retirement Board v. Fritz}, Justice Rehnquist concluded that even

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[t]he most arrogant legal scholar would not claim that all...cases applied a uniform or consistent [rational basis] test under equal protection principles. And realistically speaking, we can be no more certain that this opinion will remain undisturbed than were those who joined the opinion...in any of the other cases referred to in this opinion and in the dissenting opinion.
\end{quote}

449 U.S. 166, 176 n.10 (1980). Clark Neily has characterized rational basis review as “nothing more than a Magic Eight Ball that randomly generates different answers to key constitutional questions depending on who happens to be shaking it and with what level of vigor.” Clark Neily, \textit{No Such Thing: Litigating Under the Rational Basis Test}, 1 N.Y.U. J.L. & LIBERTY 897, 897 (2008). Neily indicts rational basis review further in reference to the “Supreme Court’s record of blatantly misapplying it in order to achieve preferred outcomes.” \textit{Id.} at 909.

\textsuperscript{73} See Note, \textit{Rational Reviews, Irrational Results}, 84 TEX. L. REV. 801, 802 (2006) (stating that the “government’s interests will almost always prevail over the individual’s” in rational basis review).

been unwise or deserving of stricter review. Courts, however, have cloaked these rulings in rational basis language such that ample uncertainty exists as to whether a law will receive ultra-deferential rational basis review or the so-called rational basis review “with bite.”

The danger of an unclear or “discretionary” level of scrutiny is heightened when applied to the punishment of unprotected student speech. Rational basis review would not guard against school officials’ abuse of disciplinary discretion. By definition, schools will always have a “legitimate government interest” in punishing unprotected speech. The only remaining legal question would be whether the degree of punishment bears a “rational relationship” to preventing the speech. But in rational basis review, courts permit over- and under-inclusive means. Thus, excessive punishment would always satisfy this standard because it would deter the speech at issue, even if the punishment deterred protected speech as well.


76. In U.S. Railroad Retirement Bd. v. Fritz, 449 U.S. 166, 179 (1980), the Supreme Court explained that any conceivable legitimate purpose qualifies under rational basis review. The Court stated: “Where, as here, there are plausible reasons for Congress’ action, our inquiry is at an end. It is, of course, ‘constitutionally irrelevant whether this reasoning in fact underlay the legislative decision’....” Id. (citations omitted). It follows that when student speech is unprotected because it jeopardizes the educational or protective mission of schools, school officials have at least one “conceivable legitimate purpose” for punishing the offending student.

77. See Dandridge v. Williams, 397 U.S. 471, 485 (1970) (stating that a state law, if it possesses a reasonable basis, is not unconstitutional “simply because the [law] ‘is not made with mathematical nicety or because in practice it results in some inequality’”); see also Vance v. Bradley, 440 U.S. 93, 106-09 (1979) (applying rational basis and upholding federal law mandating retirement at age sixty for Foreign Service Retirement System participants even though the scheme would be both overinclusive and underinclusive, in part because “it is in turn related to the secondary objective of legislative convenience”).

households composed of unrelated occupants although the government argued that it would help reduce fraud); Christian Heritage Acad. v. Okla. Secondary Sch. Activities Ass’n, 483 F.3d 1025, 1031 (10th Cir. 2007) (striking down athletic association’s membership requirements for nonpublic schools).
Additionally, rational basis review would not generate useful precedent. The degree that punishment relates to a goal fundamentally differs from the means-ends equal protection inquiry. In equal protection cases, the particular type of restraint must bear a rational relationship with the action's goal. In evaluating school discipline, however, a court will instead engage in the more arbitrary task of assessing the degree of punishment. For, whatever precedential import rational basis review supplies, it does not supply a meaningful metric to evaluate whether a particular punishment was too heavy, too light, or just right. What rational basis does provide is cover for a court to insert itself into school officials' decision making processes by manipulating an ambiguous level of scrutiny.

Professor Waldman has argued that courts should distinguish between speech that is entirely unprotected by the First Amendment and student speech that schools can only suppress under the ratcheted-down First Amendment guarantees afforded to students in schools. According to this view, courts should add a distinct layer of scrutiny to punishment of speech that would otherwise be protected outside of schools. This argument is problematic for a few reasons. First, federal and state law narrowly circumscribes school officials' disciplinary discretion. A compensatory First Amendment standard thus constitutes a cure in search of a disease. Worse, compensating for the added deference schools have to suppress speech with less deference to school disciplinary measures undermines the grant of deference altogether. Instead, it will push courts down the treacherous path of using the First Amendment to limit school officials' discretion to punish expression that the First Amendment simply does not protect.

78. The Fifth Circuit commented on the fundamental arbitrariness of such review, stating that, "[w]e think it a misuse of our judicial power to determine, for example, whether a teacher has acted arbitrarily in paddling a particular child for certain behavior or whether in a particular instance of misconduct five licks would have been a more appropriate punishment than ten licks." Fee v. Hemdon, 900 F.2d 804, 809 (5th Cir. 1990) (citations omitted).

79. Waldman, supra note 57 (manuscript at 38).

80. Id.

81. See infra Part III.

82. Professor Waldman relies on the idea that some properly suppressed student speech is protected outside of the school setting. Waldman, supra note 57 (manuscript at 38). This argument glosses over the Supreme Court's efforts to craft setting-specific First Amendment precedent. The First Amendment does not
III. TAKING THE FIRST AMENDMENT OUT OF THE PICTURE

To be sure, students deserve legal recourse from truly excessive punishment. But this concern does not justify erroneously construing the First Amendment to review the degree to which school officials discipline students for engaging in unprotected speech. The deference courts traditionally grant to school officials' speech suppression suggests that an analysis of discipline based on the First Amendment will be unworkable.\(^8\) As the obscenity line of cases demonstrates, concerns with self-censorship are not sufficiently compelling to upset deference to disciplinary authorities. Moreover, existing procedural constraints and state law provide sufficient limits on the extent to which a school can punish students, thus obviating the need to create a novel level of scrutiny under the First Amendment.

A. Deference Affirmed

Although the Supreme Court has not declared the extent to which schools can punish student speech, the Court has clearly indicated that school officials' decisions deserve ample deference.\(^{84}\) School administrators have both the expertise and duty to protect students from abuse and to maintain a hospitable educational environment.\(^{85}\) Recognizing this deference, the Supreme Court has directed that "[i]t is not the role of federal courts to set aside decisions of school administrators which the court may view as lacking a basis in wisdom or compassion."\(^{86}\)

The deference owed to school officials calls into question the propriety of First Amendment review of school discipline. The Supreme Court has denied that it has authority to review the ex-
tent of punishment in criminal obscenity cases, in which the punishment was far harsher than that available to school officials. Furthermore, the First Amendment rights of adults engaged in pornographic speech are, in theory, co-extensive with the rights of adults engaged in fully valued forms of speech. Hence, in the school context, where school officials deserve added deference but can only impose less severe forms of discipline, the case for declining to review the extent of discipline under the First Amendment is even stronger than in the obscenity context.

Federal courts have affirmed the deference owed to school officials by wisely ending the First Amendment inquiry after determining that the speech was unprotected. And a district court declined to extend the Wisniewski dicta to limit discipline of unprotected student speech because the court in Wisniewski found “no support for the proposition that [the student’s] suspension was unconstitutionally severe.” Indeed, Wisniewski, Doninger, and the First Amendment provide no support for judicial scrutiny of the extent to which school officials punish unprotected student speech.

88. See R.A.V. v. City of St. Paul, 505 U.S. 377, 382 (1992) (holding that content-based regulations are presumptively invalid). Despite the presumption against content-based regulations, the Supreme Court has granted greater latitude to the regulation of sexually oriented speech that falls below the Miller obscenity threshold and is therefore protected by the First Amendment. See Barnes v. Glen Theatre, Inc., 501 U.S. 560 (1991) (upholding Indiana ban on nude dancing); Young v. American Mini-Theaters, Inc., 427 U.S. 50, 70–71 (1976) (upholding city ordinance excluding adult theaters from operating in certain areas). These opinions, however, emphasize the secondary effects of sexually oriented speech and the Court has not deferred to regulation of sexually oriented speech nearly to the extent it defers to the regulation of student speech. See Erznoznik v. City of Jacksonville, 422 U.S. 205, 207 (1975) (holding ordinance unconstitutional that barred drive-in movie theaters from showing motion pictures containing uncovered “buttocks . . . or breasts”).
89. See, e.g., Ponce v. Socorro Indep. Dist., 508 F.3d 765, 772 (5th Cir. 2007); Doe v. Pulaski County Special Sch. Dist., 306 F.3d 616, 626–27 (8th Cir. 2002).
90. Cuff v. Valley Cent. Sch. Dist., 559 F. Supp. 2d 415, 422–23 (S.D.N.Y. 2008). On review, the Second Circuit vacated the district court’s grant of summary judgment for the school because the court could not find that “it was reasonable as a matter of law to foresee a material and substantial disruption to the school environment.” Cuff v. Valley Cent. Sch. Dist., 341 Fed. App’x 692, 693 (2d Cir. 2009).
B. Self-Censorship in Context

The principal First Amendment danger of harsh punishment is self-censorship. Yet, as in Alexander v. United States, the Court has brooked self-censorship resulting from harsh sanctions of expressive content when the government has a legitimate interest in punishment. School officials have a legitimate interest in maintaining a protective and educational environment and can punish unprotected student speech to cultivate such an environment. The chilling argument thus does not justify review of school discipline under the First Amendment.

Obscenity and student speech also can be distinguished from the Supreme Court's defamation precedent barring punitive damages. Defamation is a tort action involving "private" wrongs; obscenity and unprotected student speech constitute "public" wrongs. This structural distinction affects the nature of punishment for legally liable speech: State actors punish obscenity and student speech by imposing sanctions, while private defamation plaintiffs receive awards of priced speech. Through tort law's remedies jurisprudence, courts can meaningfully review whether an award of damages exceeded a reasonable price for the plaintiff's losses. Courts have no comparable metric to measure whether punishment of obscenity and unprotected student speech constituted appropriate sanctions. Thus, courts have rejected use of the First Amendment to limit the extent of obscenity punishment, as they should with unprotected student speech.

92. Gertz expressly allowed punitive damages when a plaintiff met the evidentiary requisites established by New York Times v. Sullivan up to the amount of the injury caused by the plaintiff, but found punitive damages problematic to the extent "they are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence." Gertz, 418 U.S. at 350 (citing New York Times v. Sullivan, 376 U.S. 254 (1964)). Although individuals suffer from obscenity and disruptive student speech, punishment in these contexts is not imposed by or on behalf of a private victim.
94. Criminal law also uses a proportionality principle, such that punishment ideally should be proportionate to the culpability of the defendant and the seriousness of his "public" wrong. See Kenneth W. Simons, The Crime/Tort Distinction: Legal Doctrine and Normative Perspectives, 17 WIDENER L.J. 719, 720–21 (2008).
C. Due Process Limits on Disciplinary Discretion

Courts have been willing to grant school disciplinary decisions wide deference partly because students retain due process protections that limit the extent schools can punish unprotected student speech.

1. Procedural Due Process Protections

Although not as thorough as the due process protections afforded to criminal defendants, students have procedural due process rights under the Fourteenth Amendment. The procedural due process guarantee encompasses the right of students to have fair warning of prohibited conduct.\(^96\) Moreover, the Supreme Court has interpreted the Due Process Clause to afford students facing temporary suspensions the right to receive oral or written notice of the charges against them and, if the student denies the charges, an explanation of the evidence held by the school officials as well as an opportunity to present their side of the story.\(^97\) For suspensions of longer than ten days or expulsions, students are entitled to more formal procedures.\(^98\) Depending on the state and court, these procedures can be as extensive as a full adversarial hearing.\(^99\) Finally, due process requires that school officials adhere to their own disciplinary codes, thus decreasing the likelihood that abuse of disciplinary authority will lack legal remedy.\(^100\)

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98. Id. at 584.
100. See C.J. v. Sch. Bd. of Broward County, 438 So. 2d 87 (Fla. App. 1983) (invalidating exclusion from summer session for student having knife at bus stop because knife was not a “weapon” as defined in school rule); Shuman v. Univ. of Minn. Law Sch., 451 N.W.2d 71 (Minn. App. 1990) (upholding school discipline because students “were given the procedures provided for in the honor code”); Rauer v. State Univ. of N.Y., Albany, 552 N.Y.S.2d 983, 984 (N.Y. App. Div. 1990) (upholding long-term suspension because school followed rules pertaining to academic dishonesty); Boehm v. Univ. of Pa. Sch. of Veterinary Med., 573 A.2d 575, 582 (Pa. Super. 1990) (upholding long-term suspension from private university because school “followed its Code of Rights punctiliously and ... the disciplinary proceeding complied with due process and [was] fundamentally fair”); Galveston Indep. Sch. Dist. v. Boothe, 590 S.W.2d 553, 556-57 (Tex. Civ. App.
2. Substantive Due Process Protections

Students have substantive due process rights as well. Substantive due process protects a student's individual liberty against "certain government actions regardless of the fairness of the procedures used to implement them."\textsuperscript{101} Students have had limited success in identifying specific liberty or property interests protected by the Fourteenth Amendment.\textsuperscript{102} Some courts, however, have allowed students to base substantive due process claims on school "zero tolerance" policies.\textsuperscript{103} Courts have also found substantive due process violations when school officials imposed grossly excessive physical punishment or punishment intended to inflict injury.\textsuperscript{104} The substantive due process rights enjoyed by students should not be overstated: Careless, unwise, or merely painful actions by school officials will not find remedy in substantive due process, which functions only as the ultimate safety net for individual rights.\textsuperscript{105} But substantive due process rights form one layer of the many constraints on the extent to which school officials can punish students.

D. A Better Limitation on Punishment: State Law

First Amendment review of punishment of unprotected student speech would also threaten to subvert federalism principles. Student disciplinary decisions are matters of state and lo-

\textsuperscript{103} See, e.g., Seal v. Morgan, 229 F.3d 567, 578 (6th Cir. 2000).
\textsuperscript{104} See, e.g., Gottlieb v. Laurel Highlands Sch. Dist., 272 F.3d 168 (3d Cir. 2001) (finding violation of substantive due process rights when school officials' alleged assault against student was "conscience-shocking"); Johnson v. Newburgh Enlarged Sch. Dist., 239 F.3d 246, 252 (2d Cir. 2001) (same); Neal v. Fulton County Bd. of Educ., 229 F.3d 1069, 1075–76 (11th Cir. 2000) (finding school officials' alleged beating of student sufficiently supported a claim of a substantive due process violation); P.B. v. Koch, 96 F.3d 1298, 1303–04 (9th Cir. 1996) (denying that a principal who physically assaulted students was entitled to qualified immunity because he violated their "clearly established" substantive due process rights); Hall v. Tawney, 621 F.2d 607, 613–14 (4th Cir. 1980) (holding that corporal punishment may violate a student's substantive due process rights); Orange v. County of Grundy, 950 F. Supp. 1365, 1373 (E.D. Tenn. 1996) (denying school officials' summary judgment motion because "a reasonable teacher in the individual defendants' position would have known that the day-long isolation of students without access to lunch or toilet facilities was unconstitutional").
\textsuperscript{105} See CHARLES J. RUSSO & RALPH D. MAWDSLEY, EDUCATION LAW 191 (2002).
Justice Kennedy voiced the need for deference to state law in light of America's federalist framework when he wrote that "federal control of the discipline of our Nation's schoolchildren is contrary to our traditions and inconsistent with the sensible administration of our schools." Accordingly, federal courts should be wary to assert control over the day-to-day decisions of school officials, especially when this control displaces the authority of state courts and policymakers.

The constraints state laws place on school discipline further render First Amendment review unnecessary. State tort and criminal remedies have long protected students against excessive punishment. Where states take affirmative steps to protect students from overzealous disciplinarians, federal courts have declined constitutional warrant to review school officials' disciplinary decisions. In Ingraham v. Wright, for example, the Supreme Court refused to evaluate a student's claims that corporal punishment violated the Fourteenth Amendment because "the traditional common-law remedies are fully adequate to afford due process." Although the First Amendment protects interests distinct from those covered by the Fourteenth Amendment, the presence of state common law diminishes the concern that arbitrary and excessive discipline by school officials will lack sufficient legal remedy.

Even if state tort or criminal law provided inadequate protection against unreasonable punishment, state constitutions afford independent speech guarantees. Every state constitution

106. Fee v. Hemdon, 900 F.2d 804, 809 (5th Cir. 1990).
109. See Ingraham v. Wright, 430 U.S. 651, 672 (1977); Fee, 900 F.2d at 808.
110. Ingraham, 430 U.S. at 672.
The First Amendment protects speech in language comparable to the First Amendment.111 But states have additional explicit and implicit restraints on the degree to which state actors can punish unprotected speech. Ten states have constitutions that require proportionate penalties.112 Seventeen other state constitutions bar "cruel or unusual" penalties and another six state constitutions prohibit "cruel punishment."113 A plurality of state constitutions—twenty-two—mirror the Eighth Amendment's ban on "cruel and unusual punishment.114

The Eighth Amendment does not apply to noncriminal punishment115 and states with constitutions containing identical language have been reluctant to extend this language beyond federal standards.116 Yet state courts have authority to go beyond the federal minimum standards on individual rights.117 Justice Brennan emphasized this authority by warning that "our liberties cannot survive if the states betray the trust the Court has put in them."118 And state courts have affirmatively answered Justice Brennan's call by departing from federal precedent to limit punishments they consider excessive.119 Be-

113. Id.
114. Id.
116. See SULLIVAN & FRASE, supra note 112, at 155 (explaining that state courts are surprisingly reluctant to grant broader protection against excessive penalties under state constitutions than the federal constitution provides).
117. See Kelo v. City of New London, 545 U.S. 469, 489 (2005) (emphasizing that state constitutions may have stronger restrictions on the exercise of eminent domain power than the federal constitution); Paris Adult Theatre I v. Slaton, 413 U.S. 49, 64 (1973) (stating that states may lower legal restrictions on sexually oriented speech below federally permissible levels). The Federal Bill of Rights provides a minimum level of protection of individual rights which states may exceed, but not reject. Robert Force, State "Bills of Rights": A Case of Neglect and the Need for a Renaissance, 3 VAL. U. L. REV. 125, 129 (1969).
119. See, e.g., In re Rodriguez, 537 P.2d 384, 394 (Cal. 1975) (ruling that under California's cruel-or-unusual clause "the measure of the constitutionality of punishment for crime is individual culpability in the law of this state"); Conner v. State, 626 N.E.2d 803, 806 (Ind. 1993) (holding that Indiana's proportionate punishment clause affords more protection than the Eighth Amendment);
cause many state constitutions have broader language restricting punishment than the federal constitution, and state courts have license to take broader interpretations of speech rights than the Supreme Court, state law provides a more textually plausible means to limit punishment of unprotected speech.

CONCLUSION

School officials have no easy task in managing student behavior. Unlike federal judges, public school teachers and administrators continuously develop and implement disciplinary practices as an essential part of their profession. In First Amendment actions, the Supreme Court has wisely deferred to school officials' expertise to regulate the educational environment. Courts should not undermine this deference by construing the First Amendment to require an unnecessary and unprecedented level of scrutiny of school officials' decisions to punish unprotected speech.

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