ARTICLES

REGULATION BY DEAL: THE GOVERNMENT'S RESPONSE TO THE FINANCIAL CRISIS

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INTRODUCTION

"Who are these guys that just keep coming?"
—Treasury Secretary Henry M. Paulson Jr., speaking of the serial collapse of U.S. financial institutions.[1]

Many people now claim that they knew that a financial crisis was coming, but it does not appear that those working for the government were among them. Perhaps they should have been—the government was certainly very close to the problem. Federal Reserve macroeconomic policy, inadequate regulation of the two government-sponsored enterprises (GSEs) the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and other regulatory failures with respect to the mortgage-origination industry, financial institution oversight, ratings agencies, and the securitization market all played their part in creating an unprecedented real estate and credit bubble.[2]

But as part of the solution, the government's contribution was much more fitful. When the real estate bubble popped, with catastrophic implications for the financial institutions that facilitated property purchases, the credit market, and, eventually, all of the participants in the worldwide financial system, the federal government reacted slowly, and then

1. Joe Nocera & Edmund L. Andrews, *Running a Step Behind as a Crisis Raged*, N.Y. TIMES, Oct. 23, 2008, at A1.

2. The causes of the crisis will be the subject of much debate, but we focus in this Article not on root causes, but the government response. For preliminary analysis on the origins of the crisis, see RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009); Yuliya Demyanyk & Otto Van Hemert, Understanding the Subprime Mortgage Crisis (Dec. 5, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396; Gary Gorton, The Panic of 2007 (Aug. 4, 2008), http://www.kc.frb.org/publicat/sympos/2008/Gorton.08.04.08.pdf.

uncertainly, and finally on an emergency and massive basis.

What, exactly, was the government trying to do to respond to the crisis? Observers will differ on the quality and wisdom of its actions for years to come, but we think that its response to the financial crisis was driven by the legal constraints on the government institutions that handled the crisis—and by the creative, and principally transactional, ways that the government managed those legal constraints. As the crisis developed, the government forced the sales of one of the five largest investment banks, the largest thrift in the country, and a number of consumer banks.[3] It permitted an even larger investment bank and another of the country's largest thrifts to fail. The government also took over the country's largest insurer and nationalized the two government-sponsored enterprises that mortally suffered from the popping of the housing bubble.

When these efforts failed to prevent a cascading "run" on financial institutions, the government decided, in the course of less than a month, to create through congressional action an unprecedented $700 billion asset purchase program. The government then turned this authorization into a massive investment in the country's largest financial institutions. It capstoned the investment by forcing the nation's nine largest remaining financial institutions to accept $125 billion of government equity—a partial nationalization which the United States had never seen before. Nor did the government stop there. It flooded the global markets with liquidity and entered the commercial paper market on a massive scale. And the bailouts would continue with the rescue of Citigroup and Bank of America, two of the nation's largest financial institutions. These actions would mark the largest government economic intervention in history, and left former Treasury Secretary Henry M. Paulson Jr., Federal Reserve Board Chair Ben S. Bernanke, and former President of the Federal Reserve Bank of New York and current Treasury Secretary Timothy Geithner, the apparent leaders of this government effort, in control of much of the financial economy.

Although the government never, throughout this period, acted as if it felt very constrained by the law that limited its actions, we think that its legal constraints help to explain a great deal of the government response. For example, even though the crisis first evinced itself in the struggles of Bear Stearns, an investment bank overseen by the Securities and Exchange Commission (SEC), it was the Board of Governors of the Federal Reserve

3. The forced sale of Washington Mutual's assets and its subsequent bankruptcy was the nation's largest bank failure to date. *See* David Ellis & Jeanne Sahadi, *JPMorgan Buys WaMu*, CNNMONEY.COM, Sept. 26, 2008, http://money.cnn.com/2008/09/25/news/companies/JPM_WaMu/index.htm?postversion=2008092612.

System (Federal Reserve) that failed that bank and forced its sale, with the Treasury Department participating in the process. The other big financial institution collapses that preceded the government's implementation of the Emergency Economic Stabilization Act of 2008 (EESA)[4] were largely coordinated by the Treasury Department and the Federal Reserve—regulators who did not manage these institutions. These government agencies acted because they had the resources and the flexible legal authority to do so, while they concluded that the primary supervisors of the collapsing institutions were at best unnecessary and at worst helpless in the face of the looming crisis.

We think that the government's novel efforts during the financial crisis can be usefully analyzed in two ways. First, the government has been doing deals—the sorts of deals that it usually leaves to the private sector.[5] The dealmaking ethos permeated even the staffing of the government's response—its financial crisis team was comprised largely of investment bankers, led primarily by Secretary Paulson, a veteran dealmaker who served as the Chief Executive Officer (CEO) of Goldman Sachs Group, Inc.[6] In this Article, we show how these deals were done and how the government stretched, and in some cases appeared to overstretch, its legal authority to make those deals happen. Second, the government, as a matter of administrative law, has been exploring the outer limits of its permissible authority in what it views as a time of crisis and, in so doing, conducted the management of the crisis through the two institutions least constrained by the law—the Treasury Department and the Federal Reserve. We analyze how the government's response both pushed and was shaped by the law at its disposal.

Doing deals and aggressively reinterpreting regulatory authority are not unrelated activities. Dealmakers use contract to avoid some legal

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4. Pub. L. No. 110-343, 122 Stat. 3765 (to be codified at 12 U.S.C. § 5201).

5. We think the recent deals depart from prior Federal Reserve practice in particular because of the size of the deals and the expansion of Federal Reserve authority into new deals, as well as the prominent, and relatively unprecedented, role played by dealmakers in the Treasury Department. The Federal Reserve has, of course, organized the purchase of failed banks by other banks in the past, however; it has just done so more rarely than it did here.

6. *See* Aleksandrs Rozens, *Great Expectations: Vanguard Founder Talks About the Current Market, Speculation and How Investors Need to Adjust Their Expectations*, INVESTMENT DEALER'S DIGEST: IDD, Nov. 17, 2008 (discussing Secretary Paulson's investment banking background and its influence on his reaction to the financial crisis). For an inside analysis of Treasury's response to the crisis, Philip Swagel's post hoc analysis is interesting, albeit not entirely disinterested (he was a Treasury official during the crisis). *See* Philip Swagel, *The Financial Crisis: An Inside View*, Brookings Papers on Economic Activity (Spring 2009), *available at* http://www.brookings.edu/economics/bpea/~/media/Files/Programs/ES/BPEA/2009_spring_bpea_papers/2009_spring_bpea_swagel.pdf.

constraints and often prefer to focus on arms-length negotiation, rather than regulatory authorization, as the source of legitimacy for their actions. We think that one useful way to characterize the government's role would be as that of an extraordinarily vigorous dealmaker, with some of the bad, as well as good, implications of governance by deal. For example, the early set of deals concluded by the government's team were done on tough terms for their targets; the government as "buyer" maximized its leverage over distressed institutions. Sometimes the government walked away from the table—as it did with Lehman Brothers—an act that dealmakers often do to bolster their reputation for future deals. And the government often acted in this phase of the crisis as dealmakers do—conclude it, forget it, and move on to the next deal. But when the government's deal-to-deal response appeared to be failing, the Treasury Secretary, at the urging of the Chairman of the Federal Reserve, decided that it needed a more comprehensive and systematic approach to preventing systemic fallout from the collapse of the housing bubble as well as the continuing and speeding collapse of the financial economy.[7] This holistic approach was planned as one kind of deal, where the government would purchase distressed assets from financial institutions, and turned into another kind of deal, where the government purchased sizable stakes in these financial institutions instead of buying their hard-to-price-and-sell troubled assets.

All of this suggests at least a weak sort of process consistency in the government response to the crisis. This is a consistency that many observers have concluded that the government has lacked; and to be sure, we agree with Richard Posner that there were "a series of improvisations" in the government's actions.[8] But perhaps this unusual consistency also offers a coherent explanation of the government's apparently incoherent response to the crisis. Dealmakers of the investment-banker variant, after all, do not much care about the consistency between deals. In the process they decide quickly, negotiate hard, consider transaction and other costs to the best they can, and then call it a day.[9] Moreover, although contract, securities, corporate, and other forms of law play an important role in deals, strict legal compliance has never been the principal focus of the dealmaker. Rather, risks and legal constraints must be weighed against each other in pursuit of the ultimate private goal—a completed deal. That perspective,

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7. Jon Hilsenrath et al., *Paulson*, *Bernanke Strained for Consensus in Bailout*, WALL ST. J., Nov. 10, 2008, at A1.

8. Posner, *supra* note 2, at 329.

9. This dealmaking persona was one that people commonly used to describe Secretary Paulson. *See, e.g.*, Posting of Heidi N. Moore to Deal Journal, http://blogs.wsj.com/deals/2008/09/21/is-hank-paulson-too-powerful/ (Sept. 21, 2008, 21:34 EST).

too, characterized the government's response to the crisis. Time and again, the government structured deals that pushed its legal authority to the very edge and beyond in pursuit of, and bound by, its own political, economic, and, perhaps, sociological interests.

To be sure, that legal authority made a difference with how the government structured its deals. It did so largely through the Federal Reserve, to begin with, because that agency had the resources and regulatory flexibility to serve in that role. But the Federal Reserve's legal authority was stretched as far as possible as these deals evolved. And again, here the government acted as dealmakers do—structuring the latest deal with a view toward precedent from prior transactions but willing to deviate as circumstances dictated. In the first three parts of our Article, we analyze just what the government did when it chose to act by deal.

We then turn in the final part of our Article to an evaluation of the government's approach and its implications for legal scholarship. For example, while administrative law scholars spend much of their time thinking about how the D.C. Circuit and Supreme Court might review government administrative decisions, it is worth noting that the response to the financial crisis has had nothing to do with the courts. Instead, it has been concentrated entirely in the Executive Branch and independent agencies—although aficionados of presidential control will have a difficult time identifying any particularly important presidential role in the construction and implementation of the bailout, which appears to have been conducted by the Treasury Secretary and Chairman of the Federal Reserve with some congressional blessing. Nor can one find much of a role for states in this epic corporate reorganization and insurance crisis, even though state law is the basis of corporate and insurance regulation.

But if courts and states are the missing players in the administrative law paradigm, the new process of regulation by deal exemplifies regulatory trends that are more familiar and increasingly important. In adopting a form of policymaking unlikely to be subject to judicial review (especially before congressional passage of the EESA), the government adopted a new governance model of administration, one exemplified, as many other more-prosaic initiatives are, by public–private partnerships and regulatory action positioned outside of the range of judicial review. Government by deal is not open government, and it rejects some of the usual values of administrative law, such as predecision notice to affected parties and the public; measured, unhasty action; and comment-ventilated policymaking.

Perhaps most interestingly, even as the regulation-by-deal paradigm semi-nationalized some traditional private financial services in the United States, it also contributed to the privatization of government functions, which, during this period, were in many ways "run like a business" rather

than as a regulator. The government was doing deals and taking stakes in profit-making institutions.[10] In this way, government by deal is not wholly unlike the government reinvention that analysts ranging from Tom Peters to Al Gore have urged on it.[11]

Moreover, this study informs dealmaking theory. The deals the government and its lawyers structured reaffirmed the limitations of dealmaking and deal lawyering. Dealmaking is a path-dependent process—lawyers and transaction participants rely upon network and signaling effects, structuring the current deal on the basis of the old one to advantage themselves with the benefits of prior precedent and to illustrate their capability.[12] But lawyers can overrely on this precedent to forgo innovation, resulting in an agency cost that injects inefficiencies into the dealmaking process. These inefficiencies are reinforced by the transaction costs of lawyering in high-pressure, time-sensitive environments, which can result in drafting mistakes and other errors.[13] In structuring bailouts these principles were ably on display. The quick time frames of the government's deals resulted in both mistakes and unintended consequences. Moreover, even though lawyers and participants were freed from the bounds of prior precedent, they still looked to that precedent to structure deals. But this account also shows the beauty of dealmaking and the circumstances under which innovation can occur. Despite the errors, innovation was a stronger force than normal, showing the potential of lawyers and dealmakers to create more internally efficient structures when they are not constricted by normal agency and signaling costs. We also

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10. The government even went so far as to hire a team of sophisticated investment bankers, lawyers, and asset managers to assist it in implementing the EESA.

11. *See* AL GORE, FROM RED TAPE TO RESULTS: CREATING A GOVERNMENT THAT WORKS BETTER AND COSTS LESS (1993), *available at* http://govinfo.library.unt.edu/npr/library/nprrpt/annrpt/redtpe93/index.html (follow "introduction" hyperlink). For an overview of the Peters approach to management, see THOMAS J. PETERS & ROBERT H. WATERMAN, JR., IN SEARCH OF EXCELLENCE: LESSONS FROM AMERICA'S BEST-RUN COMPANIES (1982).

12. *See* Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481 (2009); *see also* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 729–36 (1997). For a discussion of what exactly path dependency is and its detractors, see Paul A. David, *Path Dependence*, *Its Critics and the Quest for 'Historical Economics*,*' in* EVOLUTION AND PATH DEPENDENCE IN ECONOMIC IDEAS: PAST AND PRESENT 15 (Pierre Garrouste & Starvos Ioannides eds. 2001). For a more skeptical view, see STAN J. LIEBOWITZ, RE-THINKING THE NETWORK ECONOMY: THE TRUE FORCES THAT DRIVE THE DIGITAL MARKETPLACE (2002).

13. *See* Davidoff, *supra* note 12. For a further discussion of the deal lawyer as creating value net of legal fees through his or her efforts, see Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 243 (1984). *See also* Claire A. Hill, *Why Contracts Are Written in "Legalese*,*"* 77 CHI.-KENT L. REV. 59, 71 (2001).

explore the implications of the deal paradigm the government chose—venture capital instead of private equity—even though it appeared that the sort of fundamental restructuring, and often shrinking, promised by private equity was a better fit for the government, taxpayers, and, perhaps, market stability.

It is worth observing that the government has concluded distressed deals before—indeed, the underused "prompt corrective action" regime is premised on these sorts of distressed deals.[14] And governments have increasingly participated as market actors—sovereign wealth funds are an example—though our government rarely does so. Governments, though again, not the government of the United States, have nationalized firms and industries before. But this regulation by deal is new, and it is new in size, scale, and scope.

Our account is a preliminary one, and it is meant to provide a basis for further explaining what, precisely, the government did as a matter of law, and an evaluation of whether what it did worked. It is too soon to pass a final judgment on the empirical soundness of the government's strategy or to adjudge its use of the law as comprehensively good or bad.[15] What we do here is show precisely how the government's response was constrained by the law as it existed when the crisis hit and how it used the law it had, rather than the one it needed, culminating in the decision to seek further authority from Congress and then quickly reinterpreting that authority to make more deals.

In what follows, we evaluate the government's response to the crisis through a blow-by-blow, or historical, account. The gathering crisis pushed the government to rely on its traditional tools of economic control and financial regulation as it began to spread. Once Bear Stearns failed, those tools were abandoned and bailouts—or deals—became the new norm. We analyze each deal or nondeal in some detail and then dissect the bailout statute itself and the way the government interpreted, and then reinterpreted, it. Finally, we analyze the actions of the all-too-maligned SEC, as well as the other agencies involved in the government's deals. The result is a comprehensive review of the government's actions during the financial crisis. In doing so, we hope to inform and guide the coming legal debate about the validity of the government's actions and any future regulatory reform.

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14. That regime was created by the Federal Deposit Insurance Corporation Improvement Act of 1991, 12 U.S.C. § 1831n(a)(C) (2006).

15. *But see* CONG. OVERSIGHT PANEL, ACCOUNTABILITY FOR THE TROUBLED ASSET RELIEF PROGRAM (2009), *available at* http://financialservices.house.gov/TARP.html (examining whether the Troubled Asset Relief Program expenditures were justified and prudent).

I. THE GOVERNMENT IN CRISIS

A. Before the Crisis: The Macroeconomic Government

The first hints of public trouble in the credit markets began to emerge from the subprime mortgage market in April 2007. On April 2, 2007, New Century Financial, a leading subprime lender, filed for bankruptcy.[16] Other lenders involved in this industry began to experience difficulties due to disruptions in the housing and mortgage markets.[17] At first, the trouble seemed to be confined to these markets, and between April and August 2007 lenders in the general credit market, including the leveraged loan market, continued to extend credit on generous terms.[18] But in early August 2007, the difficulties in the subprime mortgage market spread unevenly into the general credit and equity markets. In the month of August, the Standard & Poor's (S&P) 500 Index declined 13%,[19] the Chicago Board Options Exchange Volatility Index, an index measuring market volatility, peaked at 37.5%,[20] and the broader credit markets began to freeze up as lenders became wary of extending additional credit.[21] One sign of the tightening in the credit markets was an August spike in the overnight dollar London Interbank Offered Rate (LIBOR), the rate at which banks loan money to one another on an overnight basis, to 5.59%.[22]

The Federal Reserve's response to the initial stages of this crisis was a traditional one designed to relubricate the credit markets. In the period from August 2007 to March 1, 2008, the Federal Reserve steadily lowered the target rate for federal funds in that period from 4.75% to 2.25%[23] and

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16. Julie Creswell & Vikas Bajaj, *Home Lender Is Seeking Bankruptcy*, N.Y. TIMES, Apr. 3, 2007, at C1.

17. *See* Vikas Bajaj, *A Cross-Country Blame Game*, N.Y. TIMES, May 8, 2007, at C1.

18. For example, on July 12, 2007, Deutsche Bank and Credit Suisse agreed to extend up to $15 billion in debt financing for the entire purchase price agreed to be paid by Hexion for Huntsman Corporation. This was a sizable commitment by the banks and permitted Hexion to finance the entire purchase price for Huntsman. *See* Press Release, Hexion Specialty Chem., Inc., Hexicon Specialty Chemicals, Inc. to Acquire Huntsman Corporation for $28.00 Per Share in Cash (July 12, 2007), http://www.hexion.com/news_article.aspx?id=1531.

19. *See* Gregory Zuckerman & Craig Karmin, *Hedge Funds Get Rattled as Investors Seek Exits*, WALL ST. J., Sept. 6–7, 2008, at B1.

20. *See* CHICAGO BD. OPTIONS EXCHANGE, 2008 HISTORICAL DATA (2009), http://www.cboe.com/micro/vix/historical.aspx (follow "New methodology: VIX data for 2004 to present" hyperlink).

21. Greg Ip, *Fed Cut Aims to Contain Damage: Stocks Soar as Bernanke Tackles Credit Crunch with Half-Point Move*, WALL ST. J., Sept. 19, 2007, at A1.

22. August 2007 LIBOR rate data is available from the British Bankers' Association. BRITISH BANKERS' ASS'N, 2007 HISTORIC LIBOR RATES, http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=141&a=11947 (follow "historic BBA Libor rates" hyperlink, then select "2007 Historic Libor Rates" internal link).

23. FED. RESERVE BD., OPEN MARKET OPERATIONS (2008),

the discount rate from 5.75% to 3.25%.[24] The Federal Reserve's action was book-ended by an equally traditional federal government response aimed at consumers. On February 13, 2008, the President signed the Economic Stimulus Act of 2008 (Stimulus Act), which provided for tax rebates to citizens and legal residents of the United States in an aggregate amount of $100 billion.[25]

Notably, the Stimulus Act also provided for a temporary increase on the limits for conforming loans that Fannie Mae and Freddie Mac could purchase to include many jumbo mortgages originated between July 1, 2007, and December 31, 2008.[26] The government response to the real estate crisis, the root cause of the economic disruption, was otherwise limited largely to the HopeNow initiative, a voluntary program to encourage loan modifications for borrowers experiencing financial difficulty in repaying their mortgages.[27]

In the fall of 2007 the stock markets recovered, and the S&P 500 Index hit an all-time high on October 9.[28] The credit markets also began to liberalize in October and November.[29] From October 1 to November 30, the overnight LIBOR rate declined to 4.72%.[30] But the real estate crisis continued, as property prices continued to decline, and financial institutions, particularly those exposed to the subprime lending market, began to recognize that many mortgage holders would be unable or unwilling to pay off their debts, forcing banks into enormous write-downs of mortgage-related assets.[31]

Financial institutions at first turned to market solutions to shore up their

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http://www.federalreserve.gov/fomc/fundsrate.htm.

24. FED. RESERVE DISCOUNT WINDOW, HISTORICAL DISCOUNT RATES: PRIMARY AND SECONDARY CREDIT (2008), http://www.frbdiscountwindow.org/historicalrates.cfm?hdrID=20&dtlID (follow "Primary and Secondary Credit" hyperlink).

25. Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (to be codified at 26 U.S.C. § 6428). For an early study of the efficacy of this program, see Christian Broda & Jonathan Parker, The Impact of the 2008 Tax Rebates on Consumer Spending: Preliminary Evidence (July 29, 2008), http://online.wsj.com/public/resources/documents/WSJ-2008StimulusStudy.pdf.

26. Economic Stimulus Act of 2008, Pub. L. No. 110-185, §§ 201, 202, 122 Stat. 619, 619–21 (2008).

27. For details of the HopeNow program, see HOPE NOW, Support & Guidance for Homeowners, http://www.hopenow.com/ (last visited Apr. 19, 2009). *See also* Ruth Simon, *Some Borrowers Rescued: Over 1 Million Got Help to Keep Homes; Foreclosures Rising*, WALL ST. J., Mar. 4, 2008, at A3.

28. Peter A. McKay, *Dow and S&P Hit Records on Fed's View*, WALL ST. J., Oct. 10, 2007, at C1.

29. Vikas Bajaj, *Investors Divided on the Fed's Rate Cut*, N.Y. TIMES, Nov. 1, 2007, at C4.

30. BRITISH BANKERS' ASS'N, *supra* note 22.

31. *See* Posner, *supra* note 2, at 66–68.

balance sheets. In the period from December 2007 through February 2008, financial institutions, along with other publicly traded companies, undertook a massive recapitalization, globally raising $155.1 billion in new capital from investors.[32] Sovereign wealth funds were the largest single investors, supplying $24 billion of the total domestic investment and creating some consternation over the increasing prominence of these foreign investors.[33] For a time, the stock market continued to trade near its fall 2007 highs.[34] However, the relatively stable equity markets hid turmoil in the credit markets as banks continued to struggle under the weight of the housing crisis and mortgage-related assets on their balance sheets. The U.S. economy was undergoing something new—a credit-driven rather than equity-driven market correction.

Then Bear Stearns almost collapsed.

B. The Preliminary Stage: The Government as Deal Facilitator

1. The Lessons of Bear Stearns

As of March 2008, Bear Stearns, an institution that had survived eighty years of Wall Street upheavals, was in a battered but—at least in the view of its executives—unbowed state. The battering was clear enough. In June 2007 two hedge funds, which were advised by Bear and created to invest in subprime mortgage-related assets and had an estimated $1.5 billion in assets at year-end of 2006, had become insolvent.[35] Their failure required Bear to commit $3.2 billion in a vain attempt to stabilize the funds and made market participants particularly wary of the investment bank's

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32. The figure was obtained by searching the Capital IQ database for private or public offerings made by firms in the Financials (primary) sector between December 1, 2007, and March 1, 2008.

33. *Hearing Before the Subcomm. on Domestic and International Monetary Policy, Trade, and Technology and the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 110th Cong. (2008) (statement of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System).

34. Michael M. Grynbaum, *Discussion of a Fed Cut Only Stirs Up Concerns About a Weak Economy*, N.Y. TIMES, Jan. 3, 2008, at C1. The market indexes were down about 10% on the year by January 23, rebounding slightly at the end of the month when the S&P 500 reached 1,355.81. *See* Edmund L. Andrews, *Fed, in Surprise, Sets Big Rate Cut to Ease Markets*, N.Y. TIMES, Jan. 23, 2008, at A1; Michael M. Grynbaum, *Rally Sputters in Late-Day Sell-Off*, N.Y. TIMES, Jan. 31, 2008, at C13. The indexes recovered slightly in February with the S&P closing out the month at 1,380.02. *See* Peter A. McKay & Joanna Slater, *Markets Wind Up in a Draw as Economic Arrows Flutter*, WALL ST. J., Feb. 28, 2008, at C1.

35. *See* Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds Are Worth Little*, N.Y. TIMES, July 18, 2007, at C2; Randall Smith, *Holders in Two Funds Want to Replace Bear*, WALL ST. J., Sept. 5, 2007, at C2.

exposure to mortgage-related assets.[36] Moreover, Bear was the most highly leveraged of the five large investment banks with an approximate 33:1 debt-to-equity ratio.[37] Bear was considered to have the largest exposure to mortgage-related assets; the bank had already taken $1.9 billion in write-downs related to its ownership of these types of assets in the fourth quarter of 2008.[38] But the news was not all bad. At the beginning of March, Bear's secured debt was rated investment grade by Standard and Poor's.[39] On March 7, 2008, its stock price closed at $70.08 per share; this was far down from its all-time high of $171.51 in January 2007, to be sure, but the market was not predicting Bear's collapse.[40]

JPMorgan's government-facilitated acquisition of Bear would turn out to be only the first of the government's deals during the market crisis. However, this first deal established a number of principles that would guide the government through the crisis. It is worthwhile to set forth these lessons before we glean them from the facts of the Bear acquisition.

First, in this initial stage, the government was hesitant to act but would do so when left with no other perceived choice. The criteria forcing the government to act would be vague, but mainly was the "too big to fail" doctrine. Institutions whose failure came too quickly or otherwise would imperil the soundness of the entire financial system would be salvaged. But here the government was picayune in its decisions, seemingly willing to save Bear but later permitting the larger Lehman Brothers to fail. We believe that Lehman was allowed to fail despite its larger size because of an overriding need for the government to appear to be a strong dealmaker willing to walk away—a position that the government felt was possible because the market had had a longer time to prepare for a Lehman downfall than a Bear one. This need was reinforced by the political and legal constraints upon the federal government, which further prevented it from saving Lehman Brothers.

Second, when acting to save an institution in the initial phase, the government looked first to penalize shareholders, but not bondholders, in a

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36. Julie Creswell & Vikas Bajaj, *$3.2 Billion Move by Bear Stearns to Rescue Fund*, N.Y. TIMES, June 23, 2007, at A1.

37. It was exactly 32.8:1. Bear Stearns Cos., Annual Report (Form 10-K), exhibit 13 (Financial Report), at 52 (Jan. 29, 2008), http://www.sec.gov/Archives/edgar/data/777001/000091412108000077/0000914121-08-000077.txt.

38. Kate Kelly, *Cayne to Step Down as Bear Stearns CEO*, WALL ST. J., Jan. 8, 2008, at A1.

39. Bear Stearns had a credit rating of AAA until March 14, 2008, when S&P cut its long-term rating by three notches to BBB. *See* Min Zeng, *Prices of Treasurys Rise in Safety Move*, WALL ST. J., Mar. 15–16, 2008, at B3.

40. *See* Andrew Ross Sorkin, *In Sweeping Move, Fed Backs Buyout and Wall St. Loans*, N.Y. TIMES, Mar. 17, 2008, at A1; NYSE Quotes, WALL ST. J., March 8–9, 2008, at B6.

proclaimed fight against moral hazard. Directors were not directly targeted and officers only intermittently penalized. In the Bear Stearns deal, the government actually permitted JPMorgan to indemnify Bear's officers and directors and otherwise did not act to forestall any arrangements between JPMorgan and Bear's current officers to work at JPMorgan after the merger. Again, this may have been a bow to legal limitations as the government required the nominal cooperation of the Bear board of directors to arrange this bailout.

Third, the government insisted that market solutions be largely foreclosed for the sake of achieving orderly ones. In the Bear deal, the possibility that J.C. Flowers could pay more or otherwise find further financing to acquire Bear was halted by the government's insistence that an acquirer be found within an extremely short time frame. But ultimately, the government was bound by the law in its preferences, as the government found out when its attempt to arrange for Citigroup to acquire Wachovia's bank depositary assets was thwarted by Wells Fargo's timely bid. Wells Fargo exploited a legal opening to arrange its own trumping acquisition—one that the government went along with due to legal constrictions and its overriding preference for ordered solutions.

Finally, the government was willing to stretch the law and flex its authority where it could, but was not willing to boldly violate the law. The government used § 13 of the Federal Reserve Act to buy time for the Bear deal. Then, the government assisted in structuring the transaction to meet these timing needs and prevent Bear's shareholders from forestalling the deal. In doing this the government likely facilitated the stretching, if not breaking, of Delaware corporate law. But still, the government could not fully penalize Bear's shareholders as it wanted to. Instead, it was ultimately limited by the law it could not break—the requirement for a vote, which led to Bear's shareholders achieving some recompense. The government's ultimate purpose was to conclude the deal as quickly as possible; if it could not fully implement its goals in order to do this, like any dealmaker, it would accept such restrictions.

Yet, the quick failure of Bear Stearns and the government's seeming unpreparedness was a key theme that would later come to the forefront. The government's actions were reactive rather than proactive. Moreover, the government was building a case of free riding—institutions now knew that if they were too big to fail the government would help them and market solutions would disappear. Nonetheless, Bear set a deal pattern, one that would emerge and affect future bailouts.

2. The Fall of Bear Stearns

The near-bankruptcy of Bear Stearns unfolded extraordinarily quickly. It began on Monday, March 10, 2008, when rumors began to spread in the market that a major investment bank had rejected a standard $2 billion repurchase loan request from Bear Stearns.[41] From there, rumors began to increasingly spread that Bear Stearns was about to become insolvent and otherwise was in some type of financial difficulty. Counterparties became hesitant to trade with Bear and otherwise demanded collateral for their preexisting and future trades, and asset managers, such as hedge funds, began to move funds to other financial institutions.[42] Bear's fall set a precedent for the decline of other financial institutions. Throughout the crisis, rumors of a financial institution's imminent collapse would become reality through a self-fulfilling feedback loop as market participants lost confidence in the unfortunate institution, demanding collateral, withdrawing assets, and refusing to do business with the suspect institution.

During this period, the SEC concluded that Bear Stearns was adequately capitalized. As the SEC would later admit,

> Bear Stearns' registered broker-dealers were comfortably in compliance with the SEC's net capital requirements, and in addition . . . Bear Stearns' capital exceeded relevant supervisory standards at the holding company level. . . . This was consistent with what the SEC had seen over the preceding weeks, during which SEC staff—both on-site and at headquarters—monitored the capital and liquidity positions of all the CSEs, in the case of Bear Stearns on a daily basis.[43]

Bear's counterparties and prime brokerage clients disagreed. By Thursday night Bear's liquid reserves had dropped from $18.3 billion the week before to $5.9 billion, and it owed Citigroup $2.4 billion.[44] More perilously, Bear required daily financing of approximately $75 billion to function. These funds were obtained in the daily short-term repurchase (repo) market, with Bear putting up collateral assets in exchange for cash liquidity. On Thursday morning, Bear was unable to obtain approximately $20 billion of the $75 billion required.[45] The rapid decline of Bear's liquidity showed the perils of using short-term repo lending for liquidity

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41. Roddy Boyd, *The Last Days of Bear Stearns*, FORTUNE, Apr. 14, 2008, at 89.

42. *See* Brett Philbin & Rob Curran, *Boeing Rides Higher, but Bear Struggles*, WALL ST. J., Mar. 14, 2008, at C5; *see also* Kate Kelly, *Fear, Rumors Touched Off Fatal Run on Bear Stearns*, WALL. ST. J., May 28, 2008, at A1.

43. Press Release, SEC, Chairman Cox Letter to Basel Committee in Support of New Guidance on Liquidity Management (Mar. 20, 2008), http://sec.gov/news/press/2008/2008-48.htm.

44. Kelly, *supra* note 42.

45. *See* WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET 47–53 (2009).

purposes. These funds could disappear at any time if the sophisticated lenders providing them became unwilling to lend. When that happened on Thursday, March 13, Bear concluded that without outside assistance it would have to file bankruptcy the next day.[46] In the course of the Thursday night, the Federal Reserve Bank of New York (New York Federal Reserve) decided to guarantee a twenty-eight-day loan from JPMorgan to Bear in the amount of $30 billion.[47]

This particular government action also set a precedent: it was done through a Federal Reserve institution via the legal authority that would be used for each of the government's ad hoc bailouts (as well as a number of other moves designed to inject liquidity into the financial markets). For the legal authority to make this loan, the Federal Reserve relied upon the broad language of its discount window authority, § 13 of the Federal Reserve Act, a law that was last invoked to the benefit of nonbanks in the Great Depression.[48] The pertinent part of § 13 reads,

> 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 . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when . . . indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: *Provided*, [t]hat before discounting . . . the Federal Reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions.[49]

This section, which would form the basis of the government's response to a number of other bailouts, provides the Federal Reserve the right to make loans to, as the Federal Reserve interpreted it during the crisis, any

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46. *See Hearing Before the S. Joint Economic Comm.*, 110th Cong. (2008) (statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System), http://jec.senate.gov/index.cfm?FuseAction=Hearings.HearingsCalendar&ContentRecord_id=0af929fa-0f03-d201-bdb3-2e0cd4eece87&Region_id=&Issue_id (select "The Honorable Ben Bernanke, Chairman of the Federal Reserve" hyperlink).

47. *See* Bear Stearns Cos., Current Report (Form 8-K) (Mar. 16, 2008), http://www.sec.gov/Archives/edgar/data/777001/000091412108000249/be12284854-8k.txt; *see also Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (2008) (statement of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=ec013d8f-fe1e-4fb6-a514-ab93be32ad38&Witness_ID=b428e0eb-d844-4add-9d85-8fab78ba065a (select "viewfile" hyperlink).

48. Press Release, Fed. Reserve Bank of N.Y., Summary of Terms and Conditions Regarding the JPMorgan Chase Facility (Mar. 24, 2008), http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html; *see also* Greg Ip, *Central Bank Offers Loans to Brokers, Cuts Key Rate*, WALL ST. J., Mar. 17, 2008, at A1.

49. 12 U.S.C. § 343 (2006).

financial institution. In addition, it would also turn out that the Federal Reserve would have substantial leeway in setting the interest rates for these loans. This is because § 14(d) authorizes the Federal Reserve to fix the rates for loans under this section "with a view of accommodating commerce and business."[50] The so-called discount window was open to virtually anyone, at least as far as its text went, even if decades of practice suggested otherwise. The only condition was that a supermajority of Federal Reserve board members agree that the circumstances were indeed "unusual and exigent." This meant that, in exchange for the inexpensive money, the recipient had to establish that it had sought credit elsewhere and make the loan "secured to the satisfaction" of the Federal Reserve.[51]

Moreover, in administering the discount window and providing assistance to banks, the Federal Reserve's actions are effectively removed from judicial review. While no court has held that Federal Reserve decisions are unreviewable as a matter of law, courts have steered clear of substantively reviewing both monetary policy decisions and bank financial assistance. In *Raichle v. Federal Reserve Bank*, Judge Augustus Hand concluded that there was nothing inappropriate with a legally constituted bank making loans to other banks and setting interest rates for those loans.[52] And after the Franklin National Bank failed in 1974 and the Federal Reserve provided financial assistance, the Second Circuit concluded that

> [a]bsent clear evidence of grossly arbitrary or capricious action on the part of [the Federal Reserve or the Treasury Department] . . . it is not for the courts to say whether or not the actions taken were justified in the public interest, particularly where it vitally concerned the operation and stability of the nation's banking system.[53]

Thus, the Federal Reserve, through its New York subordinate, acted in a novel manner and with relative impunity in providing this backstop guarantee to assist Bear Stearns. In later testimony, Chairman Bernanke would offer the reason. He stated that this guarantee was necessary in order to forestall the bankruptcy of Bear—an event which he asserted would have systemic ramifications and cause widespread, perhaps

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50. *Id.* § 357.

51. *Id.* § 343. The Federal Reserve and Treasury Secretary have since suggested that this security requirement actually constrains the flexibility of the central bank in opening the discount window—but since the collateral requirement is left up to the Federal Reserve's discretion, these claims seem like disingenuous efforts to argue for a limitation on the power of the bank where there is none. *See, e.g.*, Posting of David Zaring to Conglomerate, http://www.theconglomerate.org/2008/10/must-the-fed-ta.html (Oct. 15, 2008).

52. 34 F.2d 910, 913 (2d Cir. 1929).

53. Huntington Towers, Ltd. v. Franklin Nat'l Bank, 559 F.2d 863, 868 (2d Cir. 1977).

catastrophic domino losses in the financial market.[54]

But the government appeared to sour on the idea of saving Bear quickly and turned to a preselected partner in the private sector to do the job. Secretary Paulson informed Bear that the Federal Reserve would terminate the guarantee and loan in seventy-two hours, leaving Bear to find an alternative transaction by that time or declare bankruptcy.[55] The reasons for the government's reversal of course on Bear still remain somewhat murky, but the next move by the government was less so.[56] It apparently already had an idea about an acquirer for Bear.

There were two prospective bidders—JPMorgan and a consortium of private equity firms led by J.C. Flowers. The Federal Reserve and the Treasury Department, which were both actively involved in structuring this bailout, were unwilling to commit to providing the approximately $20 billion in financial assistance J.C. Flowers required to make an acquisition, essentially locking the J.C. Flowers group out of the process.[57] Furthermore, Treasury pushed JPMorgan to offer as low a price as possible for Bear, a company that on Friday had closed at $30 a share and the prior Monday had closed at $70 a share. Under Secretary of the Treasury Robert Steel would later testify that Secretary Paulson encouraged this low price in order to again prevent future moral hazard by financial institutions.[58] The

54. *See Hearing Before the S. Joint Economic Comm.*, 110th Cong. (2008) (statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System), http://jec.senate.gov/index.cfm?FuseAction=Hearings.HearingsCalendar&ContentRecord_id=0af929fa-0f03-d201-bdb3-2e0cd4eece87&Region_id=&Issue_id (select "The Honorable Ben Bernanke, Chairman of the Federal Reserve" hyperlink). It remains unclear whether this would have actually occurred. Bear Stearns's prime-brokerage business constituted 21% of the industry and its collapse may have left many hedge funds without collateral and assets leading to follow-on economic effects. Certainly these follow-on effects were apparent in the case of the failure of Lehman.

55. *See* Kate Kelly, *Bear Stearns Neared Collapse Twice in Frenzied Last Days*, WALL ST. J., May 29, 2008, at A1; Stephen Labaton, *Bear Stearns in the Committee Room*, N.Y. TIMES, Apr. 4, 2008, at C1.

56. Two explanations have been proffered. First, that the guarantee had failed to forestall Bear's clients from withdrawing funds and that Bear was going to default on the JPMorgan loan on Monday. By forcing Bear into a transaction, the Federal Reserve was protecting its guarantee and preventing any monetary loss. This is the story put forth by the Federal Reserve. *See Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (2008) (statement of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=ec013d8f-fe1e-4fb6-a514-ab93be32ad38&Witness_ID=b428e0eb-d844-4add-9d85-8fab78ba065a (select "viewfile" hyperlink). The second reason offered is a political one: that the Treasury Department, particularly Secretary Paulson, did not want to be seen as bailing out Bear and facilitating future moral hazard. Given that the threat to the financial system remained if Bear collapsed, it also remains unclear whether the government would have fulfilled its threat to cut off Bear if it did not find such a transaction. *See* Kelly, *supra* note 55.

57. *See* Cohan, *supra* note 45, at 88; Kelly, *supra* note 55.

58. *See Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th

chastened investment bank took the deal.[59]

3. JPMorgan Acquires Bear Stearns

The final $2 a share price agreed to be paid by JPMorgan was punishing, but punishing acquisitions of publicly held corporations can, at least in theory, be voted down by the shareholders. The terms of the final merger agreement show that this was a substantial worry of the participants. In order to ensure that the Bear shareholders would not block this transaction, the lawyers hastily negotiated a number of innovative deal-protection devices designed to forestall this possibility. The resulting deal terms are interesting partly because the hastily concluded acquisition contained some surprises for the sophisticated lawyers and clients involved, and partly because some of the deal terms were flatly inconsistent with the Delaware law that governed the transaction. As we will see, the resulting government-provoked transaction became a deal that required still more government intervention to close.

The lawyers for both sides innovated to negotiate an acquisition with terms different than those normally utilized in strategic acquisitions in order to meet their unique purposes. Most prominently, Bear granted to JPMorgan an option to purchase an amount of common stock equal to 19.9% of Bear's outstanding common stock. The option was exercisable if Bear agreed to be acquired by a third party. The maximum compensation JPMorgan could earn on this option by exercising it and selling the stock was uncapped (i.e., unlimited).[60] In addition, in connection with Bear's agreement to be acquired, JPMorgan agreed to guarantee certain of Bear's trading liabilities through a third-party guarantee agreement. This guarantee, however, expired upon the termination of the merger agreement. Nonetheless, the guarantee would still apply to any liabilities incurred by Bear before termination so long as the Bear board of directors had not previously recommended that its shareholders vote against the JPMorgan transaction.[61] Finally, the merger agreement contained a force-the-vote provision under Delaware General Corporation Law § 146 which required Bear to repeatedly hold its shareholder meeting for one year from the date

Cong. (2008) (statement of Robert K. Steel, Under Secretary for Domestic Finance), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=95e2f1ae-1dc8-49ad-84c0-f8d9a1d38bd8.

59. Kelly, *supra* note 55.

60. Bear Stearns Cos., Current Report (Form 8-K), exhibit 99.2 (Stock Option Agreement) (Mar. 20, 2008), http://www.sec.gov/Archives/edgar/data/777001/000091412108000252/be12335840-ex99_2.txt.

61. Bear Stearns Cos., Current Report (Form 8-K), exhibit 99.1 (Guaranty Agreement) (Mar. 20, 2008), http://www.sec.gov/Archives/edgar/data/777001/000091412108000252/be12335840-ex99_1.txt.

of the agreement or until Bear's shareholders approved the merger agreement and the merger.[62]

The option and the force-the-vote terms in the Bear merger agreement were modeled upon more-traditional provisions of this type. However, both deal-protection devices differed from the standard provisions in fundamental ways. The option granted by Bear to JPMorgan was an uncapped one, providing for unlimited compensation to JPMorgan in the case of a competing, higher bid, a feature that the Delaware courts had ruled invalid in other circumstances in the 1994 case of *Paramount Communications, Inc. v. QVC Network, Inc.*[63] Moreover, the provision providing for Bear to rehold its shareholder meeting for one year until the merger agreement was approved was a modification of a traditional force-the-vote provision which only required that the company hold one vote. It too was of dubious legal validity under the *Blasius* standard and perhaps other Delaware standards of review—including as coercive or preclusive antitakeover devices invalid under the *Unocal* doctrine.[64]

These innovations were negotiated in the hurry of a forty-eight-hour period. JPMorgan would soon discover that these provisions did not work as the parties originally intended. In particular, the one-year revote provision provided Bear Stearns a one year "put," or option-to-sell, right to JPMorgan. During this time, the JPMorgan guarantee would be in place and Bear could operate safe in the assurance that its liabilities would be backed by the guarantee.[65] JPMorgan realized after the announcement of this agreement and the hostile reaction of Bear's shareholders that the

62. *See* Bear Stearns Cos., Current Report (Form 8-K), exhibit 2.1 (Agreement and Plan of Merger by and Between Bear Stearns Cos. and JP Morgan Chase & Co.) (Mar. 20, 2008), http://www.sec.gov/Archives/edgar/data/777001/000091412108000252/be12335840-ex2_1.txt.

63. 637 A.2d 34, 51 (Del. 1993).

64. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955–57 (Del. 1985). *Blasius* and *Unocal* set the framework for courts to review certain actions taken by boards of directors in the context of a shareholder vote or defensive measure, respectively. *Blasius* requires a "compelling justification" for intentional interference with shareholders' voting franchise by a board of directors. *Blasius*, 564 A.2d at 660–62; *see also* MM Cos. v. Liquid Audio, Inc., 813 A.2d. 1118 (Del. 2003). *Unocal*, as subsequently applied by the Delaware courts, applies a three-pronged test to determine whether the board reasonably perceived a threat to the corporation and whether the defensive measure taken was either preclusive or coercive and reasonable in relation to the threat posed. *Unocal*, 493 A.2d at 955–57; *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995). *See generally* Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713 (2009) (elaborating on the *Blasius* and *Unocal* standards in the context of the Bear Stearns transactions).

65. *See* Posting of Steven M. Davidoff to N.Y. Times DealBook, http://dealbook.blogs.nytimes.com/2008/03/24/bears-big-guarantee/ (Mar. 24, 2008, 9:30 EST).

interaction of these two provisions could allow Bear to stabilize during this time period and find a third-party buyer who could pay a higher price.[66] And Bear realized this too.[67] Moreover, parties were still refusing to trade with Bear because of the uncertainty surrounding this transaction.

On this basis, the parties entered into a renegotiation to reform these provisions and more tightly bind Bear to JPMorgan.[68] In exchange for an increase in the consideration paid to $10 per share in JPMorgan common stock and a guarantee which extended to additional Bear liabilities, JPMorgan's 19.9% option was eliminated. In exchange, JPMorgan was issued a 39.5% stake in Bear or 95 million newly issued common shares in exchange for 20,665,350 newly issued common shares in JPMorgan worth $950 million on the date of announcement.[69] In addition, JPMorgan immediately acquired another 9.93% of Bear's shares in the open market, giving JPMorgan an aggregate 49.43% ownership of Bear at the time of the establishment of the record date for voting on the Bear transaction.[70] Finally, the guarantee was amended so that it terminated 120 days after the first "no" vote of Bear's shareholders on the merger agreement and the merger.[71]

The initial transaction had largely been within the confines of a traditionally structured strategic acquisition. However, the second deal pushed further afar from the traditional deal structure and was designed to increase the chance that JPMorgan's acquisition of Bear would occur. This was particularly true of Bear's issuance of 39.5% of its outstanding common stock, a truly novel provision which, together with JPMorgan's market purchases, stretched Delaware law to the breaking point.[72]

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66. *See* Andrew Ross Sorkin, *JPMorgan in Negotiations to Raise Bear Stearns Bid*, N.Y. TIMES, Mar. 24, 2008, at A1; Kelly, *supra* note 55.

67. Kelly, *supra* note 55.

68. Sorkin, *supra* note 66.

69. Bear Stearns Cos., Current Report (Form 8-K), exhibit 2.2 (Share Exchange Agreement) (Mar. 24, 2008), http://www.sec.gov/Archives/edgar/data/777001/000091412108000260/be12368022-ex2_2.txt. The JPMorgan shares were not registered and JPMorgan did not provide registration rights to Bear for these shares. This was presumably done so that the resale of these shares by Bear would be extremely difficult. Bear could not therefore sell them to independently increase its liquidity continuing its dependence upon JPMorgan. *See* Posting of Steven M. Davidoff to N.Y. Times DealBook, http://dealbook.blogs.nytimes.com/2008/03/24/jpmorgan-and-bear-throw-down-the-gauntlet/ (Mar. 24, 2008, 14:34 EST).

70. Bear Stearns Cos., Definitive Proxy Statement (Schedule 14A) (April 28, 2008), http://www.sec.gov/Archives/edgar/data/777001/000119312508092860/ddefm14a.htm.

71. Bear Stearns Cos., Current Report (Form 8-K), exhibit 99.1 (Amended and Restated Guaranty Agreement) (Mar. 24, 2008), http://www.sec.gov/Archives/edgar/data/777001/000091412108000260/be12368022-ex99_1.txt.

72. Bear's 39.5% share issuance was no doubt structured separately from the open market share purchase to comply with the Delaware ruling in *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d. 914, 938 (Del. 2003). By separating these purchases in distinct

JPMorgan, advised by its attorneys, appeared willing to push the bounds of Delaware law, but in structuring the revised transaction in this manner, JPMorgan no doubt felt safe in an assurance that a court would be reluctant to challenge a federal-government-backed deal. Here, the federal government had endorsed the second deal, albeit insisting that its guarantee be revised to provide that JPMorgan bear the first billion dollars of losses under it.[73] The Federal Reserve was demonstrating its willingness for an ordered solution, but Treasury officials also reportedly expressed private displeasure at Bear stockholders receiving this increased consideration.

JPMorgan and its lawyers proved right in their judgments about any court challenge. On April 9, 2008, Vice Chancellor Roger Parsons abstained from ruling in the shareholder litigation brought by shareholders in the Delaware Chancery Court challenging the transaction.[74] He stated, "I find the circumstances of this case to be *sui generis*. What is paramount is that this Court not contribute to a situation that might cause harm to a number of affected constituencies, including U.S. taxpayers and citizens, by creating the risk of greater uncertainty."[75]

Professors Kahan and Rock have described this as a strategic use of comity, and they appear right.[76] Delaware did not want to be seen as challenging the federal government. The plaintiffs in the New York case initially pursued a preliminary injunction hearing, but they too soon realized that a New York court would similarly be reluctant to challenge the federal government. On May 7, 2008, the plaintiffs dropped their motion for an injunction, instead electing to pursue monetary damages.[77]

JPMorgan's acquisition of Bear closed on May 30, 2008.[78]

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transactions, JPMorgan could attempt to defend the share issuance if the open market purchases were found by a Delaware court to violate Omnicare's prohibitions on completely locked-up acquisition transactions. *See* Posting of Steven M. Davidoff to N.Y. Times DealBook, http://dealbook.blogs.nytimes.com/2008/03/24/is-jpmorgan-getting-too-clever/ (Mar. 24, 2008, 12:06 EST) (stating that JPMorgan's share acquisitions were likely structured to preserve a litigation position that these were two purchases that should be viewed separately).

73. Press Release, Fed. Reserve Bank of N.Y., *supra* note 48.

74. *See In re* Bear Stearns Cos. Shareholder Litigation, C.A. NO. 3643-VCP, 2008 WL 959992, at *8 (Del. Ch. Apr. 9, 2008).

75. *Id*. at *6.

76. *See* Kahan & Rock, *supra* note 64; *see also* Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57 (2009).

77. Posting of Steven M. Davidoff to N.Y. Times DealBook, http://dealbook.blogs.nytimes.com/2008/05/09/euthanizing-bear/ (May 9, 2008, 11:28 EST). The plaintiffs' claims were subsequently dismissed by the New York court on December 4, 2008. *In re* Bear Stearns Litigation, 870 N.Y.S.2d 709 (Sup. Ct. 2008), *available at* 2008 WL 5220514.

78. Bear Stearns Cos., Current Report, (Form 8-K) (June 2, 2008), http://www.sec.gov/Archives/edgar/data/777001/000091412108000468/0000914121-08-000468-index.htm.

C. The Initial Stage: The Government as Dealmaker

The period following the fall of Bear Stearns and the crisis in subprime mortgages prompted four responses by the government over the next six months. First, on the day that Bear agreed to be acquired by JPMorgan, the Federal Reserve opened its discount window beyond the banks that it oversees, specifically to the seventeen-odd institutions listed by the New York Federal Reserve as "primary dealers" in government securities that reported their statistics to the Federal Reserve.[79] The availability of this inexpensive money was to be secured by a wide range of investment-grade securities.[80] Once again, § 13 of the Federal Reserve Act was the basis for the novel expansion of the window.[81]

Second, the government used the crisis to push for some long-cherished reform of the financial regulatory system. On March 31, 2008, Secretary Paulson released a report recommending administrative and legislative changes to government regulation of finance. The recommendations—the so-called Paulson Blueprint—plumped for enhanced powers for bank regulation, to be placed into the hands of the Federal Reserve as well as Treasury, and for the regulatory supervision apparatus of the government to be consolidated by, among other things, merging the CFTC with the SEC.[82] The report did not result in any immediate congressional action, and indeed was derided by many legislators as having no chance of passage, not least because it was propounded by an unpopular Administration during an election year.

Third, the Federal Reserve, after its novel involvement in the Bear Stearns takeover, reverted to its more typical role of setting macro-level monetary policy. In the period from March 18, 2008, to October 8, 2008, the Federal Reserve continued to cut the target rate for federal funds from 2.25% to 1.5%[83] and the discount rate from 2.5% to 1.75%.[84]

Fourth, on July 24, 2008, the government passed the Housing and Economic Recovery Act of 2008 (HERA),[85] an attempt to address the

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79. Federal Reserve Bank of New York, Primary Dealer Credit Facility: Program Terms and Conditions, http://www.newyorkfed.org/markets/pdcf_terms_080316.html (last visited Apr. 16, 2009).

80. *Id.*

81. *See* 12 C.F.R. § 201.4(d) (2009).

82. *See* U.S. DEP'T OF TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf.

83. FED. RESERVE BD., *supra* note 23.

84. *See* FED. RESERVE DISCOUNT WINDOW, HISTORICAL DISCOUNT RATES, http://www.frbdiscountwindow.org/historicalrates.cfm?hdrID=20&dtlID (follow "primary and secondary credit" link).

85. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008) (to be codified at 42 U.S.C. § 4511).

housing crisis. HERA provided, in theory, $300 billion in aid to subprime housing buyers (if they could qualify for it) and also set the GSEs as principal actors in engineering a housing recovery.[86] The bill increased the regulatory oversight of the two GSEs and expanded the conservatorship powers of the federal government over the entities.[87] At the time of the passage of this Act, Secretary Paulson, commenting on the conservatorship powers the HERA provided the new Federal Housing Administration (FHA), stated that "[i]f you've got a bazooka, and people know you have it, then you may not have to take it out."[88]

These four actions were each, in their own way, dramatic, but none of them were designed to comprehensively resolve the crisis, which had spread from housing to finance and existed in the present, while portending an increasingly threatening future. The hope apparently was that the broadening of the discount window would be enough to protect the financial system. The homeowner aid, though somewhat small solace, was aimed at that section of the economy, and the regulatory reform proposals, which were anything but small gestures, were quickly deemed to be a project for the future.[89]

The government apparently hoped that the markets would take the lead in sorting themselves out. However, for some companies, particularly Fannie Mae and Freddie Mac, the private markets no longer appeared to be a good alternative. In July and August 2008 storm clouds began to gather over both companies. The government urged the institutions to recapitalize, but their stockholders resisted the dilution, and investors, wary perhaps of an equity-destroying Bear Stearns-like bailout, stayed away.[90]

On July 11, 2008, the Office of Thrift Supervision (OTS) ominously closed the IndyMac Bank and placed it into conservatorship with the Federal Deposit Insurance Corporation (FDIC).[91] This was the second-largest bank failure in the United States. Even after the bank was seized, people lined up in the thousands to withdraw their money despite the existence of federal insurance for their deposits, which was particularly troubling for the government.[92]

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86. *Id.* § 1311.

87. *Id.*

88. Stephen Labaton & David M. Herszenhorn, *A Rescue for Fannie and Freddie Kindles Opposition and Political Duels*, N.Y. TIMES, July 16, 2008, at C1.

89. *See* Damian Paletta, *Regulators Take Steps to Aid Bank Liquidity*, WALL ST. J., July 16, 2008, at A2 (discussing the FDIC's new policies aimed at increasing financing availability for mortgage origination and securitization).

90. James R. Hagerty & Serena Ng, *Banks Hit as Fannie, Freddie Get Downgrade*, WALL ST. J., Aug. 23–24, 2008, at A1.

91. Louise Story, *Regulators Seize IndyMac After a Run on the Bank*, N.Y. TIMES, July 12, 2008, at C5.

92. *See* E. Scott Reckard & Andrea Chang, *Banks Hit by Fallout from the Crisis at*

In late August, the ratings agencies downgraded the preferred stock ratings of Fannie and Freddie from A minus to AA minus, in the case of Standard & Poor's, and from A1 to Baa3, in the case of Moody's. In light of this, the need for each GSE to raise capital was further heightened but also made more difficult.[93] The market pressure on Fannie's and Freddie's stocks due to solvency fears created yet another detrimental self-reinforcing feedback loop ensuring that these fears would come to pass. This problem appeared particularly exacerbated in the case of Fannie and Freddie by the possibility of nationalization by the federal government, a factor that further shied off possible investors. Paulson's big bazooka unfortunately appeared to serve the opposite from its intended purpose.

1. The Nationalization of Fannie Mae and Freddie Mac

After losing the market's confidence, Fannie and Freddie lost the government's confidence the weekend of September 5, 2008. First, government auditors discovered that the accounting records of Fannie and Freddie significantly overstated their capital.[94] According to these accounting reevaluations, the GSEs, thinly capitalized in the best of times, were technically insolvent. Second, the government concluded that whatever efforts the GSEs were making to recapitalize were failing. Treasury resolved to seize the enterprises on September 7, pursuant to its authority under HERA—a rare instance during this period where the Federal Reserve's § 13 powers were not involved.[95]

That statute provided that the FHA, the primary regulator of the GSEs,

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IndyMac, L.A. TIMES, July 15, 2008, at A1. Notably, at the time the Office of Thrift Supervision (OTS) attacked Senator Charles Schumer for causing the collapse of the bank. The OTS stated in its press release announcing the closing that

> [t]he immediate cause of the closing was a deposit run that began and continued after the public release of a June 26 letter to the OTS and the FDIC from Senator Charles Schumer of New York. The letter expressed concerns about IndyMac's viability. In the following eleven business days, depositors withdrew more than $1.3 billion from their accounts.

See Press Release, Office of Thrift Supervision, OTS Closes IndyMac Bank and Transfers Operations to FDIC (July 11, 2008), http://www.ots.treas.gov/index.cfm?p=PressReleases&ContentRecord_id=37f10b00-1e0b-8562-ebdd-d5d38f67934c&ContentType_id=4c12f337-b5b6-4c87-b45c-838958422bf3&MonthDisplay=7&YearDisplay=2008.

93. *See* Hagerty & Ng, *supra* note 90 (describing the effects of such downgrades on banks and investors and noting the increased fears among them that the government might move to take full control of the GSEs).

94. *See* Gretchen Morgenson & Charles Duhigg, *Mortgage Giant Overstated Size of Capital Base*, N.Y. TIMES, Sept. 7, 2008, at A1.

95. The ensuing conservatorship decision was technically invoked by the Federal Housing Authority (FHA), an independent government agency, but the FHA appeared to follow the decisions of the Treasury Department on this matter—at least, the negotiations happened at Treasury, and the conservatorship was announced by Paulson. *See* Charles Duhigg, *As Crisis Grew, a Few Options Shrank to One*, N.Y. TIMES, Sept. 8, 2008, at A1.

"is authorized . . . to appoint conservators for the enterprises."[96] Moreover, HERA had provided the Treasury Secretary with an equally broad grant of authority to recapitalize the GSEs. Section 1117 of HERA stated, "the Secretary of the Treasury is authorized to purchase any obligations and other securities issued by the corporation . . . on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine."[97]

The CEO of each GSE was fired and replaced. In addition, the FHA later cut the exit package of the Fannie CEO as much as $8 million and the Freddie CEO from $15 million[98] under the authority of § 1318 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 as amended by HERA.[99] This last act would be the sole example of the government acting to claw back executive pay in connection with a bailout. In order to increase each GSE's capital, Treasury also entered into senior preferred share purchase agreements with Fannie Mae and Freddie Mac for each to issue up to $100 billion of senior preferred stock to the Treasury Department.[100]

The GSEs initially issued only $1 billion of preferred stock but each was permitted to draw greater amounts up to this $100 billion limit as needed up to the amount, if any, by which its total liabilities exceeded total assets.[101] The issued preferred shares were ranked senior to Fannie's and Freddie's existing preferred shares and paid Treasury a 10% yield if paid in cash and 12% if paid in kind.[102] This yield was significantly below the approximate 15% yield on the GSEs' other outstanding preferred.[103] The

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96. 12 U.S.C § 4513(b) (2006).

97. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1117, 122 Stat. 2654, 2684 (2008) (to be codified at 12 U.S.C. § 1719).

98. James R. Hagerty, *Regulator Plans to Bar Big Severance*, WALL ST. J., Sept. 15, 2008, at A1.

99. 12 U.S.C. § 4518 (2006), *amended by* Pub. L. No. 110-289, § 1114, 122 Stat. 2654, 2679–81 (2008).

100. *See* Fed. Nat'l Mortgage Ass'n, Current Report (Form 8-K), at 4 (Sept. 11, 2008) [hereinafter FNMA Form 8-K], http://www.sec.gov/Archives/edgar/data/310522/000095013308003096/w67133e8vk.htm; Fed. Home Loan Mortgage Corp., Current Report (Form 8-K) (Sept. 11, 2008) [hereinafter FHLM Form 8-K], http://www.sec.gov/Archives/edgar/data/1026214/000102621408000030/f67154e8vk.htm. These preferred stock commitments would later be increased to $200 billion each. *See* Press Release, U.S. Dep't of the Treasury, Statement by Secretary Tim Geithner on Treasury's Commitment to Fannie Mae and Freddie Mac (Feb. 18, 2009), http://www.treas.gov/press/releases/tg32.html.

101. OFFICE OF PUB. AFFAIRS, U.S. DEP'T OF THE TREASURY, FACT SHEET: TREASURY SENIOR PREFERRED STOCK PURCHASE AGREEMENT (2008), http://www.treas.gov/press/releases/reports/pspa_factsheet_090708%20hp1128.pdf.

102. *Id.*

103. Press Release, Fannie Mae, Fannie Mae Announces Third Quarter Common and Preferred Stock Dividends (Aug. 8, 2008), http://www.fanniemae.com/newsreleases/2008/4445.jhtml;jsessionid=K1SEMXFZDKW2V

terms of the preferred prevented each GSE from paying any dividend on the GSE's equity securities while any part of the government's preferred interest remained outstanding.[104]

Treasury also received a warrant to purchase 79.9% of the outstanding common stock of each of Fannie and Freddie. The warrant was exercisable for a twenty-year period and had a nominal exercise price of $0.00001 per share.[105] Through this mechanism, the government effected a transaction to significantly, but not completely, dilute the holders of these securities and significantly reduce their value. But the government did not place its ownership interest higher into the capital structures of each GSE in order to penalize or otherwise wipe out the secured or subordinated debt of these entities.

This was likely done for both political and economic reasons—again the government's actions were constrained by the outer boundaries of the law. The secured debt was issued by Fannie and Freddie to finance mortgage lending and had historically been viewed as having an implicit (now effectively explicit) government guarantee. The amount outstanding was over $5.14 trillion in mortgage-backed securities and guarantees, and Treasury could not eliminate or otherwise impair this debt without risking significant, if not catastrophic, disruption to the mortgage market.[106] The subordinated debt was generally perceived by the market as riskier and was not viewed as having a government guarantee.[107] Fannie and Freddie utilized this debt to finance their riskier, nonconforming loans and for trading capital.[108] However, a substantial portion of the subordinated debt, like much of the secured debt, was held by foreign financial institutions and sovereigns. It was privately viewed that if this debt was impaired, it would

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J2FQSISFGI?p=Media&s=News+Releases; Press Release, Freddie Mac, Freddie Mac Summary of Dividends (2008), http://www.freddiemac.com/investors/pdffiles/div0908.pdf.

104. OFFICE OF PUB. AFFAIRS, *supra* note 101.

105. *See* FNMA Form 8-K, *supra* note 100, at 2, 9.

106. Fannie's total mortgage portfolio in the consolidated balance sheets as of December 31, 2007, was $2,832,793 million with an additional $206.5 billion for other guaranties not recorded in the consolidated balance sheets. FED. NAT'L MORTGAGE ASS'N, ANNUAL REPORT (Form 10-K) (Feb. 27, 2008) [hereinafter FNMA Form 10-K], http://www.sec.gov/Archives/edgar/data/310522/000095013308000795/w48295e10vk.htm. Freddie's total mortgage portfolio as for December 31, 2007, was $2,102,676 million. FREDDIE MAC, 2007 ANNUAL REPORT [hereinafter FHLMA Annual Report], http://www.freddiemac.com/investors/ar/pdf/2007annualrpt.pdf. The combined mortgage portfolios and guarantees of both GSEs amounted to $5,141,969 million. *See* James R. Hagerty et al., *U.S. Seizes Mortgage Giants: Government Ousts CEOs of Fannie, Freddie; Promises Up to $200 Billion in Capital*, WALL ST. J., Sept. 8, 2008, at A1.

107. *See* STANDARD & POOR'S, RESEARCH UPDATE: FANNIE MAE AND FREDDIE MAC RATINGS PLACED ON CREDIT WATCH NEGATIVE; SENIOR DEBT RATING AFFIRMED 2 (2008).

108. *See* FNMA Form 10-K, *supra* note 106, at 116; FHLMA Annual Report, *supra* note 106, at 5.

drive away foreign lenders from U.S. debt at a time when the United States required this money to service its federal obligations.[109] Thus, the government limited its actions to impairing the value of the GSEs' preferred and common stock. Here, the government particularly impacted the many depositary institutions that were permitted to invest in the GSEs' preferred stock and had done so in search of a higher return.

Moreover, the government did not completely wipe out the preferred and common shareholders of the GSEs. Rather, the government limited its interest to the 79.9% figure. The exact reasons for this limitation have yet to be disclosed, but it does not appear that this issuance was structured to maintain value for the security holders. Rather, it was likely done for one or more of the following reasons: (1) to support a position that the GSEs did not have to be consolidated onto the books of the federal government for accounting purposes (something the Congressional Budget Office disputed); (2) to build a case that each GSE was not now a government-controlled entity so that the government's unique accounting rules did not have to be adopted by these entities; (3) to ensure that these GSEs could still deduct interest paid on their loans from the government, something they would be unable to do under § 163 of the Internal Revenue Code if they were deemed "controlled" by the government;[110] and (4) to ensure for Employee Retirement Income Security Act (ERISA) purposes that the GSEs were not deemed "controlled" by the government, making the government joint and severally liable for these entities' ERISA plan liabilities.[111]

A former Treasury official would later assert that this was indeed done for accounting purposes in order to keep Fannie Mae's and Freddie Mac's liabilities off the government's balance sheet.[112] But for whatever reason, the government felt that it could not completely eliminate these security holders' interests. The government's willingness, as with Bear, to seemingly act within the law had allowed the Fannie and Freddie preferred and common shareholders to retain a meaningful interest in the companies. Moreover, to the extent the government was fighting moral hazard, it would have presumably have wanted to also impair Fannie's $11.1

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109. David M. Dickson & David R. Sands, *Overseas Debt Drives Bailout of Fannie, Freddie*, WASH. TIMES, Sept. 9, 2008, at A1.

110. This reason was likely not applicable here as the GSEs lacked profits in the foreseeable future.

111. *See* Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1002(14)(E) (2006).

112. *See* Swagel, *supra* note 6 ("The 79.9 percent ownership was chosen in light of accounting rules that would have brought GSE assets and liabilities onto the government balance sheet at 80 percent ownership.").

billion[113] and Freddie's $4.5 billion[114] outstanding subordinated debt. This did not happen. Instead, the government was acting as a dealmaker structuring a bailout using the law, but also acting within and to the limits of its political interests. This led Treasury and the Federal Reserve to impair the preferred and common shareholders and the FHA to limit the severance packages of these CEOs, but it did not go so far as allowing the government to act purely in pursuit of its stated purposes. Even assuming that it had any bearing in a financial action of this enormity, moral hazard in this context thus seemed to, at best, be a shaky principle to rely upon to justify the government's structuring actions.

In connection with the conservatorship of Fannie and Freddie, the federal government had now become the owner or guarantor of approximately 42% of American mortgages, and the extent of the guarantees was only growing in size and scope.[115] Secretary Paulson announced that these entities' retained mortgage and mortgage-backed securities portfolio would be shrunk to a smaller size of approximately $850 billion in assets by December 31, 2009, and would continue to decline by 10% per year until each reached an asset portfolio size of $250 billion.[116] However, this would only occur in later years. Instead, Secretary Paulson announced that the government intended to grow these institutions over the next fifteen months in order to provide assistance to the housing market.[117]

In addition, the Federal Reserve also announced that it would accept a wider array of collateral at the discount window from investment banks, including equity securities.[118] The legal authority for this was, once again, the flexible § 13 of the Federal Reserve Act, which makes the discount window widely available. Haphazardly, the Treasury and Federal Reserve were beginning to guarantee much of the U.S. financial system.

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113. Fed. Nat'l Mortgage Ass'n Quarterly Report (Form 10-Q), at 82 (Aug. 8, 2008), http://www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf.

114. *See* Fed. Home Loan Mortgage Corp., Quarterly Report (Form 10-Q) (Aug. 6, 2008), http://sec.gov/Archives/edgar/data/1026214/000102621408000026/f58905e10vq.htm.

115. The figure is as of September 20, 2008. *See* Fed. Nat'l Mortgage Ass'n, Quarterly Report (Form 10-Q), at 9 (Nov. 10, 2008), http://sec.gov/Archives/edgar/data/310522/000095013308003686/w71392e10vq.htm; Fed. Home Loan Mortgage Corp., Quarterly Report (Form 10-Q) (Nov. 14, 2008), http://sec.gov/Archives/edgar/data/1026214/000102621408000043/f65508e10vq.htm#113.Sep.

116. *See* OFFICE OF PUB. AFFAIRS, *supra* note 101.

117. *See* Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), http://www.ustreas.gov/press/releases/hp1129.htm.

118. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 14, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm.

2. The Week that Changed Everything

In the wake of the partial nationalization of Fannie and Freddie, the already-troubled credit markets began to completely freeze up.[119] But the government still did not directly act. Indeed, when the Federal Reserve met on September 16, it did not again lower interest rates and instead focused on the problem of commodity inflation.[120] Still, it was apparent that the credit market remained disrupted. This was a very different animal than an equity decline, which had been typical of financial crises in the past century. Unlike equity crises, this was something that was harder for the public to see.

a. The Bankruptcy of Lehman Brothers and the Sale of Merrill Lynch

During the weekend of September 13, 2008, Lehman suffered from the same self-fulfilling feedback loops as Bear. On September 10, 2008, Lehman had pre-announced quarterly earnings: a loss of $3.9 billion for that quarter and gross asset write-downs of $7.8 billion.[121] Lehman also announced on that day plans to hive off its troubled commercial-real-estate-related and other assets into a separate "bad" bank.[122] The plan had been criticized as insufficient by many analysts.[123] Rumors began to circulate of Lehman's inability to survive.[124] These rumors quickly created their own feedback loop as customers began to pull assets from Lehman and demand collateral on counterparty trades as they became concerned for Lehman's

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119. Carrick Mollenkamp et al., *Lending Among Banks Freezes*, WALL ST. J., Sept. 17, 2008, at A1.

120. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 16, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080916a.htm (noting that "the inflation outlook remains highly uncertain"). This was not an irrational move by the Federal Reserve. The economy and exports were still growing while commodity inflation was reaching historical levels. Moreover, there was a common wisdom theory being circulated that the current credit crisis had been brought on by an unduly low level of interest rates set by the Federal Reserve in the period from 2001 to 2005. *See*, *e.g.*, Allan Sloan, *How Keeping Short Rates Low Created a Fiasco*, WASH. POST, Sept. 17, 2008, at D7.

121. Lehman Bros. Holdings, Inc., Current Report (Form 8-K), exhibit 99.1 (Press Release, Lehman Brothers Announces Preliminary Third Quarter Results and Strategic Restructuring), at 5 (Sept. 10, 2008), http://sec.gov/Archives/edgar/data/806085/000110465908057829/a08-22764_2ex99d1.htm.

122. *Id.* at 3. Lehman intended to spin off $25 billion to $30 billion of its commercial real estate portfolio into a separate publicly traded company, Real Estate Investments Global, in the first quarter of 2009. *Id.*

123. Randall Smith, *Lehman's Revamp Plan Draws Doubters: Analysts Wonder If Fixes Can Occur in Time to Be of Help*, WALL ST. J., Sept. 11, 2008, at C1.

124. *See* Joe Bel Bruno, *Lehman Plunges on Concerns About Capital Levels*, ASSOCIATED PRESS, Sept. 9, 2008 ("The steep decline in Lehman's shares began shortly after Dow Jones Newswires reported that the head of South Korea's financial regulator said talks about a possible investment had ended.").

survival. By the weekend of September 13, Lehman's liquidity position had significantly deteriorated, to approximately $1 billion, and the company was facing a loan call by JPMorgan.[125] Lehman was the next financial institution faced with insolvency if it could not find a buyer or obtain government backing. Initially, Bank of America and Barclays were interested acquirers.[126]

But Merrill Lynch & Co. had its own problems emerging at this time; after Lehman, Merrill was perceived as the next at risk of the five investment banks. Merrill's CEO Jonathan Thain would conclude that if Lehman did not survive, his bank would now be viewed as the weakest of the investment banks and subject to the same viral self-fulfilling feedback loops.[127] The perception of the viability of the investment-bank model was now in question. In light of the market turmoil and higher leverage ratios of these investment banks compared to more-regulated bank holding companies, market participants were fearful of doing business and investing in these institutions. Market investors, aware of this wariness, began selling their stock in the investment banks, once again making it harder for them to raise capital and assuage investors, leading to more concern about the survival of these institutions—the feedback loop was whirring.

Fearful of Merrill's survival and being stuck in such a loop, Thain contacted Bank of America about an acquisition, and that weekend Merrill agreed to be acquired in an approximately $50 billion transaction by Bank of America.[128] This left only Barclays as a willing acquirer of Lehman. Likely due to political reality, personal preference, and legal limitations on the government's power, Paulson insisted that the private market find a solution to Lehman Brothers. However, Barclays was thrown out of the race when its own British regulator, the Financial Services Authority, refused to approve an acquisition.[129] Perhaps because they felt that the government would actually act and they could still free ride on such

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125. Carrick Mollenkamp et al., *The Two Faces of Lehman's Fall: Private Talks of Raising Capital Belied Firm's Public Optimism*, WALL ST. J., Oct. 6, 2008, at A1. On September 11, JPMorgan demanded from Lehman $5 billion in additional collateral in easy-to-sell securities to cover lending positions that JPMorgan's clients had with Lehman. *Id.*

126. *See* Hilsenrath et al., *supra* note 7.

127. *See* Merrill Lynch & Co., Proxy Statement (Schedule 14A), at 49–52 (Nov. 3, 2008), http://www.sec.gov/Archives/edgar/data/65100/000095012308014246/g15211mldefm14a.htm; *see also* Jonathan Keehner & Bradley Keoun, *Bank of America Said to Reach $44 Billion Deal to Buy Merrill*, BLOOMBERG.COM, Sept. 14, 2008, http://www.bloomberg.com/apps/news?pid=20601110&sid=alGoI3fTq1Us (quoting an analyst stating that "[i]f Lehman fails, the next bank to be attacked would be Merrill. They are attempting to forestall that attack by linking with Bank of America.").

128. *See* Cohan, *supra* note 45, at 435.

129. *Id.* at 439.

government conduct, the major financial institutions also refused to assist Lehman directly and instead put in a $70 billion facility to backstop trading when Lehman filed for bankruptcy.[130] On Monday, September 15, 2008, Lehman's holding company filed for Chapter 11.[131] Notably, most of Lehman's subsidiaries did not file for bankruptcy, and on that Tuesday, Lehman agreed to sell its U.S. broker deal operation minus certain troubled commercial-real-estate-related assets to Barclays for a fire-sale price of $250 million.[132]

Many observers would accuse the government of making a mistake in failing to bail out Lehman, leaving its bondholders without recourse, the credit insurance that it had underwritten meaningless, and its significant issued commercial paper worthless. The finance minister of France criticized the government for letting such an important global financial player default on its obligations.[133] Regardless of whether Lehman should have been allowed to fail, it is still unclear whether the government realized the extent of Lehman's obligations. On the other hand, the drastic market reactions that flowed from Lehman's failure ultimately drove the government to adopt a more comprehensive approach to the crisis.

But that approach had to wait. We interpret part of what drove the decision to let Lehman fail to an inclination by Paulson, who, as dealmakers sometimes do, wanted to make a statement about his willingness to bail out all financial institutions. Secretary Paulson would later publicly state that the reason he did not bail out Lehman was because "[w]e didn't have the powers," since Lehman lacked enough assets to provide sufficient collateral for a Federal Reserve loan.[134] The government was clearly hamstrung here by the failure to have the power to simply seize Lehman. However, given that the Federal Reserve had previously interpreted (and would later interpret) its statutory authority to have broad reach to make loans in the context of the Bear Stearns matter, we believe this explanation is not credible. The government may not have been able to seize Lehman but the Federal Reserve could loan it money. Instead, it appears that Paulson was restricted from acting politically and wanted to

130. *See* Carrick Mollenkamp et al., *Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash: Fed Will Expand Its Lending Arsenal in a Bid to Calm Markets; Moves Cap a Momentous Weekend for American Finance*, WALL ST. J., Sept. 15, 2008, at A1.

131. *Lehman Brothers Files for Chapter 11 Bankruptcy Protection*, ASSOCIATED PRESS, Sept. 15, 2008; Ben White & Michael M. Grynbaum, *The Street After Lehman Brothers*, N.Y. TIMES, Sept. 16, 2008, at C1.

132. Jeffrey McCracken et al., *Lehman in New Talks to Sell Assets to Barclays*, WALL ST. J., Sept. 16, 2008, at C1.

133. *See* Nocera & Andrews, *supra* note 1.

134. *Id.*

make a statement, as dealmakers do, about his willingness to bail out all financial institutions.

In the wake of the Lehman bankruptcy and Merrill's agreement to be acquired by Bank of America, the investment-banking model was shaky at best. On September 21, the final two independent investment banks regulated by the SEC, Goldman Sachs & Co. and Morgan Stanley, Inc., left the agency's regulation to become bank holding companies, overseen by the Federal Reserve—and potentially protected by that apparently more capable agency.[135] These two investment banks were pursuing a path toward stability by acquiring bank deposits—an ironic event as bank deposits were also short-term financing. Nonetheless, the market perception was that this model was more reliable than one which relied upon short-term prime brokerage deposits and repo lending for liquidity. The SEC's program overseeing investment banks like Bear Stearns and Lehman was quietly shuttered, meaning that any pretence that the SEC could make at performing banking-style supervision of the capitalization of investment banks ended.[136] As the SEC chair would testify before Congress, somewhat charitably,

> [The supervisory] program was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate of the CSE program, and weakened its effectiveness.[137]

b. The Nationalization of AIG

As Lehman died and Merrill disappeared, another famous financial name also teetered on the edge of insolvency. American International Group (AIG), a global financial conglomerate with the largest insurance business in the United States, had suffered approximately $21.7 billion in losses out of its London subsidiary, which had been writing insurance and credit default swaps on mortgage-related assets.[138] AIG looked more stable than the investment banks.[139] AIG was principally an insurance company—the

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135. *See* Posting of Michael J. de la Merced et al. to N.Y. Times DealBook, http://dealbook.blogs.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies/ (Sept. 21, 2008, 21:35 EST).

136. Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), http://www.sec.gov/news/press/2008/2008-230.htm.

137. *Id.*

138. As of September 30, 2008, the net unrealized market valuation loss of AIG's London Subsidiary, AIG Financial Products Corp., from super senior credit default swap portfolio amounted to $21.726 billion. Am. Int'l Group, Inc., Quarterly Report (Form 10-Q), at 65 (Nov. 10, 2008) [hereinafter AIG Third Quarter Form 10-Q], http://www.sec.gov/Archives/edgar/data/5272/000095012308014821/y72212e10vq.htm.

139. *See* Monica Langley et al., *Bad Bets and Cash Crunch Pushed Ailing AIG to Brink*,

conventional wisdom was that any loss of confidence would only affect it slowly rather than in the overnight manner Bear and Lehman were struck. Nonetheless, AIG became caught in a different species of feedback loop, one driven by ratings cuts and mark-to-market accounting rules.

The decline in AIG stock, due to its losses and its inability to effectively raise capital due to these stock declines, had led the rating agencies to cut AIG from its AAA rating to A minus.[140] Under the $441 billion in derivative contracts AIG was a party to, it was consequently required to put up $14.5 billion in collateral.[141] AIG had never anticipated that it would be downgraded, but the collateral requirement in the midst of a credit crisis rendered the company technically insolvent and showed the fallacy of AIG's assumption. Moreover, in connection with this collateral requirement, AIG's accountants reviewed its asset values and AIG was forced to record mark-to-market losses of approximately $60 billion.[142] On Monday, September 15, 2008, it was technically insolvent when the New York State Insurance Commissioner permitted AIG to borrow $20 billion from AIG's own regulated insurance reserve funds.[143]

The federal government initially refused to provide financial assistance to AIG. But the Lehman treatment was short-lived. AIG held over one trillion dollars in assets and had 971 billion dollars in liabilities,[144] and if it defaulted on its obligations, there was every prospect of a sequence of many cross-defaults, which in turn would have forced not just losses but a significant number of corporations to refinance their debt in a credit market that was incapable of doing so. The Federal Reserve thus decided on September 16 to provide financial assistance to AIG.

Once again, though, the government would be constricted by the limits of the law in structuring its rescue. And once again, the government stuck to its developing game plan for dealmaking, driving a hard bargain in reliance on previous precedent and relying on § 13 of the Federal Reserve Act for authority. On September 16, AIG disclosed that

> [i]n connection with the revolving credit facility, AIG issued a warrant to the Board of Governors of the Federal Reserve . . . that permits the Federal

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WALL ST. J., Sept. 18, 2008, at A1.

140. Hugh Son, *AIG Rating Cuts Threaten Funding Quest, Shares Plunge*, BLOOMBERG.COM, Sept. 16, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=amuMN6feT0kE&refer=home.

141. Matthew Karnitschnig et al., *AIG Faces Cash Crisis as Stock Dives 61%*, WALL ST. J., Sept. 16, 2008, at A1; Mark Pittman, *Goldman, Merrill Collect Billions After Fed's AIG Bailout Loans*, BLOOMBERG.COM, Sept. 29, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTzTYtlNHSG8;.

142. *See* AIG Third Quarter Form 10-Q, *supra* note 138, at 114.

143. *See* Karnitschnig et al., *supra* note 141.

144. Am. Int'l Group, Inc., Quarterly Report (Form 10-Q), at 1–2 (Aug. 6, 2008), http://sec.gov/Archives/edgar/data/5272/000095012308008949/y59464e10vq.htm.

> Reserve, subject to shareholder approval, to obtain up to 79.9% of the outstanding common stock of AIG (after taking into account the exercise of the warrant).[145]

On September 26, AIG announced that it had entered into definitive agreements with regard to its government assistance.[146] The Federal Reserve extended an $85 billion loan on hard terms. The interest rate was 8.5% over LIBOR on funds drawn and 8.5% on undrawn funds plus a $1.7 billion commitment fee paid to the Federal Reserve. Moreover, the credit agreement with the Federal Reserve required that AIG's free cash flow be paid over to service the Federal Reserve loan as well as the proceeds of any of AIG's asset disposals or capital raisings.[147] For security the Federal Reserve received a first priority lien on all of the unregulated assets of AIG.[148] Due to insurance and other state and federal regulation, this was the limit that the government could receive under current law. The loan terms were better than AIG could have received in the market, but were still clearly designed to force AIG to downsize or perhaps disappear in order to service the debt.

In exchange for providing this loan, the government received AIG preferred shares equivalent to a 79.9% voting and dividend interest in AIG—the GSE precedent in deals was rapidly becoming the norm.[149] Though the loan was issued by the Federal Reserve, again pursuant to its authority under § 13, the preferred shares were actually issued to a trust for the benefit of the Treasury Department.[150] It is unclear why the interest was for the benefit of Treasury and not the Federal Reserve; presumably, this was a matter of control and who would realize the profits. In addition, the government has yet to fully explain why the interest was placed into trust rather than issued directly to the government. The presumption, however, is that the government did this in order to keep a distance between the government and AIG, and provide some colorable pretext to prevent political meddling in the workings of the company. There was also

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145. Am. Int'l Group, Inc., Current Report (Form 8-K) (Sept. 18, 2008), http://www.sec.gov/Archives/edgar/data/5272/000095012308011147/y71385e8vk.htm.

Initially, AIG stated that the government would only take up to a 79.9% interest. This led to speculation that a market loan could be arranged. Rumors were that former AIG CEO Hank Greenberg would arrange an alternative that would prevent shareholders from being wiped out. *See* Joanna Chung, *Former AIG Chief to Outline Alternate Rescue Plan*, FIN. TIMES, Oct. 14, 2008, at 30.

146. Am. Int'l Group, Inc., Current Report (Form 8-K) (Sept. 26, 2008), http://sec.gov/Archives/edgar/data/5272/000095012308011496/y71452e8vk.htm.

147. *Id.* exhibit 99.1 (Credit Agreement by and between American International Group, Inc. and Federal Reserve Bank of New York), at 24.

148. *Id.* exhibit 99.1, at 42.

149. *Id.* exhibit 99.1, at exhibit D.

150. *Id.*

the question of whether the Government Corporation Control Act of 1945,[151] which requires congressional authorization in certain circumstances for the government to own private companies, would be violated if the government took full control. When the trust instrument was released three months later, it provided the trustees almost complete control of AIG, an extraordinary delegation of the government's power.[152] Clearly, matters of open government and the ordinary controls an investor would desire were not the government's goals or perhaps within their grasp given the legal limitations. Again, though, the government had acted to significantly dilute current common stockholders of AIG in a manner comporting with and limited by political and legal realities. Once again, the statutory lever for action was § 13 of the Federal Reserve Act, and, once again, that source of authority explains why it was the Federal Reserve that took action to seize AIG rather than another government institution such as the Treasury Department. The idea was that under the plain language of the statute, interpreted imaginatively, the Federal Reserve could extend credit, upon the right showing, to any company or individual. The Federal Reserve assumed the power to do so and, in effect, included a power to insist on conditions on the loan, like the severe conditions imposed on AIG.

The ordinary details of corporate law were not the sort of hurdles that the government found very worrying. AIG did not have sufficient authorized common stock in its certificate of incorporation to issue warrants to the government, but it did have a "blank check" preferred provision in its certificate.[153] This type of provision permits a corporation to issue preferred shares on such terms and with such rights as the board deems appropriate. This permitted AIG to issue out 100,000 shares of convertible participating serial preferred stock with rights to 79.9% of the votes and dividends paid on AIG common and preferred stock.[154] Once again, the lawyers had innovated to bring about a novel solution to meet the government's dealmaking needs.

New York Stock Exchange (NYSE) Listed Company Manual § 312.03 requires a company to obtain a shareholder vote prior to the issuance of an amount equal to 20% or greater of its common stock or preferred shares

151. 31 U.S.C. § 9102 (2006).

152. See Am. Int'l Group, Inc., Current Report (Form 8-K), exhibit 10.1 (AIG Credit Facility Trust Agreement), at 3–10 (Jan. 23, 2009), http://www.sec.gov/Archives/edgar/data/5272/000095012309001128/y74153exv10w1.htm.

153. AIG had 5,000,000,000 common shares authorized and 2,948,038,001 common shares outstanding as of September 30, 2008. AIG Third Quarter Form 10-Q, *supra* note 138, at 2.

154. *See* Am. Int'l Group, Inc., Current Report (Form 8-K), exhibit D (Sept. 26, 2008), http://sec.gov/Archives/edgar/data/5272/000095012308011496/y71452e8vk.htm.

convertible into common stock.[155] This would normally have required AIG to obtain shareholder approval for this issuance. However, there is an exception under NYSE Listed Company Manual § 312.05 if the delay in vote would "seriously jeopardize the financial viability" of a company and "reliance by the company on this exception is expressly approved by the Audit Committee of the Board."[156] AIG, a NYSE-listed company, relied upon the exemption to avoid a shareholder vote on the preferred share issuance.[157] The NYSE had permitted reliance upon this exemption before in the Bear Stearns transaction, and it did so here as well.[158] It appears that this rule was simply ignored in the case of Fannie and Freddie with the NYSE taking no action. Nonetheless, AIG still was required under Delaware law to hold a shareholder vote to amend its certificate of incorporation to authorize the issuance of the common stock the preferred is convertible into. AIG initially appeared to take the position that the government's preferred shares would be able to vote on the transaction, making approval a foregone conclusion.[159] However, when a shareholder suit was brought challenging this practice as violating Delaware law, which allowed for a separate class vote of the common shareholders, AIG backtracked and asserted that the common stockholders would separately vote to approve this conversion.

In the months following, the AIG rescue would take up more government resources, showing the perils of ad hoc bailout as the problems with AIG turned out to be more than just short-term liquidity. On October 8, the New York Federal Reserve agreed to accept up to $37.8 billion in investment-grade fixed-income securities from AIG in exchange for cash collateral. The exchange was meant to provide additional liquidity to AIG and allow AIG to exchange that cash for the securities it had lent to third parties. Then on October 27, 2008, the New York Federal Reserve allowed four of AIG's subsidiaries to participate in the Federal Reserve's commercial paper program up to an amount of $20.9 billion and to use the proceeds of the loans to prepay moneys borrowed by AIG under AIG's $85

155. NYSE LISTED COMPANY MANUAL § 312.03 (2009), *available at* http://nysemanual.nyse.com/lcm/ (follow "Section 3" hyperlink; then follow "312.00 Shareholder Approval Policy" hyperlink).

156. *Id.* § 312.05.

157. *See* Press Release, Am. Int'l Group, Inc., AIG Notice (Sept. 26, 2008), http://media.corporate-ir.net/media_files/irol/76/76115/releases/092608a.pdf.

158. *See* JPMorgan Chase & Co., Current Report (Form 8-K) (Mar. 24, 2008), http://sec.gov/Archives/edgar/data/19617/000089882208000319/jpm8k.htm.

159. *See* Posting of Steven M. Davidoff to N.Y. Times DealBook, http://dealbook.blogs.nytimes.com/2008/09/26/notes-from-the-maelstrom/ (Sept. 26, 2008, 12:04 EST). AIG would later back away from this position on the eve of the restructuring of its transaction. *See* Transcript of Teleconference, Walker v. Am. Int'l Gorup [sic], Inc., No. 4142-CC (Del. Ch. Nov. 7, 2008).

billion credit facility with the New York Federal Reserve.[160]

On November 10, the government announced another restructuring of its financial support to AIG and the New York Federal Reserve announced two new lending facilities for AIG, again invoking § 13 of the Federal Reserve Act.[161] This brought the government's potential support for AIG up to $173.1 billion. The government's initial thought that the bailout of AIG would cost a mere $20 billion was mistaken. But the new rejiggered bailout was a dose of reality—the government had initially failed to comprehensively deal with the AIG situation and the ability of counterparties to demand cash collateral. Instead, the government's punitive actions in the ostensible name of moral hazard had harmed AIG and only hastened this process. The government's new approach was now designed to stabilize AIG rather than dismember it.

But AIG would return to the well for a third time on March 1, 2009, for another $30 billion in loan commitments. The government again reworked the terms of its bailout, and the government's aggregate commitments to AIG, excluding the commercial paper program, rose to $182.5 billion.[162]

This would explode in public fury the week of March 17, 2009, over the payment of approximately $165 million in bonuses to executives at AIG's financial products business.[163] This was the selfsame business that had entered into the now-infamous credit default swaps (CDSs) contracts that

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160. Am. Int'l Group, Inc., Current Report (Form 8-K) (Oct. 30, 2008), http://www.sec.gov/Archives/edgar/data/5272/000095012308013926/y72249e8vk.htm; Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout: Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, at A1. For a more in-depth analysis of the AIG bailouts, see William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346552.

161. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Nov. 10, 2008), http://www.federalreserve.gov/newsevents/press/other/20081110a.htm. The government rearranged its 79.9% ownership interest in AIG in connection with this new deal. Under the EESA, Treasury was required to take an equity interest in connection with any security purchase. However, the amount under the EESA was in the "reasonable" discretion of the Secretary of the Treasury. In the case of AIG the government only received warrants to purchase shares equivalent to 2% of AIG's issued and outstanding shares. This was less than the 15% value of the total injection Treasury took in other injections. The reason is that if Treasury had taken a warrant amount similar to the other deals, it would have wiped out all of AIG's equity. Nonetheless, the government still negotiated to receive an additional 77.9% "equity" interest in AIG in connection with the making of the Federal Reserve loan—the same preferred shares previously issued only in a reduced amount—bringing its total interest in AIG up to 79.9% as it was in the initial bailout.

162. *Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of Orice M. Williams, Director, Financial Markets and Community Investment, Government Accountability Office).

163. *See* Edmund L. Andrews & Peter Baker, *At AIG, Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 15, 2009, at A1.

had destroyed AIG. The outrage over these inappropriately structured retention payments—they were paid regardless of performance—was justified. But the outrage was more—it reflected public anger at repeated, unexplained government action that appeared to benefit corporate executives at the expense of the wider public. In the wake of the extreme display of public discontent, President Barack Obama ordered that the government attempt to obtain repayment of the bonuses.[164]

The outcry missed the real issue with AIG, though. In the wake of the public scrutiny, AIG also disclosed that almost $60 billion in the government's bailout funds had gone to European banks to satisfy collateral calls.[165] The $165 million was meaningless compared with this $60 billion payment.

The government had also allowed these European and American banks to be made whole at 100 cents on the dollar without value to the American taxpayer except for the decaying AIG businesses. In addition, it was also disclosed that the government had repurchased at notional value $62 billion worth of securities to unwind AIG's book of CDSs. This payment was made in connection with the November lending facilities and was made despite the fact that these were collateralized at about 57% of that value.[166]

The payments may have been justified in order to ensure market confidence in AIG and the full repayment of the government funds. In other words, the government now needed to act to ensure that AIG stayed in a suitable operating condition in order to ensure that AIG repaid the tens of billions it still owed to the government. Nonetheless, the failure of the government to adequately justify these payments was yet another source of public discontent.

c. The SEC Takes Action

One could be excused for wondering where the SEC was during the week that Lehman went bankrupt and AIG almost collapsed. In fact, however, the SEC rarely played an important role at any stage of the crisis. The SEC, after all, was in no position to bail out or backstop the investment banks under its aegis—and, indeed, was forced to eliminate its program

164. *See* Posting to New York Times DealBook, http://dealbook.blogs.nytimes.com/2009/03/17/obama-in-effort-to-undo-bonuses-at-aig/?scp=2&sq=Obama%20order%20bonuses&st=cse (Mar. 17, 2009, 7:42 EST).

165. Press Release, Am. Int'l Group, Inc., AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions (Mar. 15, 2009), http://www.aig.com/aigweb/internet/en/files/Counterparties150309RELonly_tcm385-155648.pdf.

166. *See* Posting of Steven M. Davidoff to New York Times DealBook, http://dealbook.blogs.nytimes.com/2009/03/17/seven-sad-truths-about-aig/ (Mar. 17, 2009, 12:42 EST).

overseeing those banks. During the week that changed everything, the SEC did act, however; it intervened in the market place itself, initiating a much-criticized ban against short sellers. It followed that ban up with an accounting clarification that also proved to be somewhat controversial. And its remaining activities tended toward longer term investigations rather than immediate action. Nonetheless, these actions were symbolic more than substantive. When looking back at the SEC's actions, it appears that the SEC, lacking regulatory power and sidelined by the Federal Reserve and Treasury, was acting more to show that it was indeed acting and providing value, however questionable, than for any holistic or integrity-driven regulatory purpose.

Short selling, where the seller borrows a share, sells it immediately, and repays the original seller later (after, the seller hopes, the price of the share has declined), is a well-worn feature of securities markets—as is the criticism of the practice by the CEOs of the companies that are shorted and a minority of academic economists.[167] In the post-Bear Stearns stage of the crisis, the SEC announced investigations into market manipulation—widely perceived to be a warning that it would investigate short sellers who spread false rumors about companies.[168] When those investigations did not reduce the quantity of shorting, it banned the practice, albeit temporarily. The SEC's bans on shorting, passed as emergency rules in the wake of the post-Lehman and AIG collapses and then partly extended through some awkward interim temporary final rules for the better part of a year, occasioned criticism from many market participants and economists.[169]

The criticism turned, in part, on the overinclusiveness of the ban, which the SEC announced as a mechanism to protect financial stocks but which turned into something more. The exchanges that administered the rules quickly let seemingly anyone take advantage of the ban, listing companies such as GE, IBM, and auto manufacturers among those who volunteered to be covered by the ban.[170] After its temporary ban on naked shorting and any short selling of financial and other stocks expired, the SEC adopted "interim temporary final rules" that extended the naked shorting ban and forced some hedge funds to report their shorts on a weekly basis—a

167. *See* Itay Goldstein & Alexander Guembel, *Manipulation and the Allocational Role of Prices*, 75 REV. ECON. STUD. 133, 133–35 (2008) (arguing that short selling manipulates price information, distorting resource allocation and reducing economic efficiency).

168. For background, see Press Release, SEC, SEC Expands Sweeping Investigation of Market Manipulation (Sept. 19. 2008), http://sec.gov/news/press/2008/2008-214.htm.

169. *See* Tom Lauricella et al., *SEC Extends 'Short' Ban as Bailout Advances*, WALL ST. J., Oct. 2, 2008, at C1.

170. *See SEC Short Ban List Now Covers More than 900 Firms*, REUTERS, Sept. 22, 2008, http://www.forbes.com/reuters/feeds/reuters/2008/09/22/2008-09-22T223757Z_01_N22281931_RTRIDST_0_SHORTSELLING-SEC-UPDATE-3.html.

controversial decision, given that it had the potential to reveal the trading strategies of the funds, which they regard as proprietary. The rules also extended the SEC's ban on naked shorting[171] and required large hedge-fund managers to disclose their shorts, a controversial move given that hedge funds are very secretive about their trading strategies.[172]

As for accounting, shortly after banning shorting, the SEC issued a clarification about "fair value" accounting, an alternative to the mark-to-market accounting which, now that the market was heavily discounting mortgage-related assets, was devastating the balance sheets of publicly traded financial institutions. As the SEC's chief accountant explained, "When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable."[173] Although it is unclear whether this clarification departed materially from already-extant accounting standards, the implication was clear: companies that relied on fair value accounting could presume that they would not be targeted by SEC enforcement. The agency also began a longer term study on mark-to-market accounting.[174]

The short ban was quite controversial, but the SEC's other crisis-related actions were decidedly less so because they did not appear to be particularly meaningful solutions. For example, it was not so controversial to investigate the quality of credit-rating-agency evaluations of the mortgage-backed financial instruments that led to the crisis—but that was just an investigation,[175] and one that drew its criticisms of the work of the financial ratings agencies rather late in the progression of the crisis.[176] Nor was the SEC's ongoing auction-rate-securities investigation particularly

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171. Amendments to Regulation SHO, 73 Fed. Reg. 61,706 (Oct. 17, 2008) (to be codified at 17 C.F.R. pt. 242), *available at* http://www.sec.gov/rules/final/2008/34-58773.pdf. Naked shorting is an often-criticized practice where a stock is shorted without actually borrowing it.

172. Disclosure of Short Sales and Short Positions by Institutional Investment Managers, 73 Fed. Reg. 61,678 (Oct. 17, 2008) (to be codified at 17 C.F.R. pts. 240 & 249), *available at* http://www.sec.gov/rules/final/2008/34-58785.pdf.

173. Press Release, SEC, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008), http://sec.gov/news/press/2008/2008-234.htm.

174. *See* Press Release, SEC, SEC Commences Work on Congressionally Mandated Study on Accounting Standards (Oct. 7, 2008), http://sec.gov/news/press/2008/2008-242.htm.

175. *See* Press Release, SEC, SEC Proposes Comprehensive Reforms to Bring Increased Transparency to Credit Rating Process (June 11, 2008), http://sec.gov/news/press/2008/2008-110.htm.

176. *See* Press Release, SEC, SEC Examinations Find Shortcomings in Credit Rating Agencies' Practices and Disclosure to Investors (July 8, 2008), http://sec.gov/news/press/2008/2008-135.htm.

interesting, though the agency would trumpet the settlements made in the investigation as part of the government's financial crisis response.[177]

Former SEC Chairman Christopher Cox has said that "[n]ever in this agency's history has this fundamental mission been more relevant, and more urgent."[178] But the SEC will probably review its performance during the crisis and wonder about its regulatory relevance, let alone the urgency of its role as a market watchdog. The SEC has played a peripheral role in the government's response to the financial crisis—even though the collapse of two investment banks that it putatively regulated both announced and greatly exacerbated the crisis.

During that response the scope of the SEC's mission has, if anything, declined: the agency has lost its authority to oversee the investment banks after the failures of Bear Stearns and Lehman. It had nothing to say about Merrill Lynch as that investment bank concluded a quick merger with Bank of America in the wake of Lehman's failure. In addition, as the bailout began to take shape, the SEC appeared to play little part in the work of the Federal Reserve and the Treasury Department in devising a government response. While those agencies, for example, were devising the bailout, the SEC reminded investors that broker accounts are insured by the Securities Investor Protection Corporation (SIPC),[179] celebrated the speedy acquisition of Lehman's bankrupt remains by Barclays,[180] and announced that it would be putting possible market manipulators under oath.[181] All of this occurred in the midst of a sense of malaise within the agency. As the *New York Times* reported after the Bear Stearns failure, "Staff lawyers in the S.E.C. enforcement division say high turnover, tight budgets and a new, looser attitude toward corporate wrongdoing are sapping morale. The

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177. *See* Press Release, SEC, Citigroup Agrees in Principle to Auction Rate Securities Settlement (Aug. 7, 2008), http://sec.gov/news/press/2008/2008-168.htm. The premise behind the auction-rate-securities investigations was that these banks had promised investors that they could sell certain long-term securities at weekly auctions, making the securities quite liquid. But when the credit markets began to tighten in early 2008, the auctions failed, and banks refused to purchase the securities in lieu of a buyer. The SEC investigations into auction-rate-securities representations mostly preceded the heart of the financial crisis, but they were not entirely unrelated to the general tightening of credit that began once the housing bubble popped. *See* Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-Rate Securities*, N.Y. TIMES, Feb. 15, 2008, at C6.

178. *See* Christopher Cox, Chairman, SEC, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008), http://sec.gov/news/speech/2008/spch100808cc.htm.

179. *See* Press Release, SEC, Statement of SEC Division of Trading and Markets Regarding the Protection of Customer Assets (Sept. 20, 2008), http://sec.gov/news/press/2008/2008-216.htm.

180. *See* Press Release, SEC, SEC Acts to Support Swift Court Approval of Barclays Acquisition of Lehman Brothers, Inc. (Sept. 20, 2008), http://sec.gov/news/press/2008/2008-215.htm.

181. *See* Press Release, SEC, *supra* note 168.

staffing and budget of the S.E.C. have lagged far behind the explosive growth of the markets the commission must police."[182]

The result of the crisis may be especially unkind to the SEC, which appears likely to become a consumer protection and prosecution shop rather than a tool the government can use to address systemic risk in finance. This latter power now appears much more likely to stay with the Federal Reserve or Treasury Department. In a move consistent with public choice stories about agencies,[183] the SEC has sought new turf to replace its old turf. It has since asked Congress for the authority to regulate credit default swaps—the form of insurance that contributed to AIG's fall. It has also sought congressional legislation for a precise role for SEC supervision of the brokerage arms of the investment banks.[184]

The SEC has played this role before—after the fall of Enron in 2001, it sought more authority to make up for its failure to identify the company's wrongdoings, and received it in Sarbanes–Oxley. But while it may achieve more consumer-like authority over the financial markets, we believe it is likely that the real systemic powers to be granted in the coming regulatory reform will go to the Federal Reserve and Treasury.[185] If this occurs, then in the grand-scale regulatory turf wars, the SEC will be a net loser.

d. The Treasury Guarantees the Money Market System

The bankruptcy of Lehman and the nationalization of AIG had a terrible effect on the financial markets, not least because of all the counterparties wiped out by Lehman's bankruptcy. Panic gripped lenders and the credit markets began to shut down overnight. Market participants acted on fear and information asymmetry—at this point any mortgage-related assets held by financial institutions were poison to be valued as worthless at best—to

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182. Jenny Anderson, *A Fear that the Market's Watchdog Is Losing Its Bite*, N.Y. TIMES, Apr. 8, 2008, at C1.

183. *But see* Daryl J. Levinson, *Empire-Building Government in Constitutional Law*, 118 HARV. L. REV. 915, 921–22 (2005) (arguing that the evidence of unfettered turf accumulation is mixed at best).

184. *Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. 6 (2008) (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c17161d3-a5f7-4544-9ade-7dc2197ddce0 ("With each of the remaining major investment banks now constituted within a bank holding company, it remains for the Congress to codify or amend as you see fit the Memorandum of Understanding between the SEC and the Federal Reserve, so that functional regulation can work.").

185. This appears to be the intent of the current regulatory reform proposals put forth by the Obama Administration. *See* U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM (2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

move funds to more secure assets. The dollar LIBOR rate on overnight lending went from 2.15% on September 12 to 6.44% on September 16.[186] Meanwhile, in a sign that the markets were beginning to lose confidence in financial institutions, credit default swaps on Morgan Stanley's and Goldman Sachs's debt rose dramatically.[187] As this panic and follow-on effects from the Lehman bankruptcy and AIG nationalization spread, other, normally staid areas of finance were thrown into turmoil. Perhaps most perilously, money market funds came very close to their own sort of unprecedented collapse. These funds had for decades provided a great deal of unexciting credit to the financial markets, usually by investing in short-term bonds and commercial paper.[188]

The returns on such funds were rarely impressive, but the risks of holding them had always been thought to be minimal. That is, until September 16, when the Reserve Primary Fund declared that it had "br[oken] the buck," meaning that every dollar invested in the fund was, as of the 16th, worth less than a dollar.[189] Reserve Primary broke the dollar floor after writing off $785 million in Lehman Brothers debt.[190] Investors never suspected that they could be susceptible to these kinds of losses; Reserve Primary was a blue-chip fund in a blue-chip industry: at the beginning of September it was worth $64.8 billion, and, in addition to being massive, it was the oldest money market fund in the country.[191]

Money market funds had essentially never lost money (on one other occasion, in 1994, a small fund broke the buck), and the fall set off a wave of shocked withdrawals by investors in the funds.[192] The resulting outflow of money was remarkable, even for an industry that has always offered easy entry and exit; Reserve Primary's assets plunged more than 60% to $23 billion in two days.[193] Other funds admitted that they too had suffered substantial losses from the disappearance of Lehman, which was an enormous producer of the commercial paper that was the bread and butter

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186. BRITISH BANKERS' ASS'N, *supra* note 22.

187. *See DBRS Lowers Outlook on Morgan Stanley, Goldman Ratings*, REUTERS, Sept. 17, 2008, http://www.reuters.com/articlePrint?articleId=USN1751866920080917 ("The cost of protecting Morgan Stanley and Goldman debt with credit default swaps rose on Wednesday, reflecting investor uncertainty about the financial sector. Five-year CDS on Morgan Stanley rose by 40 basis points to 796 basis points.").

188. These funds are required by the SEC to hold debt that matures in ninety days, by weighted average. *See* Christopher Condon, *Reserve Primary Money Fund Falls Below $1 a Share*, BLOOMBERG.COM, Sept. 16, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aAj1pHOSthQA&refer=home.

189. *Id.*

190. *Id.*

191. *Id.*

192. *See* John Waggoner, *Money Market Fund Breaks a Buck*, USA TODAY, Sept. 17, 2008, at 4B.

193. *See* Condon, *supra* note 188.

of the money markets.[194]

The results were close to catastrophic for the industry, as the funds experienced substantial investor flight to treasury bonds and other asset classes. Over that week, $170 billion of investor funds flowed out of the money market institutions.[195] The follow-on effects of this collapse were potentially even more catastrophic—if the money market system collapsed, the principal purchaser of commercial paper would disappear from that market. If that happened, hundreds of U.S. corporations would no longer be able to finance their working capital at a time when credit on that scale was largely unavailable. For perhaps the third time that week, a financial doomsday seemed to loom.

The government once again substantially stretched its regulatory authority to act quickly to preserve the assets of the country's principal purchasers of short-term debt. On September 19, the Treasury Department announced that it would insure the funds up to a ceiling of $50 billion.[196] As the Department explained, its goals were to "provide[] support to investors in funds that participate in the program and [assure that] those funds will not 'break the buck'" and "alleviate investors' concerns about the ability for money market mutual funds to absorb a loss."[197]

The program was created and financed through a novel use of Treasury's supervision of an obscure pile of assets on hand for international currency crises. Treasury based its power to insure the money market on the Gold Reserve Act of 1934.[198] That statute created the Exchange Stabilization Fund (ESF), which permitted the Department to hold gold and various currencies to deal with macro shocks to the economy.[199] As amended in the late 1970s, the Gold Reserve Act, another Depression-era-style broad grant of authority, provided in relevant part that

> [t]he Department of the Treasury has a stabilization fund . . . . Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary . . . , with the approval of the President, may deal in gold, foreign

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194. Evergreen Investments, a money market fund owned by Wachovia, for example, had to be bailed out by its parent to avoid breaking the buck. *See* Daisy Maxey, *Wachovia to Bolster Evergreen Funds, More Support to Come*, DOW JONES NEWSWIRES, Sept. 15, 2008, http:// lloyds.com/CmsPhoenix/DowJonesArticle.aspx?id=404668.

195. *See* Diana B. Henriques, *Treasury to Guarantee Money Market Funds*, N.Y.TIMES.COM, Sept. 20, 2008, http://www.nytimes.com/2008/09/20/business/20moneys.html.

196. Press Release, U.S. Dep't of the Treasury, Treasury Announces Guaranty Program for Money Market Funds (Sept. 19, 2008), http://www.treasury.gov/press/releases/hp1147.htm.

197. *Id.*

198. *Id*.

199. U.S. DEP'T OF THE TREASURY, EXCHANGE STABILIZATION FUND: INTRODUCTION (2007), http://www.treas.gov/offices/international-affairs/esf/.

exchange, *and other instruments of credit and securities*.[200]

Treasury concluded that "other instruments" could be interpreted to permit it to provide guarantees for money market funds, although funds like Reserve Primary dealt largely in dollars, and the Gold Reserve Act was clearly aimed at non-dollar-denominated wealth. Treasury also obtained the President's approval for the interpretation, as the text of the statute required.[201]

Treasury's money market insurance had takers in the two weeks following the announcement, including "some of the nation's largest mutual fund companies," as the *New York Times* reported, but it failed to unfreeze the short-term credit markets.[202] Moreover, its failure mimicked, at least initially, the government's other foray into short-term credit in the aftermath of the fall of Lehman and AIG.[203] The Federal Reserve also enacted an initial money market financing facility on September 18, one day before Treasury announced its money market insurance program.[204] One month later, the Federal Reserve bolstered its own money market relief program by pairing it with a facility that would both finance and purchase the commercial paper and short-term debt that were the stock in trade of money market funds.[205]

The Exchange Stabilization Fund-backed insurance was also a short-lived program. Congress quickly acted to make the ESF program a one-time-only program. The final version of EESA provided that the Secretary was "prohibited from using the Exchange Stabilization Fund for the establishment of any future guaranty programs for the United States money market mutual fund industry,"[206] and the House report accompanying the bill made it very clear that the program was designed to "[p]rotect[] the Exchange Stabilization Fund from incurring any losses due to the temporary money market mutual fund guarantee by requiring the program created in this Act to reimburse the Fund [and p]rohibit[] any future use of the Fund for any guarantee program for the money market mutual fund

200. 31 U.S.C. § 5302(a)(1), (b) (2000) (emphasis added).

201. *Id.* § 5302(b).

202. Diana B. Henriques, *As Cash Leaves Money Funds, Financial Firms Sign Up for U.S. Protection*, N.Y. TIMES, Oct. 2, 2008, at C10.

203. That second foray was the decision by the Federal Reserve to establish its own program to purchase commercial paper (the sort of short-term bonds issued by financial institutions like Lehman and large companies like GE).

204. FED. RESERVE, ASSET BACKED COMMERCIAL PAPER (ABCP) MONEY MARKET MUTUAL FUND (MMMF) LIQUIDITY FACILITY (AMLF OR "THE FACILITY"), http://www.frbdiscountwindow.org/mmmf.cfm?hdrID=14 (last visited June 9, 2009).

205. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Oct. 21, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081021a.htm.

206. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 131, 122 Stat. 3797 (2008) (to be codified at 12 U.S.C. § 52336).

industry."[207]

That statute was passed on October 4, meaning that the effective ongoing life of the money market insurance gambit was roughly a fortnight.[208] It nonetheless exemplified the novel market participation being tried by the government as the crisis worsened and the at least short-term failure of many of those first stretches of regulatory authority to permit participation in new capital markets. Rather than being a central part of the government's response to the crisis, the money market fund insurance policy is interesting more as an example of it. Ad hoc, marked by a rapid response to unprecedented financial market chaos, and authorized by an unconventional interpretation of a Depression-era statute that created a program meant to do something else, Treasury's money market adventure looked quite like the Federal Reserve's own novel forays into support of the financial markets, even if there was little else consistent about what the government was up to.

D. The End of the Beginning: Government as Deal Machine

1. The Bankruptcy of Washington Mutual

The Washington Mutual (WaMu) and Wachovia transactions occurred while the EESA was being debated and eventually passed. Both of these institutions and a number of other large consumer banks were, at the time, suffering from slow-motion bank runs. The government's rescue efforts of WaMu and Wachovia aptly illustrated the government's dealmaking skills.[209] In WaMu's demise, the FDIC was the primary governmental actor. Pursuant to its authorization under the Federal Deposit Insurance Act, on September 25, the FDIC seized the bank depositary assets of WaMu and sold them to JPMorgan for a $1.9 billion cash payment.[210] The FDIC announced this transaction without informing the WaMu management. In fact, the CEO of WaMu was on a plane at the time, unaware that his company's depositary assets had been seized.[211] It was

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207. H. COMM. ON FIN. SERVS., 111TH CONG., SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION (2009), http://www.financialservices.house.gov/essa/final_bill_section-by-section.pdf.

208. Congress did not eliminate the program through the EESA, as some earlier drafts of the bill suggested.

209. National City Corp. would subsequently also be acquired by PNC Financial Services Group, Inc. in a government-supported transaction. *See* Press Release, PNC Financial Services Group, PNC to Acquire National City (Oct. 24, 2008), http://pnc.mediaroom.com/index.php?s=43&item=591.

210. *See* Robin Sidel et al., *WaMu Is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, at A1.

211. *Id.*

subsequently disclosed that the FDIC had decided to engineer this transaction over a week before.[212] The FDIC had prearranged JPMorgan's purchase; JPMorgan had even been able to confidentially undertake a $10 billion capital raising before and in connection with this purchase.[213] The day after the FDIC's seizure and sale, the remaining independent holding company of WaMu filed for bankruptcy.[214] TPG, which had invested $1.35 billion in WaMu in April 2008, lost its entire investment, one of the largest and quickest losses by a private equity firm ever.[215]

2. The Forced Sale of Wachovia

The collapse and workout of Wachovia unfolded in a less orderly manner, again showing the limits of government power. As of the weekend of September 27, Wachovia appeared to be insolvent. The FDIC was again the primary government actor; in a hectic weekend, the FDIC selected Citigroup as the acquirer for Wachovia's depositary assets. In choosing Citigroup, the FDIC was expressing the government preference for orderly as opposed to market solutions. The FDIC refused to support a competing offer by Wells Fargo to acquire the entirety of Wachovia and a proposal by Wachovia itself to maintain it as a stand-alone entity. On Monday, September 29, Citigroup and Wachovia executed an exclusivity agreement, pursuant to which the parties agreed to negotiate definitive documentation for Citigroup to purchase the depositary assets of Wachovia for $2.1 billion.[216] Wachovia would remain a functioning company operating a rump business consisting of "Wachovia Securities, which combined with A.G. Edwards is the nation's third largest brokerage firm . . . and Evergreen Investments, which is Wachovia's asset management business, as well as Wachovia retirement services and Wachovia's insurance brokerage businesses."[217]

Citigroup's plans were disrupted, however, when Wells Fargo decided to again bid for Wachovia on that Thursday. Wells Fargo likely did so because of the imminent passage of the EESA, which would permit Wells Fargo to utilize $74 billion in Wachovia's carryforward losses, a tax

212. *Id.*
213. *See* Posting of Heidi N. Moore to Deal Journal, http://blogs.wsj.com/deals/2008/09/29/how-jp-morgan-raised-115-billion-in-24-hours/ (Sept. 29, 2008, 9:03 EST).
214. Peg Brickley, *Washington Mutual Files for Chapter 11 Bankruptcy*, DOW JONES NEWSWIRES, Sept. 29, 2008, http://English.capital.gr/NewsPrint.asp?id=585174.
215. *See* Peter Lattman, *WaMu Fall Crushes TPG*, WALL ST. J., Sept. 27–28, 2008, at B1.
216. Wachovia Corp., Current Report (Form 8-K), at 2 (Sept. 29. 2008), http://sec.gov/Archives/edgar/data/36995/000119312508203284/d8k.htm.
217. *Id.*

advantage that now made this acquisition quite financially attractive.[218] This time the FDIC provided its approval to this transaction and, in fact, informed Wells Fargo that if a merger proposal was not signed by October 3, Wachovia's banking subsidiaries would be put into receivership. That Thursday night, October 2, Wells Fargo and Wachovia agreed to a merger agreement for Wells Fargo to acquire the entirety of Wachovia for approximately $15.1 billion.[219] Here, we see the FDIC's actions as acknowledging the legal realities that under the agreements Citigroup and Wachovia had signed, Wells Fargo could still make a competing bid.

Wells Fargo's lawyers were from Wachtell, Lipton, Rosen & Katz, the same law firm who represented JPMorgan in the Bear Stearns acquisition, and they negotiated an agreement with similar features as the one in Bear Stearns. Wachovia agreed to a force-the-vote provision modeled on the one in the Bear agreement that required the company to rehold its shareholder meeting to approve the merger repeatedly during a six-month period after a first "no" vote on the transaction.[220] Wachovia also issued ten shares of preferred stock to Wells Fargo in exchange for one thousand shares of Wells Fargo, equivalent to a 39.9% preferred share interest in Wachovia.[221] Wells Fargo could use these shares to approve the transaction. As Bear and AIG did, Wachovia sidestepped the NYSE Rules on a shareholder vote for this issuance by invoking the "insolvency" exception, asserting that Wachovia would have had to file bankruptcy without this transaction.[222]

Citigroup sued Wells Fargo and Wachovia in New York state court that Saturday and the parties litigated in state and federal court over the weekend as Citigroup attempted to salvage its deal in the courts.[223] However, on Tuesday the FDIC privately intervened and forced the parties to halt their litigation and sign a tolling agreement in order to negotiate a resolution. The FDIC then attempted to mediate a deal, but when Citigroup and Wells Fargo could not agree on a resolution, Citigroup dropped its bid for these assets and Wells Fargo proceeded to acquire Wachovia.[224] The government's preference in these matters for an ordered solution to a

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218. Eric Dash & Ben White, *Wells Fargo Swoops In*, N.Y. TIMES, Oct. 4, 2008, at C1.

219. *See* Wachovia Corp., Current Report (Form 8-K), exhibit 99(a) (Merger News Release) (Sept. 29, 2008) [hereinafter Wachovia Form 8-K], http://sec.gov/Archives/edgar/data/36995/000119312508205973/dex99a.htm.

220. *Id.* exhibit 2.1 (Merger Agreement), at 29, 32.

221. *Id.* exhibit 2.2 (Share Exchange Agreement).

222. *Id.*

223. *See* Posting of Steven M. Davidoff to N.Y. Times DealBook, http://dealbook.blogs.nytimes.com/2008/10/05/the-mad-dash-to-a-legal-victory/ (Oct. 5, 2008, 22:49 EST) (detailing the litigation between the parties during that weekend).

224. Francesco Guerrera & James Politi, *Wells Set to Acquire Wachovia in $11.7bn Deal After Citi Pulls Out*, FIN. TIMES, Oct. 10, 2008, at A17.

designated bidder had once again been in evidence. Citigroup had, in hindsight, made a mistake in failing to lock up Wachovia, and Wells Fargo had forced the government to allow a market solution. Wells Fargo, given a measure of government endorsement due to its superior legal position, had once again showed that acquirers in such circumstances were not afraid to push the envelope on the law. Here, Wells Fargo and its lawyers followed the path first tread by JPMorgan in its Bear acquisition. Again, a government-backed acquisition had substantially stretched but not broken the laws for the structuring of an acquisition, safe in the assumption that the courts would not want to intervene.

3. The Saving of Morgan Stanley

The last pre-EESA episode of government as dealmaker occurred over the weekend of October 11. On Friday, October 10, 2008, it did not appear that Morgan Stanley would survive the weekend. The S&P 500 Index had declined 18% that past week, mirroring a decline with the rest of the general stock market.[225] Morgan Stanley closed at the end of Friday at $9.68 a share, down 57% in the space of a week.[226] The next Tuesday, October 14, Morgan Stanley was scheduled to close its $9 billion investment from Mitsubishi Bank for 21% of Morgan at a price of at least $25.25 per share.[227] However, the stock price of Morgan reflected a heightened publicly perceived risk that this injection would not occur. Morgan Stanley was now trading with a market capitalization less than Mitsubishi's entire investment.[228] Mitsubishi had signed a definitive purchase agreement for this transaction, but over that weekend invoked the material adverse change clause in the agreement.[229]

The government responded in this case to assure a deal. Reportedly over that weekend the Treasury Department had privately assured Morgan that it

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225. *See* Google Finance, S&P 500 Index Historical Prices, http://www.google.com/finance/historical?cid=626307&startdate=Oct+6%2C+2008&enddate=Oct+10%2C+2008 (last visited July 30, 2009).

226. Google Finance, Historical Prices for Morgan Stanley, http://finance.google.com/finance/historical?q=NYSE:MS&start=125&num=25 (last visited Apr. 8, 2009).

227. Press Release, Morgan Stanley, Mitsubishi UFJ Financial Group to Invest $9 Billion in Morgan Stanley (Sept. 29, 2008), http://www.morganstanley.com/about/press/articles/6962.html; *see also* Morgan Stanley, Inc., Current Report (Form 8-K), exhibit 10.1 (Securities Purchase Agreement) (Oct. 3, 2008), http://www.sec.gov/Archives/edgar/data/895421/000089882208000945/body8k.htm.

228. *See* Posting to N.Y. Times DealBook, http://dealbook.blogs.nytimes.com/2008/10/10/morgans-market-value-falls-below-mitsubishi-deal-price/ (Oct. 10, 2008, 13:04 EST).

229. *See* Andrew Ross Sorkin, *Morgan Is Backed: Fed Offers Assurances for Japanese Bank's Investment*, N.Y. TIMES, Oct. 13, 2008, at A1.

would support the investment bank if the Mitsubishi investment failed. The government also provided assurances to Mitsubishi that if the government was subsequently forced to provide capital to Morgan it would not significantly dilute Mitsubishi's investment.[230] The government's prior requirement that shareholders be significantly harmed in any bailout was beginning to inhibit private solutions as parties refused to invest, fearful of later government action. It was at this point that the government abandoned this position for future transactions. With these government assurances, Morgan Stanley and Mitsubishi agreed to a minor reworking of their transaction; on Monday the investment completed and Mitsubishi invested the full $9 billion in Morgan.[231]

After the Morgan transaction, the government would have one more surprise deal left, its biggest of all, the $125 billion investment forced upon the nine largest U.S. financial institutions. This would mark a change in the government's approach as it turned from dealmaker to administrator of the Troubled Asset Relief Program (TARP). In order to understand the government's final spate of dealmaking in this period, it is first necessary to turn to the EESA and its negotiation and underpinnings.

II. THE GOVERNMENT TAKES COMPREHENSIVE ACTION

After the government decided to act comprehensively, the result was a departure from ad hoc deals but not—at least not entirely—from ad hoc dealmaking. In this Part, we analyze the legislative process that went into the bailout and the terms of the bailout itself. As we have already suggested, although the financial crisis was rooted in the decline of the property market, the variety of short-term shocks and intermediate emergencies that characterized its day-to-day and week-to-week evolution shaped the way the government responded to it. After the failure of Lehman and near failure of the other investment banks contributed to the quick decline in the availability of short-term credit, unprecedented problems in the money market sector of the financial industry, and a knock-on effect on a number of other banks, the Treasury and Federal Reserve changed course in that week that changed the world. The two agencies announced that a comprehensive solution to the financial crisis would now be required, one that would necessitate the imprimatur of Congress.

Clearly, the government's ad hoc strategy was failing and a greater response was needed. But the Federal Reserve had, up to that point, spent

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230. *Id.*

231. *See* Press Release, Morgan Stanley, Mitsubishi UFJ Financial Group Closes $9 Billion Equity Investment in Morgan Stanley as Part of Global Strategic Alliance (Oct. 13, 2008), http://www.morganstanley.com/about/press/articles/7025.html.

many of its own billions in bailing out the investment banks and injecting liquidity into the capital markets. In addition, the government was using Fannie and Freddie to purchase up to $40 billion in underperforming mortgage-backed securities per month.[232] The government, no doubt, could have continued to provide liquidity and even conducted the mortgage-related asset purchases it would propose to Congress with its current authority. So, Why did it now turn to Congress?

We believe that that the government's turn to Congress was for three reasons. First, a significant government action was likely necessary to restore confidence in the market and allow for investors to return to the marketplace. Second, foreign regulators were beginning to act in a more holistic manner, raising the possibility of capital flight abroad to more-stable government-backed financial institutions. Finally, although the Federal Reserve had a substantial amount of funds at its disposal, the Treasury Department did not, and neither of these institutions had very clearly delineated authority to intervene flexibly and comprehensively in the financial markets. Going to Congress for additional authority allowed for a more comprehensive and regulatory-defined response. The government may have wanted to get some legislative assent to its ever more unprecedented interventions in the economy.[233] Moreover, it is also possible that the Treasury Secretary grew tired of relying on the independent and difficult to oversee Federal Reserve to implement its preferred rescue approaches.[234] The result was a turn away from the deal-to-deal approach and toward Congress. But in turning toward Congress, the government was also allowing for more political future dealmaking by recentering legal authority for the bailout away from the Federal Reserve and to the Treasury Department.

A. The Paulson Proposal and the Congressional Reaction

The text of the first draft of the bailout bill submitted to Congress came from the Treasury Department on September 20, with all the hallmarks of emergency; there has never been a shorter draft statute that would have committed such a large amount of money. Treasury sought at least $700

232. Dawn Kopecki, *Fannie, Freddie to Buy $40 Billion a Month of Troubled Assets*, BLOOMBERG.COM, Oct. 11, 2008, http://www.bloomberg.com/apps/news?pid=20601103&sid=aDjJYMSphyM0&refer=news.

233. Many of the commentators on the bailout will no doubt, for reasons along these lines, analogize the bailout to the use of force authorization that preceded the 2003 invasion of Iraq. For a libertarian version of such fears, see Ron Paul, *Commentary: Bailouts Will Lead to Rough Economic Ride*, CNNPOLITICS.COM, Sept. 23, 2008, http://www.cnn.com/2008/POLITICS/09/23/paul.bailout/.

234. *See* Hilsenrath et al., *supra* note 7 (chronicling the debate between the Federal Reserve and Treasury regarding the government's response to the financial crisis).

billion taxpayer dollars to purchase the troubled, difficult-to-value, and impossible-to-sell mortgage-related assets of financial institutions. This so-called Paulson proposal was three pages long and consisted of 849 words.[235]

Under the Paulson proposal, Treasury would be empowered to "purchase, and to make and fund commitments to purchase, on such terms and conditions as determined by the Secretary, mortgage-related assets from any financial institution having its headquarters in the United States."[236] To do this, Treasury was to be allowed to sell "securities" to raise the $700 billion necessary, and could have no more than "$700,000,000,000 outstanding at any one time," a requirement that would have permitted the Secretary to loan out more than that amount in total, as long as he was able to sell off previously acquired assets.[237] Moreover, the bill authorized Treasury to implement the bailout via wide-ranging powers, including the right to appoint personnel and manage these assets.[238]

The limitations on Treasury's power were threefold. First, the draft contained a two-year sunset clause, a characteristic congressional imposition for controversial modern legislation.[239] Second, the draft required the Treasury secretary to report to Congress on the process of

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235. *See* Posting to N.Y. Times DealBook, Sept., 20 2008, http://dealbook.blogs.nytimes.com/2008/09/20/the-bush-administrations-700-billion-rescue-plan/ (Sept. 20, 2008, 11:29 EST). The word count was obtained through Microsoft Word's word-count function.

236. *See* 110TH CONG., LEGISLATIVE PROPOSAL FOR TREASURY AUTHORITY TO PURCHASE MORTGAGE-RELATED ASSETS (2008) http://www.moore.house.gov/Resources/documents/TreasuryBailoutDraftBill.doc [hereinafter Treasury Draft Bill].

237. *Id.* § 6. Though this would help if the crisis was larger than the initial number proposed—at the time there was speculation that it might be over a $1.5 trillion crisis. *See* Joe Nocera, *A Hail Mary Pass, Hoping to Find a Receiver in the End Zone*, N.Y. TIMES, Sept. 20, 2008, at C1.

238. Specifically, the proposed statute provided the following:

> The Secretary is authorized to take such actions as the Secretary deems necessary to carry out the authorities in this Act, including, without limitation:
>
> (1) appointing such employees as may be required to carry out the authorities in this Act and defining their duties;
>
> (2) entering into contracts, including contracts for services authorized by section 3109 of title 5, United States Code, without regard to any other provision of law regarding public contracts;
>
> (3) designating financial institutions as financial agents of the Government, and they shall perform all such reasonable duties related to this Act as financial agents of the Government as may be required of them;
>
> (4) establishing vehicles that are authorized, subject to supervision by the Secretary, to purchase mortgage-related assets and issue obligations; and
>
> (5) issuing such regulations and other guidance as may be necessary or appropriate to define terms or carry out the authorities of this Act.

Treasury Draft Bill, *supra* note 236.

239. *Id.* § 5.

using the $700 billion.[240] Third, in enacting these provisions, the Secretary's draft directed his attention to two particular goals: the interests of "providing stability or preventing disruption to the financial markets or banking system; and . . . protecting the taxpayer."[241]

Most controversially, Paulson's proposal did not provide for judicial review of anything his Department did; instead "[d]ecisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency."[242] By providing no review of Treasury's decisions, either by a court or any other part of the Executive Branch, it was not clear what sort of limits the suggested considerations for the Secretary's purchasing decisions would impose.

Generally, when Congress legislates in the economy, it can do as it wishes—even when that action would involve massive government expenditures with few procedural strings attached. Congress bailed out savings and loans before,[243] and survived constitutional challenge then.[244] The constraints on the sort of legislation represented by the Paulson bill only come from the Constitution, and, when legislation does not impinge on particular rights guaranteed by the Bill of Rights, the constitutional pitfalls are threefold, implicating the Due Process Clause, the nondelegation doctrine, and the Commerce Clause. Because these constitutional concerns arose in every version of the bailout bill, including the one eventually passed by Congress, we sketch the way that they apply to legislation here; our principal insight, however, is that when Congress acts, the nature of the authority game changes—the constraints on economic legislation are few, and lie mostly in disfavored provisions of constitutional law.

The Due Process Clause forbids deprivations of life, liberty, or property without "due process of law."[245] That famously undefined term has required centuries of judicial unpacking but, as currently interpreted, did not look like a serious restriction on the Paulson draft (or, indeed, any other variant of the bailout legislation). To be sure, the purchase of troubled assets threatened to deprive the asset holders of their property; the bailout, given Treasury's past practices, would be accompanied by a *sub silentio* threat that the government might pay pennies on the dollar for the troubled

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240. *Id.* § 6.

241. *Id.* § 4.

242. *Id.* § 8.

243. *See, e.g.*, Federal Deposit Insurance Corporation, The S&L Crisis: A Chrono-Bibliography, http://www.fdic.gov/bank/historical/s&l/ (last visited Apr. 9, 2009).

244. *See* Donald F. Kettl, *The Savings-and-Loan Bailout: The Mismatch Between the Headlines and the Issues*, 24 POL. SCI. & POL. 441 (1991).

245. U.S. CONST. amend. V.

assets. But courts have never been willing to make constitutional cases out of the type of arms-length transactions contemplated by Paulson's asset purchase proposal, even in situations where the sellers to the government have little other option.[246] Volunteers, in short, generally forfeit the limited rights that due process exercises over their sales to the government.[247]

Usually when Congress acts in the economy, it alludes to the Commerce Clause, which permits the federal government to legislate (and otherwise act) "to regulate Commerce . . . among the several States."[248] There was no such allusion in the Paulson proposal.[249] But ever since *Wickard v. Filburn*, Congress has been permitted to devise administrative schemes that regulate the most local of transactions, like (in that case) the growth of wheat by farmers for personal consumption.[250] Troubled mortgage-related assets, which tended to agglomerate pieces of many mortgages concluded in many different local jurisdictions, were unlikely to be interpreted differently, and, indeed, no one during the bailout debate suggested that the bill unconstitutionally expanded Congress's ability to regulate interstate commerce.

The constitutional question most troublingly presented by the Paulson draft—albeit less obviously by the congressional statutes that elaborated Treasury's responsibilities and that followed it—was whether the bill delegated an unconstitutionally undefined amount of power to Treasury. The nondelegation doctrine provides that statutes that do not provide an "intelligible principle" limiting broad authority delegated to the Executive Branch might unconstitutionally give the Executive the power to perform essentially legislative functions.[251]

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246. *See* Jere D. McGaffey, *Formation of the Partnership*, *in* 1 PARTNERSHIPS, LLCS, AND LLPS 51, 78 (2007).

247. A similar analysis would apply under the Takings Clause. Under the traditional *Penn Central* test, regulatory takings claims are only viable when the government frustrates "distinct" investment-backed expectations and where there is a substantial diminution in the value of the asset. *See* Penn Cen. Transp. Co. v. New York City, 438 U.S. 104 (1978). It is not clear that the shareholders in financial institutions could not expect dilution of their shares through equity injections, either from the government or from other shareholders; this sort of dilution is common in public corporations. Moreover, courts have looked for substantial diminutions in value directly attributable to the taking, which may be difficult to prove in light of the battering financial stocks were taking anyway and, except in the case of AIG, might be too high a barrier for an equity dilution claim to get off the ground. *See, e.g.*, Concrete Pipe & Prods. of California, Inc. v. Constr. Laborers Pension Trust, 508 U.S. 602, 645 (1993) (finding that a 46% diminution in value did not support a taking).

248. U.S. CONST. art. I, § 8, cl. 3.

249. Although it did use the phrase "commercial mortgages." *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 3, 122 Stat. 3766 (to be codified at 12 U.S.C. § 5202).

250. Wickard v. Filburn, 317 U.S. 111, 128–29 (1942).

251. *See* J.W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928) (concluding that an "intelligible principal" in the statute permitted the Customs Service to

Nondelegation questions arise for any statute that awards responsibilities for administration to any agency, but the doctrine has only had one good year—1935, when two extraordinarily broad delegations from the New Deal Congress to the Roosevelt Administration were found to transgress the limits of the clause.[252] The Paulson draft, expansive though it was, was probably no more likely to suffer from this particularly rare constitutional defect. The statute was focused on a particular topic, asset purchases, which alone suggested the existence of an intelligible principle.[253] The draft also directed Treasury to protect the taxpayer as well as provide stability to the markets, which was also a sign that it was focused on particular goals.[254]

The possible nondelegation problem in the Paulson proposal laid in the fact that the bill did, in authorizing the bailout, permit the Secretary to run banks (or appoint the employees to do so), buy things, issue regulations, and so on. Broad though these powers were, they were not limited by the Paulson draft: "The Secretary is authorized to take such actions as the Secretary deems necessary to carry out the authorities in this Act, including, *without limitation*" sales, appointments, regulations, etc.[255]

It was that "without limitation" language—suggesting that the powers granted to Treasury were examples, rather than limited authorizations, that most raised the possibility of unconstitutionality. After all, unlimited powers to spend $700 billion looks almost exactly like the powers that Congress, and not the Treasury Department, is supposed to exercise, and the nondelegation doctrine is premised on the idea that Congress cannot give away too many of its legislative powers. Had it been passed, the Paulson draft could, at least in regard to this provision, have been a fascinating test of the nondelegation doctrine.

However, Congress did not pass the Paulson bill word for word. It instead countered with a few draft bills offering the Treasury Secretary more limited authority. Of these, the so-called Dodd proposal exemplified the legislative response. That proposal added detail to the Paulson proposal and some possibly ceremonial restrictions on corporate governance but retained the basic concepts of the bailout—the $700 billion, the administration by Treasury, and the broad flexibility the government would have to tailor its approach to events. The most important parts of the

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revise tariff duties).

252. *See* Panama Ref. Co. v. Ryan, 293 U.S. 388 (1935); A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935).

253. J.W. Hampton, Jr., & Co., 276 U.S. at 409.

254. *See* Treasury Draft Bill, *supra* note 236 and accompanying text.

255. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101, 122 Stat. 3767 (2008) (to be codified at 12 U.S.C. § 5211) (emphasis added).

congressional counterproposal were those granting wider discretion to Treasury to purchase securities, thereby permitting equity injections as well as purchases of troubled-asset purchases, and those cabining Treasury's discretion through an oversight board, reporting by the Government Accountability Office, and, most notably, permitting judicial review. As the Senate explained, "We include[d] a provision to ensure the federal government gets warrants from companies that sell their bad assets to us." This was an optional proposal, to be sure, but one that gave Treasury the authority to implement the bailout through those injections.[256]

After an extremely short debate, and a series of front-page headlines, on September 29, the House of Representatives, led by an unlikely coalition of conservative Republicans opposed to government intervention in markets and liberal Democrats convinced that the bailout would not help the most downtrodden victims of the collapse of the housing bubble, voted down the Dodd proposal that amended the Paulson plan.[257] The stock market cratered during the vote itself,[258] much handwringing ensued, and three days later, the House revisited the bill, slightly amended and larded with a number of tax breaks and other member-specific benefits.

Both it and the Senate quickly passed the amended statute on October 4, which had grown from 3 pages in length to 451 pages in length in less than two weeks. Much of the additional verbiage was dedicated to the pork necessary to create a legislative majority in the House. But the bailout plan itself had expanded remarkably and Treasury had actually obtained in aggregate more authority to structure the program.

B. The Bailout Statute

The bailout statute was rooted in two programs that the Secretary could implement—one similar to the original troubled-asset purchases proposal, and the other a new, and relatively optional, insurance program. As for the initial program, the statute provided,

> The Secretary is authorized to establish the Troubled Asset Relief Program (or "TARP") to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary.[259]

256. Summary of Dodd Legislative Changes to Treasury Proposal (Sept. 22, 2008), http://www.dodd.senate.gov/index.php?q=node/4567.

257. Carl Hulse & David Herzenhorn, *Defiant House Rejects Huge Bailout; Stocks Plunge; Next Step is Uncertain*, N.Y. TIMES, Sept. 30, 2008, at A1.

258. The Dow Jones Index itself dropped almost 400 points in 5 minutes. *Id.*

259. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101(a)(1), 122 Stat. 3767 (2008) (to be codified at 12 U.S.C. § 5211).

Again, the grant of authority here was quite broad. The critical term *troubled assets* was defined in the congressional legislation to include not just "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability" but also "any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability," which would also prove to be helpful language for the Secretary's pivot from asset purchases to equity injections.[260]

As for the insurance program, apparently added to the bill at the behest of Republicans uncomfortable with the more direct market intervention represented by asset purchases, it was a mandatory feature of the Secretary's plan. But the terms of offering were entirely at the Secretary's discretion:

> The Secretary may develop guarantees of troubled assets and the associated premiums for such guarantees. Such guarantees and premiums may be determined by category or class of the troubled assets to be guaranteed . . . . Such guarantee may be on such terms and conditions as are determined by the Secretary, provided that such terms and conditions are consistent with the purposes of this Act.[261]

To implement these programs, the final iteration of the legislation granted Treasury substantial authority. The Secretary had the power to hire, fire, contract, issue regulations, "establish[] vehicles" to hold assets, and so on—Treasury's powers exercised pursuant to this section were only subject to judicial review for arbitrariness and capriciousness.[262]

Arbitrary and capricious review is the standard language of the Administrative Procedure Act (APA), but the complicated way it was finally added to the bailout statute is worth some analysis. Judicial review is the most powerful oversight tool Congress has, and in recent high profile statutes—such as the Military Commissions Act in the war on terror[263]—it elected not to require it. The policy reasons why are straightforward: judicial review is slow and *ex post*, judges are inexpert at complicated financial matters, and in the case of the savings and loan bailout it was adjudged by some to be ineffective.[264] Requiring it had the potential to

260. *Id.* § 3(9).
261. *Id.* § 102.
262. *Id.* § 101(c)(4).
263. *See generally* Military Commissions Act of 2006, 10 U.S.C. § 948 (2006).
264. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101(c)(4), 122 Stat. 3765, 3767 (2008) (to be codified at 12 U.S.C. § 5211).

change the entire character of the bailout from something done quickly by the Secretary to something done much more bureaucratically, with final determinations made over, potentially, a course of years of appeals, reversals, and remands. The chosen arbitrary and capricious standard is a favorable one for the government but not overwhelmingly so. In reported APA decisions in National Labor Relations Board and Environmental Protection Agency cases, the government wins somewhere between 55% and 65% of the time, according to estimates from Cass Sunstein and Thomas Miles.[265] Moreover, the judicial review was drafted confusingly. On the one hand, "Actions by the Secretary . . . shall be held unlawful and set aside if found to be arbitrary, capricious, an abuse of discretion, or not in accordance with law." But, on the other hand, "No injunction or other form of equitable relief shall be issued against the Secretary for actions pursuant to section 101 [the power-granting section] . . . other than to remedy a violation of the Constitution."[266]

Because arbitrary and capricious review essentially is equitable relief, it was unclear how, exactly, this sort of review would work. Indeed, the Supreme Court said exactly that in *Doe v. Chao*, where it referred to the "the general provisions for equitable relief within the Administrative Procedure Act" and cited a section of the same Title 5, Chapter 7 referenced in the bailout bill's judicial review provisions.[267] And so the bill appeared to grant judicial review in one section, and then took it away, by taking away equitable relief, in the other section.

Perhaps attributable to the speed of the bailout's passage—the time from the Paulson proposal to the president's signature was less than a fortnight—the precise availability of the judicial review provisions of the bill were never clarified by Congress.[268] The section-by-section notes prepared by the drafters said only that the section "[p]rovides standards for judicial review, including injunctive and other relief, to ensure that the actions of the Secretary are not arbitrary, capricious, or not in accordance with law."[269]

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265. Thomas J. Miles & Cass R. Sunstein, *The Real World of Arbitrariness Review*, 75 U. CHI. L. REV. 761, 777 (2009).

266. Emergency Economic Stabilization Act of 2008, § 119(a)(1)–(2).

267. 540 U.S. 614, 619 n.1 (2004). Laurence Tribe has characterized these provisions of the APA as equitable. *See* Laurence H. Tribe, *Death by a Thousand Cuts: Constitutional Wrongs Without Remedies After* Wilkie v. Robbins, CATO SUPREME CT. REV. 23, 46 n.88 (discussing 5 U.S.C. § 706).

268. Rumors of the bailout appeared on September 19, and the plan finally passed on October 3. *See Bush Praises Senate Passage of Bailout*, WMUR RADIO, Oct. 2, 2008, http://www.wmur.com/news/17604991/detail.html#-.

269. H. COMM. ON FIN. SERVS., 111TH CONG., SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION (2009), http://www.financialservices.house.gov/essa/final_bill_section-by-section.pdf.

The other oversight mechanisms added by Congress to Paulson's initial, almost wholly unsupervised draft were standard but numerous—they included an Inspector General, regular evaluation by the Government Accountability Office, an oversight board, and frequent congressional reporting.[270] As for the funding, the $700 billion was approved, but in tranches, with $250 billion available immediately and an additional $100 billion released upon the Secretary's certification that more funds would be needed.[271] The final $350 billion was not given to the Secretary immediately. However, its issuance was all but guaranteed; it would only be denied Treasury if there was a fast-tracked congressional joint resolution of disapproval before its disbursal.[272]

The final statute contained a great deal more direction for Treasury than did the initial draft, but the direction was not very specific. For example, the Secretary was told to consult with various agencies (a weak constraint), to issue regulations (though those could come after the bailout began), and instructed that he "*shall* take such steps as *may* be necessary to prevent 'unjust enrichment,'" which is specified as meaning the Secretary could not pay more for the asset than the financial institution did when it bought it.[273] The statute also required that the Secretary set conflict-of-interest regulations.[274]

Few observers had targeted excessive executive compensation as one of the causes of the crisis, but it had played a role in the political campaigns of successful Democratic candidates who would be voting on the legislation, and some powerful constituencies of the party found it to be appealing.[275] Legislative efforts to do something about executive compensation in the United States—famously, the highest in the world—found, in the crisis, a potential outlet for realization. Limits on executive compensation, clawbacks, and golden parachute bans, controversial favorites of some corporate scholars,[276] appeared in the bill, but in a way that gave the Secretary substantial authority to define how they would be

270. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 104, 105, 121, 125, 122 Stat. 3770, 3770–71, 3788, 3791 (2008) (to be codified at 12 U.S.C. §§ 5214–15, 5231, 5233).

271. *Id.* § 115.

272. *Id.*

273. *Id.* § 101(e) (emphases added).

274. *Id.* § 108(a).

275. Susan Lorde Martin, *Executive Compensation: Reining in Runaway Abuses—Again*, 41 U.S.F. L. REV. 147, 147 (2006) ("Every ten years or so, the problem of excessive executive compensation draws public attention, leading to some political action.").

276. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004). *See also* Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OX. REV. ECON. POL. 283 (2005).

implemented.[277] In cases where

> the Secretary receives a meaningful equity or debt position in the financial institution . . . , the Secretary shall require . . . limits on compensation that exclude incentives for senior executive officers of a financial institution to take unnecessary and excessive risks . . . ;a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and a prohibition on the financial institution making any golden parachute payment to its senior executive officer during the period that the Secretary holds an equity or debt position in the financial institution.[278]

The three executive compensation limitations imposed by Congress were imposed with rather different language. The furthest reaching of the provisions—the compensation limitation—was created with terms entirely up to the Secretary to define. The retroactive clawback provision for previously paid compensation also turned, essentially, on the details the Secretary chose to impose. But the golden parachute provision was straightforwardly prohibitory.

Treasury, in short, had the flexibility to define the extent of the nonparachute terms of the executive compensation provisions as it wished. As Treasury never before regulated executive pay, the grant of authority was theoretically dramatic, but in practice unlikely to amount to a substantively meaningful limitation on American executive compensation. This calculus would later change when Congress enacted further restrictions in the $787 billion stimulus bill, the American Recovery and Reinvestment Act of 2009.[279] The provisions were inserted in the bill at the behest of Senator Dodd and opposed by the Obama Administration. As passed these provisions further limited compensation and purported to limit incentive compensation for the five most senior executive officers and twenty highest paid executives at companies receiving more than $500 million in TARP funds.[280]

Moreover, some of the oversight mechanisms, though not overly onerous in what they could require Treasury to do, raised their own legal concerns. The Oversight Board, for example, was comprised of the Federal Reserve Chair, the Treasury Secretary, the Director of the Federal Housing Finance Agency (FHFA), the Chairman of the SEC, and the Secretary of

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277. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111, 122 Stat. 3776, 3776–77 (2008) (to be codified at 12 U.S.C. § 5221).

278. *Id.*

279. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, 516–20 (2009).

280. *Id.* § 7001; *see also* Edmund L. Andrews & Eric Dash, *Stimulus Plan Places Tightens Reins on Wall St. Pay*, N.Y. TIMES, Feb. 14, 2009, at A1.

Housing and Urban Development.[281] Three of these five officials—the Federal Reserve chair, the SEC chair, and the director of FHFA—chaired so-called independent agencies. Independent agency chairs may only be fired for cause, and the prospect of being unable to remove overseers limits the President's ability to oversee the overseers, which is not without constitutional moment, ever since *Myers v. United States*, which announced the theory of the unitary executive and awarded the president relatively broad removal powers.[282]

However, the Oversight Board was hardly charged with notable responsibilities; it was meant to "review[] the exercise of authority under a program developed in accordance with this Act, including [] policies implemented by the Secretary," and the "effect of such actions in assisting American families in preserving home ownership, stabilizing financial markets, and protecting taxpayers." But the tangible results of this review would be to make "recommendations, as appropriate, to the Secretary" and "report[] any suspected fraud."[283]

Accordingly, although the composition of the Oversight Board might be interesting to administrative law scholars, it is unlikely that its unconventional structure will result in a judicial setback for the bailout because it will be difficult to pinpoint anything that the Board will have done that will injure anyone, and therefore it may be difficult to establish standing.

The bailout statute represented a dramatic expansion of the government powers to enter the financial markets, but it also represented a massive grant of flexibility to the Treasury Department, accompanied by hundreds of billions of authorized dollars. That the authorization was unprecedented is perhaps obvious. But by creating a vehicle for Treasury to purchase distressed assets and pairing the vehicle with substantial flexibility, it gave the Department the authority to explore a variety of alternative approaches to resolve the crisis. In short, although the bailout statute appeared to contemplate creating a government market participant, it did not forbid the government from returning to the ad hoc approach it had taken earlier and doing deals—that is, taking equity—with the financial institutions most troubled by the credit crisis. As would be quickly seen, Congress had taken Paulson's one-shot mortgage-related deal and given him a machine gun available for multiple dealmakings.

281. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 104, 122 Stat. 3766 (2008) (to be codified at 12 U.S.C. § 5214).

282. 272 U.S. 52, 176 (1926).

283. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 104(a)(2)–(3), 122 Stat. 3770 (2008) (to be codified at 12 U.S.C. § 5214).

C. The Commercial Paper Program

Even as the legislative response to the crisis produced a bill that the government began to gear up to implement, the Federal Reserve found it difficult to give up action by regulation through its very flexible interpretation of § 13 of the Federal Reserve Act. Still apparently worried about the illiquid short-term credit markets—the markets that were supposed to be the most liquid of all—and the limited immediate success of the money market insurance initiative of the Treasury Department, the Federal Reserve announced its own foray into commercial paper, the short-term bonds issued by financial institutions like Lehman and large companies like General Electric and, because of their less-than-ninety-day duration, exempted from regulation by the SEC.[284]

On October 6, the Federal Reserve announced that it would purchase commercial paper directly from issuers—a substantial commitment, given that the commercial paper market was worth $1.6 trillion at the time.[285] The Federal Reserve apparently hoped that a direct commercial paper purchase program would offer direct relief to big institutions that needed to be sure of the availability of short-term financing but were still unable to find money market funds or other willing purchasers. It dubbed its effort the "Commercial Paper Funding Facility."[286]

Once again, the governance issues were striking. Congress did not okay the foray into commercial paper, and no one even mentioned commercial paper during congressional testimony during the bailout legislation debate. Moreover, creating the program moved the Federal Reserve into a form of business oversight because the agency would be getting either security or money in exchange for its paper from corporations.[287]

None of this appeared to trouble the central bank. The Federal Reserve created the commercial paper facility by emergency regulation and a quick, albeit supermajority, vote.[288] This is not to suggest that the Federal

284. Jon Hilsenrath & Prabha Natarajan, *Federal Reserve to Buy Commercial Paper*, SMART MONEY, Oct. 7, 2008, http://www.smartmoney.com/breaking-news/smw/?story=20081007094827.

285. For the number, see John Carney, *Commercial Paper: Neither a Borrower nor a Lender Be*, CLUSTERSTOCK, Oct. 6, 2008, http://www.clusterstock.com/2008/10/commercial-paper-neither-a-borrower-nor-a-lender-be. For background, see Edmund L. Andrews & Michael M. Grynbaum, *Central Bank Would Buy Companies' Unsecured Debt*, N.Y. TIMES, Oct. 7, 2008, at A1.

286. BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECON. STABILIZATION ACT OF 2008: COMMERCIAL PAPER FUNDING FACILITY (2008), http://www.federalreserve.gov/monetarypolicy/files/129mmiff.pdf.

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

288. Craig Torres, *Fed to Purchase U.S. Commercial Paper to Ease Crunch*, BLOOMBERG.COM, Oct. 7, 2008,

Reserve was engaged in a headlong rush to give Wall Street and big corporations whatever they wanted; the government action, though obviously a subsidy of sorts, was no giveaway. The Federal Reserve did not buy the paper at a big discount. It used a "spread over the 3-month overnight index swap (OIS) rate," mooting one hundred basis points as a target for the paper, in an effort to mimic what would happen in the commercial paper market under more-normal market conditions.[289] It required some security (although it defined that security quite flexibly), such as assets, an upfront fee, or a guarantee from someone else. And it organized the facility in a somewhat nonintuitive manner; it created a special purpose vehicle to which it will loan money at the federal funds rate. "Draws on the facility will be on an overnight basis," will be "with full recourse to the S[pecial] P[urpose] V[ehicle] and will be secured by all the assets of the SPV."[290]

Finally, the arrangement was designed to last for a short period—six months—although, of course, given its broad interpretation of its § 13 powers, the Federal Reserve could renew the facility as it wished. We discuss the Federal Reserve's actions with regard to commercial paper partly to be comprehensive, but partly also as a reminder that the bailout statute was one of a number of approaches that the government was pursuing during the crisis. The Federal Reserve in particular continued to resourcefully resort to its § 13 powers to try other ways of helping to ease the credit squeeze, and, of course, during this period it was exploring a variety of macroeconomic approaches including coordinated injections of liquidity into the money supply and the like.[291]

III. THE AFTERMATH OF GOVERNMENT ACTION

We save much of the consideration of the implementation of the bailout—a work in progress, with effects that will be felt for years—for the future. But one aspect of the immediate aftermath of the bailout bill's passage is worth analysis. As soon as Treasury received its authority to purchase troubled assets, it decided not to do so. Following the lead of the United Kingdom and other European countries, Treasury instead decided to take equity in struggling banks rather than taking the assets off their hands.

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http://www.bloomberg.com/apps/news?pid=20601087&sid=aAyx4qPsKSZk&refer=home.

289. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 286.

290. *Id.* at 2–3. Why the fancy footwork? As John Carney has observed, "This neatly gets around any issue about whether the Fed should be in the business of making unsecured loans since it won't be lending directly to commercial paper issuers." *See* John Carney, *Another Huge Bailout: Fed's New Commercial Paper Fund*, CLUSTERSTOCK, Oct. 7, 2008, http://www.clusterstock.com/2008/10/fed-announces-commercial-paper-bailout-fund.

291. *See* Treasury Draft Bill, *supra* note 236 and accompanying text.

The dealmaking precedent formed by the government's actions before the bailout, in short, proved hard to break.

The Treasury Department, after obtaining hard-won legislation, pivoted from the asset purchase plan mooted before Congress to an equity purchase program, and in the end decided to make equity injections a central part of any rescue.[292] Why did Treasury turn from the plan it had asked Congress to approve to an entirely different approach? The markets did not respond well to the possibility of government purchases of hard-to-value assets. After a few days of stock market declines, continued credit market turmoil, and an increasing internationalization of the crisis as banks in Europe began to find their own balance sheets in crisis, observers began to call for the injection of equity into banks, with the idea roughly being that providing banks with the capital on hand to meet their obligations that would not be met if they had to sell their unsaleable assets would be better than taking the unsaleable assets off their hands.[293]

The European proposal was accompanied by a more comprehensive government intervention into the markets, though this comprehensiveness was partly a function of the fact that European depositors were less protected than their American counterparts to begin with. The European governments, in addition to announcing that they would guarantee the safety of the deposits in banks—thus providing the insurance on deposits that already existed in the United States via the FDIC—suggested that they were inclined to inject capital into the banks themselves. In addition, a number of economists, of all ideological stripes, urged a partial nationalization of the banks as a more efficient way to unfreeze the credit markets.[294]

The result was something that looked like a global rejection of the value of the American asset purchase plan. After Great Britain announced that it would bail out its banks by taking equity in them, other European countries began to announce similar approaches.[295] Meanwhile, the troubled-asset

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292. *See* Press Release, U.S. Dep't of the Treasury, Secretary Geithner Introduces Financial Stability Plan (Feb. 10, 2009), http://www.financialstability.gov/docs/fact-sheet.pdf. The Treasury Department would later return to attempt to implement a troubled-asset purchase program in partnership with private entities. *See* Press Release, U.S. Department of the Treasury, Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernake, and Chairman of the Federal Deposit Insurance Corporation Sheila Bair (July 8, 2009), http://www.financialstability.gov/latest/tg_07082009.html.

293. *See* Greg Mankiw's Blog, http://gregmankiw.blogspot.com/2008/10/how-to-recapitalize-financial-system.html (Oct. 8, 2008) ("There is broad agreement among economists that what the financial system needs right now is not only an injection of liquidity but also a recapitalization.").

294. *See id.*

295. *See* Paul Krugman, Op-Ed., *Gordon Does Good*, N.Y. TIMES, Oct. 13, 2008, at A29

purchase plan contained a number of logistical complexities, running from valuation to eligibility, and so on, which suggested that it would be difficult to implement quickly. The notable result was that the Americans deferred to the global approach. First, Treasury announced that it would consider, like Britain, taking equity in banks.[296] It paired this announcement with the FDIC deposit guarantee increase to $250,000 and the first Federal Reserve commercial paper initiative.[297] Moreover, Treasury indicated that it believed it had the authority to turn away from asset purchases, even though it had not sought this authority in its initial bailout request. As Treasury Secretary Paulson said on October 8,

> [T]he EESA adds broad, flexible authorities for Treasury to buy or insure troubled assets, provide guarantees, and inject capital. We will use all of the tools we've been given to maximum effectiveness, *including strengthening the capitalization of financial institutions of every size*. We will design programs that encourage healthy institutions to participate.[298]

The "strengthening . . . capital[]" phrase—or partly nationalizing banks, in essence—was not what the initial bailout appeared to contemplate; it was, after all, both pitched and passed as a "Troubled Assets Relief Program." Based on the debate that happened when the statute was passed, observers could be excused for thinking that the assets at issue were the mortgage-backed securities that the financial institutions could not sell.

But the relevant grant of authority provided more; it authorized the Secretary to

> make and fund commitments to purchase . . . troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary . . . [including] establishing vehicles that are authorized, subject to supervision by the Secretary, to purchase, hold, and sell troubled assets and issue obligations.[299]

Moreover, "troubled assets" were defined, in relevant part, as

> *any other financial instrument* that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System,

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(noting that at a specially convened European summit, the major economies of Europe agreed to generally follow Great Britain's prescriptive approach to the banking crisis).

296. Edmund L. Andrews & Mark Landler, *U.S. May Take Ownership Stake in Banks to Ease Credit Crisis*, N.Y. TIMES, Oct. 9, 2008, at A1.

297. *See* Saskia Scholtes, *FDIC Expands Its Guarantees as Confidence Flags*, FIN. TIMES, Oct. 15, 2008, at 9 (on FDIC limits); Press Release, Fed. Reserve Bd. (Sept. 19, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080919c.htm (on commercial paper).

298. *See* Press Release, U.S. Dep't of the Treasury, Statement by Sec'y Henry M. Paulson, Jr. on Fin. Markets Update (Oct. 8, 2008), http://www.treas.gov/press/releases/hp1189.htm (emphasis added).

299. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §101, 122 Stat. 3767 (2008) (to be codified at 12 U.S.C. § 5211).

> *determines the purchase of which is necessary to promote financial market stability*, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.[300]

The result was a rapid change in the way Treasury decided to use its $700 billion authorization, and one more consistent with the emerging global approach.[301] Over a busy weekend on October 19, Treasury announced that it would inject a quick $125 billion into the nation's largest banks, and that it had cajoled them all into accepting the money as their duty as regulated entities.[302]

As a legal matter, Treasury announced that it interpreted a detail added to the bailout bill to give Treasury the authority to change its approach so quickly:

> The law gives the Treasury Secretary broad and flexible authority to purchase and insure mortgage assets, and to purchase any other financial instrument that the Secretary, in consultation with the Federal Reserve Chairman, deems necessary to stabilize our financial markets—including equity securities. Treasury worked hard with Congress to build in this flexibility because the one constant throughout the credit crisis has been its unpredictability.[303]

The terms of the capital injections would grant the government warrants to purchase common stock and outright grants of preferred stock, which was *pari passu* to existing preferred shares in the capital structure of the banks. The scheme certainly had the effect of diluting the equity of the existing shareholders of the banks, but it contained provisions encouraging relatively quick repayment—the government's initial dividend rate was to be 5%, but that rate would increase to 9% after five years. The warrants would also be reduced both in size and in value if the financial institution that accepted the equity would repurchase the preferred shares or the warrants quickly.[304]

In fact, on November 12, 2008, Secretary Paulson announced that the government was completely abandoning the idea of TARP and instead using the entirety of its first $250 billion for injections in troubled financial

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300. *Id.* § 3 (emphases added).

301. *See* Krugman, *supra* note 295.

302. *See* Mark Landler, *U.S. Investing $250 Billion to Bolster Bank Industry; Dow Surges 936 Points*, N.Y. TIMES, Oct. 14, 2008, at A1.

303. *See* Press Release, U.S. Dep't of the Treasury, Interim Assistant Sec'y for Financial Stability Neel Kashkari Remarks Before the Inst. of Int'l Bankers (Oct. 13, 2008), http://www.treas.gov/press/releases/hp1199.htm.

304. The executive compensation limitations on those banks that accepted the equity would also, of course, encourage their quick repayment of the government's investment. In addition, the Federal Reserve later amended its regulations to allow these preferred share injections to be treated as Tier 1 capital. *See* Press Release, Bd. of Governors of the Fed. Reserve Syst. (Oct. 16, 2008), http://www.federalreserve.gov/newsevents/press/bcreg/20081016b.htm.

institutions.[305] And using this authority broadly, Secretary Paulson also announced that the EESA capital injection program would be extended to nonbank financial institutions that provide credit, such as credit card providers.[306] Treasury also announced that it would try to distribute the first $250 billion tranche quickly.[307]

In this gap period between November 2008 and January 20, 2009, the date the Obama Administration took office, the Treasury Department continued its practice of regulation by deal to increasing public and congressional criticism. In particular, it devoted large resources to two large banks, providing more dealmaking regulation, where control remained in the hands of the operators of the enterprise, but investment remained the government's role. Consider Citigroup: an inefficient behemoth in the best of times, it appeared to be coming apart amidst market fears for its ability to survive in late November.[308]

Over the weekend of November 22, the FDIC, Federal Reserve, and Treasury Department stepped in to stabilize Citigroup. The Treasury, Federal Reserve, and FDIC collectively agreed to fund the off-balance-sheet purchase of approximately $306 billion of Citigroup's troubled assets.[309] This appeared to be a variation on the bad bank model that Lehman had proposed and was modeled on the initial, failed Wachovia–Citigroup deal. Treasury agreed to take the first $5 billion of losses on these assets, the FDIC the next $10 billion, and the Federal Reserve the remainder. The government guarantee was subject to a loss-sharing agreement wherein 10% of the losses were to be borne by Citigroup.

In addition, Citigroup agreed to guarantee the first $29 billion in losses. In exchange for this guarantee, the government received $7 billion in preferred shares in Citigroup and invested another $20 billion in exchange for a further issuance of preferred shares. But unlike other beneficiaries under the EESA, this preferred stock barred the paying of dividends by Citigroup above one cent per share for three years and yielded a higher interest rate of 8% from their issuance. The government slotted Citigroup in the middle bailout category between the stable financial banks and the

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305. *See* Press Release, U.S. Dep't of the Treasury, Remarks by Sec'y Henry M. Paulson, Jr. on Fin. Rescue Package & Econ. Update (Nov. 12, 2008), http://www.treas.gov/press/releases/hp1265.htm.

306. *Id.*

307. *See* Press Release, U.S. Dep't of the Treasury, Statement by Sec'y Henry M. Paulson, Jr. on Capital Purchase Program (Oct 20, 2008), http://www.treas.gov/press/releases/hp1223.htm.

308. *See* Eric Dash & Louise Story, *Citigroup Leads the Way as Financial Stocks Go into Freefall*, N.Y. TIMES, Nov. 21, 2008, at B1.

309. Citigroup Inc., Current Report (Form 8-K) (Nov. 26, 2008), http://idea.sec.gov/Archives/edgar/data/831001/000095012308016585/y72849e8vk.htm.

systemically failing ones like AIG. Finally, Treasury received $2.7 billion in warrants to purchase common shares of Citigroup. These warrants were priced beneficially to Citigroup on a twenty-day moving average, so the strike price was $10.61 per share, a price significantly out of the money compared to Citigroup's trading price the Friday before the deal announcement of $3.78. Treasury only took 10% of the total value of the preferred in warrants, as opposed to 15% in prior EESA transactions. The reason likely was to keep the government's ownership interest below a certain threshold. On January 2, 2009, after announcing the Citigroup bailout, the government created the Targeted Investment Program—a new program under the EESA encompassing bailouts like Citigroup that were investments in neither systemically failing nor stable financial institutions.[310]

On February 27, Citigroup announced that its federal bailout would again be reworked. This time Citigroup agreed to offer to exchange common stock for up to $27.5 billion of Citigroup's preferred shares. The federal government agreed to exchange up to $25 billion of its preferred shares under this offer.[311] The offer closed on July 24, 2009, with the government now owning 34% of Citigroup.[312]

The Citigroup model and this new program would be used in the Bank of America bailout in early January 2009. At the time Bank of America claimed that its need for funds was related to a massive $15.3 billion loss at the newly acquired Merrill Lynch, a fact that Bank of America apparently knew of in mid-December but did not disclose at the time.[313] This nondisclosure would become quite controversial as Bank of America CEO Ken Lewis would later claim that this information was not disclosed at the request of the federal government. Nonetheless, in December Bank of America informed the government that it was thinking of invoking the material adverse change clause in its acquisition agreement for Merrill Lynch to attempt to terminate its obligation to acquire the bank. The full details of the government's conversations with Bank of America are still unknown, but apparently the government claimed that Bank of America lacked a legal basis to make this allegation and that, in order to preserve

310. See Press Release, U.S. Dep't of the Treasury, Treasury Releases Guidelines for Targeted Investment Program (Jan. 2, 2009), http://www.ustreas.gov/press/releases/hp1338.htm.

311. Citigroup Inc., Current Report (Form 8-K) (Feb. 27, 2009), http://www.sec.gov/Archives/edgar/data/831001/000095010309000421/dp12698_8k.htm.

312. *See* Associated Press, *Citigroup Completes $58 Billion Stock Swap*, FORBES.COM, July 27, 2009, http://www.forbes.com/feeds/ap/2009/07/27/ap6702311.html.

313. *See* Bank of America Corp., Current Report (Form 8-K), exhibit 99.1 (Press Release) (Jan 16, 2009), http://idea.sec.gov/Archives/edgar/data/70858/000119312509007109/0001193125-09-007109-index.idea.htm.

market stability, it preferred that Bank of America complete the acquisition. The government also apparently threatened to remove Mr. Lewis from his position if he invoked the material adverse change clause and offered a carrot of more financial assistance.[314] The Bank of America bailout was finalized on January 15, 2009, bringing the total government investment in Bank of America to $45 billion.[315]

Meanwhile, public criticism increased, claiming that the government's program was ineffective, opaque, haphazard, and overly beneficial to financial institutions.[316] On January 11, 2009, the Congressional Oversight Panel for Economic Stabilization released a scathing report on the implementation of the EESA asserting that "[t]here has been much public confusion over the purpose of the TARP, and whether it has had any effect on the credit markets, helped in price discovery for frozen assets, or increased lending."[317] That same day Congressman Barney Frank submitted the TARP Reform and Accountability Act of 2009 to Congress with the purpose of "reform[ing] the Troubled Asset Relief Program of the Secretary of the Treasury and ensur[ing] accountability under such Program."[318] In the wake of these criticisms, the Obama Administration publicly proposed a return to the initial troubled-asset purchase program proposed by Treasury Secretary Paulson. This was a startling turn of events, and we believe it highlighted the failure of the government to publicly put forward a more cohesive plan.

ANALYSIS AND CONCLUSION

We conclude with a reflection on the consistent patterns of financial crises, and then return to some of the lessons we take from the government's response to this most recent one and their implications for the scholarly literature. We think that, as a study of deals, the government did save the financial system but did not achieve its full objective—financial stabilization—through its dealmaking. But this judgment will need to be reevaluated with the benefit of time and further research. We consider other implications of the government's response for deal and regulation theory. For regulation, we conclude that the crisis marks a rejection of federalism, a triumph of agencies over courts, an example of

314. *See* Liz Rappaport, *Lewis Testifies U.S. Urged Silence on Deal*, WALL ST. J., Apr. 23, 2009, at A1.

315. *See* Bank of America Corp., Current Report (Form 8-K) (Jan. 22, 2009), http://idea.sec.gov/Archives/edgar/data/70858/000119312509009753/d8k.htm.

316. *See* Floyd Norris, *Another Crisis, Another Guarantee*, N.Y. TIMES, Nov. 25, 2008, at B1.

317. *See* CONG. OVERSIGHT PANEL, *supra* note 15, at 8.

318. TARP Reform and Accountability Act of 2009, H.R. 384, 111th Cong. (2009).

the nuanced effects law can have on emergency, and a surprising foray into corporatist governance. For deals, we conclude that the crisis illustrates a way out of the path-dependence story that characterizes much deals scholarship, a surprising embrace by the government of a venture capital model of deals where a private equity model might have made more sense.

We agree with Charles Kindleberger that financial crises have a timeline.[319] Government responses to crises have their own pattern as well. The response often begins with the scramble of governments to keep up with fast-paced and deleterious market events, leading to an initial, ad hoc phase in government action, where emergencies are responded to with emergency-style rules and emergency-style process.[320] In sufficiently serious crises, the next phase may be a legislative one—beginning with outraged congressional hearings and then new legislative authority. At about this time, implementation of the criminal investigations hit their stride, leading to the ex post punishment—often quite severe punishment—of a few symbols of the crisis, such as high-ranking CEOs and some unfortunate exemplars of excess.[321] Finally, there is reform; either reform forgone in favor of blue-ribbon commissions and minor regulatory reorganization, or reform embraced by new legislation and a restructuring of the financial regulatory system.

If this pattern is relatively robust, it is hardly a template for what to do. Instead, the felt—and, we suspect, correct—lesson from prior panics is that the key to stemming a downfall is leadership and the confidence it provides investors. The goal is to ameliorate the short-term disjunctions in capital markets as investors—due to information asymmetry and outright fear—transfer assets in a desperate search for safety. In *The Panic of 1907*, Robert Bruner and Sean Carr detail the role of J.P. Morgan Jr. in leading the New York markets toward stability.[322] That crisis, like this one, began with macroeconomic turbulence, came to a head with the fall of a bank (although not one that collapsed into an orchestrated sale, as did Bear Stearns), and subsided in a flurry of dealmaking and asset guarantees led by Mr. Morgan rather than by the Treasury Department.[323] In a more recent

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319. *See* CHARLES P. KINDLEBERGER & ROBERT ALIBER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES 24–25 (5th ed. 2005).

320. *See Oversight of Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities: Impact on the Economy and Credit Availability: Hearing Before the H. Comm. on Financial Services*, 110th Cong. (2008) (statement by Henry M. Paulson Jr., Secretary, United States Department of the Treasury), http://www.treasury.gov/press/releases/hp1279.htm.

321. We draw no definitive conclusions about the usefulness of the criminal response here. Nonetheless, it is typically, and apparently is in this case, a part of the government's postbailout tool kit that it deems important.

322. *See generally* ROBERT F. BRUNER & SEAN D. CARR, THE PANIC OF 1907 (2007).

323. *Id.*

U.S. financial crisis, albeit a smaller one, the collapse of Long-Term Capital Management, the New York Federal Reserve played a crucial leadership role organizing a private-sector solution.[324] And that leadership often turns on dealmaking. In its initial response, the government, or the primary actor in the case of J.P. Morgan, is a dealmaker, deciding which entities live or die, structuring transactions to save the market, and attempting to restore stability through dramatic transactions.

The government's experience during this financial crisis was consistent with some prior ones in this way, though it demonstrated the limits of such a response—and perhaps the difficulties faced by the government in this crisis suggest that it embraced the dealmaking role creatively but imperfectly. The government drove hard, creative bargains, but each deal did not restore the confidence the government thought it would. Instead, in today's complex, interconnected world, each deal seemingly brought on more problems and unintended consequences as it created a world where free riding on government action became the norm. Moreover, the government's so-called guiding principle of moral hazard, even to the extent it was applied with integrity—which it was not—seemed to be out of sorts in such a momentous financial crisis. The government nonetheless resisted a comprehensive solution and continued to structure and initiate deals reactively. It did so until it became clear that this path was no longer appropriate. In short, we view the government's turn to the EESA as a signal that it felt bound by legal restraints and ultimately could not push past them until it acted to adopt a more comprehensive, confidence-building program designed to alleviate the lost confidence, fear, and information asymmetry in the markets. It was at this point that the principle of moral hazard was abandoned for more practical approaches.

But then it structured the biggest deal of all—the $125 billion TARP injection into the nine largest U.S. financial institutions—acting in a similar manner but with a more comprehensive tone. This big deal, mirrored on the pattern of smaller ones, did make a difference. But the bailout deal underscored the lack of a holistic approach to the crisis. Ultimately, the legislative bailout marked the end of the beginning of the crisis, but not the end of the government's action in the crisis.

As to all of this, the bailout is now being administered and implemented—this will constitute the middle stage of the crisis. Once the crisis is over, it will be worth reflecting further on what went wrong with the system of financial regulation and how it might be reformed. But work on what should come next, and on how this massive new intervention in the economy would be implemented, precisely, we save for future research—it

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324. For an overview, see ROGER LOWENSTEIN, WHEN GENIUS FAILED (2000).

is too soon to know how the only partly implemented bailout scheme will work. But in this study we have attempted to lay the framework for that study and also a foundation for government action in future crises.

Although events like the financial crisis are momentous enough for analysis in their own right, it is worth noting some of the implications of the bailout for scholarship, particularly the scholarship of where decisionmaking power lies, and how deals are made.

A Triumph of Agencies over Courts. In light of the crisis, some public law scholars will feel better about their preferred interpretations on the locus of decisionmaking than others. For example, those writers less inclined to focus on the centrality of the courts in the administrative state look like they were on to something. Amid the drama of the crisis, there has not been a single judicial decision of note, which is consistent with a trend in administrative law. Much of what agencies do now, such as regulation by best practice and international harmonization, is regulation exempt from judicial review.[325] Ever since the founding of the Office of Management and the Budget, it has appeared that legal interpretation within the Executive Branch itself is a critical component of government decisionmaking—so much so that some scholars have characterized the modern era as one of "presidential administration."[326] The bailout, by essentially cutting courts out of the analysis, is largely consistent with this analysis of the focus of government actions. The difference is that the President has had apparently little to do with the government's administration of the crisis, which has been coordinated by a cabinet secretary and the head of a so-called independent agency—one that lies at least partly outside the Executive Branch.[327]

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325. For an overview of best practices rulemaking, see David Zaring, *Best Practices*, 81 N.Y.U. L. REV. 294 (2006).

326. *See, e.g.*, Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2246 (2001). As a descriptive matter, Presidentialists tend to locate the (to their minds) worth enhancements of the President's role in the domestic administrative state in a series of executive orders. President Reagan's 1981 Executive Order on regulatory review, No. 12,291, required agencies within the Executive Branch to run their draft regulations by the White House's Office of Management and Budget in the White House before promulgating them, a sea change in the structure of the federal bureaucracy that marked the beginning of ever greater amounts of presidential control over it. The Clinton Administration's cognate Executive Order No. 12,866 underscored the need for OMB to review particularly significant regulatory action on a cost–benefit plan and adopted an annual regulatory planning process.

327. As the *New York Times* has reported, "[B]y all outward appearances, Mr. Bush has been reduced this week to almost a bit player in his own government, as Washington has reoriented itself away from the White House and toward Treasury Secretary Henry M. Paulson Jr. and the Federal Reserve chairman, Ben S. Bernanke." Sheryl Gay Stolberg, *Bush Emerges After Days of Financial Crisis*, N.Y. TIMES, Sept. 19, 2008, at A1. Bernanke heads the Federal Reserve, which is an independent agency outside of the Executive Branch's control in that he and his fellow Federal Reserve Board members may not be fired

A Rejection of Federalism. On the other hand, those public law scholars inclined to focus on the importance of states in our federal system must consider the all-but-nonexistent role that states have played in the crisis response.[328] If anything, the bailout phenomenon of states lining up for a piece of the federal bailout, and the ensuing prospect of federal supervision over the money, is a rebuke to the often too hopeful fans of federalism.[329] The states have had almost nothing useful to add to the federal government's response to the crisis. Some have suggested that their passivity is a sign of wise laissez-faire, suggesting that there are only federal supremacists in foxholes. During the crisis, those state officials with the capacity to act—the Delaware Court of Chancery, which briefly entertained the Bear Stearns shareholder litigation, for example, or the prosecutors in the New York State Attorney General's Office—have either gotten out of the way of or cooperated with federal officials.[330]

An Embrace of Alternative Governance. While courts and states are the missing players in this administrative law paradigm, the new process of regulation by deal exemplifies some trends that are increasingly apparent in modern administration. The deals marked a turn by the government toward an administrative approach with much in common with what some have called New Governance.[331] That sort of governance tends to involve public–private partnerships, a more networked approach to regulation, and regulatory action positioned outside of the range of judicial review.[332]

The governance model adopted during the early stages of the financial crisis featured all of these hallmarks and, because it did so, helps to

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except for cause, are confirmed by the Senate, and have budget powers apart from those of the president. *See* Paul R. Verkuil, *The Purposes and Limits of Independent Agencies*, 1988 DUKE L.J. 257, 278 ("The Federal Reserve Board (FRB) leaps to mind. It is one of the largest, truly independent agencies (right down to an independent Chair), but it is a policymaker of the highest order.").

328. *See, e.g.*, Stuart Minor Benjamin & Ernest A. Young, *Tennis with the Net Down: Administrative Federalism Without Congress*, 57 DUKE L.J. 2111, 2150–51 (2008) (describing the way the courts could interpret the Constitution to ensure a role for state autonomy).

329. *See* Rob Hotakainen, *States Want Their Own Federal Financial Bailout*, MCCLATCHY, Nov. 15, 2008 ("Led by California with a $28 billion hole in its budget, 41 states are in financial trouble, and many of their leaders are looking to Congress to bail them out."), *available at* http://www.azcentral.com/news/articles/2008/11/14/20081114economy-states1114-ON.html.

330. *See supra* notes 74–78 and accompanying text. The New York State Attorney General's Office instead focused on more-high-profile issues such as executive compensation and perks provided at AIG. *See* Hugh Son, *New York's Cuomo Queries AIG on Bonuses and Raises*, BLOOMBERG.COM, Nov. 18, 2008, http://www.bloomberg.com/apps/news?pid=20601103&sid=arDpTEBIMPe8&refer=us.

331. For a discussion of New Governance, see, for example, Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 344 (2004).

332. *See id.* at 342, 466.

illustrate the limits of the traditional paradigms of administrative procedure. That traditional paradigm is, it appears, fine for ordinary administration but less clearly appropriate for emergency governance.[333] Nor is the traditional paradigm being used particularly vigorously, even in traditional areas of administrative law. As the government pursues these sorts of public–private models in other areas, and adopts business-style approaches like best practices and benchmarking to do the sorts of things that rules used to be used to do, that traditional model is looking more and more pinched by government practice, both typical and, as in the case of the financial crisis, atypical.[334]

At any rate, regulation by deal is yet another example of administration through an alternative to the traditional administrative law, and while its flexibility and creativity have their benefits, the alternatives look different from traditional administrative law in both good and bad ways. New Governance is not without costs, as illustrated by the response to the financial crisis. Government by deal has not been open government (the government did not divulge the deals it was doing until those deals were concluded), and it rejects some of the usual values of administrative law, such as predecision notice to affected parties and the public and comment-ventilated policymaking.[335] It also made very substantial and expensive government decisions very quickly, in contrast to the measured process contemplated by the APA.

Much more can be said about this form of administration than simply that it is different. In fact, if taken seriously, it comes at governance and regulation from a different conceptual starting point. For the dealmaking heralded the privatization of government functions, which, during this period, were "run like a business" rather than as a regulator. By doing deals, the government embraced the model that organizational analysts ranging from Tom Peters to Al Gore have urged on it.[336] Supervision by acquisition, and then, presumably, a form of activist investor participation in governance, is a very different sort of oversight than the traditional paradigm of supervision separate and apart from the privately run financial industry.

A Possible Corporatist Turn. Finally, on the regulatory side, we mildly note that the government's response to the financial crisis took it toward a

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333. *See* Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, at 46 (Univ. of Chi. Law Sch. Pub. Law and Legal Theory, Working Paper No. 244, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301164.

334. For further examination of these trends, see Zaring, *supra* note 325.

335. *See* 5 U.S.C. §§ 553–556 (2006) (presenting certain statutory requirements for agency process).

336. *See supra* note 11 and accompanying text.

more corporatist approach to governance. Corporatism puts all the relevant parties—shareholders, stakeholders, and regulators—in the same room, with stakes in the outcome of what essentially becomes negotiated regulation.[337] It is a more European model of governance and has long been eschewed in the United States in favor of a more command-and-control model of regulation.

But corporatism is a useful shorthand for understanding the governance implications of the response to the financial crisis. By investing in financial institutions, the government has injected itself into commerce in a novel way—a way that is very different from the sort of approach traditionally adopted in American administrative law. This new approach is fundamentally different not from administrative procedure as it is practiced in the United States, but administration as it has usually been conceived.

Law's Role in Emergency. The last great emergency faced by the country was the 9/11 crisis, and the government's response to the collapse in finance has some similarities with the aftermath of the terrorist attacks. In both cases, the Executive Branch announced a number of controversial new programs, even warfare, and Congress, for the most part, got out of the way, providing broad authorizations for executive response replete with discretion and limitations on oversight. Some, including Eric Posner and Adrian Vermeule, would put this down to the Schmittian inevitability of executive decisiveness overruling legislative indecision in emergencies.[338] In this account, law tends to go by the wayside in emergencies.

Still, we are not persuaded that the government's response marks the irrelevance of legal constraint in a crisis. As we have explained, the government acted primarily through the Federal Reserve—which, as an independent agency, is certainly not part of the Executive Branch—because that institution had the legal authority to press its claims while, for

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337. Corporatism has a number of definitions. To put it slightly sociologically, it represents a Mitteleuropean structure of government that collects stakeholders in a single decisionmaking structure in which each of them has a voice and all of them together have a monopoly. *See, e.g.*, Philippe C. Schmitter, *Still the Century of Corporatism?*, *in* TRENDS TOWARD CORPORATIST INTERMEDIATION 7, 13 (Philippe C. Schmitter & Gerhard Lehmbruch eds., 1979) (defining corporatism as "a system of interest representation in which the constituent units are organized into . . . categories, recognized or licensed (if not created) by the state and granted a deliberate representational monopoly . . . in exchange for observing certain controls on their selection of leaders and articulation of demands and support"). For a more general review of corporatism, see William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99 (2008).

338. *See* Posner & Vermeule, *supra* note 333, at 3; *see also* Adrian Vermeule, *Our Schmittian Administrative Law*, 122 HARV. L. REV. 1095, 1096 (2009) ("Legal black holes and grey holes are best understood by drawing upon the thought of Carl Schmitt, in particular his account of the relationship between legality and emergencies.").

example, Treasury acting alone did not. And while the bailout statute certainly bequeathed an awesome amount of power on the government, the details of the grant changed substantially between the initial three-page proposal by the government and the 412-page bill that Congress passed—so much so that the equity injections the government settled on in response to the crisis would not have been possible unless Congress had legislated the way it did.

Un-Path-Depending Deals. The implementation of the crisis also evinces a context in which the path dependence of dealmaking can be overcome. Lawyers, of course, structure new deals on the precedent of old ones.[339] This is partly a rational inclination to resist reinventing the wheel, but partly the kind of path dependence that brings to mind the innovation-suppressing sort of network effects.[340] In the time-sensitive environments of the bailout, one might expect to see an amplification of boilerplate and repetition. And we did see some apparent errors in the hurried negotiation of the Bear Stearns deal. But the government's deals looked quite different from traditional privately negotiated deals. The government's deals were structured to take advantage of the law it had and seemed, at least until the congressionally legislated bailout, to be made in full awareness of the powerful negotiating position enjoyed by the government. Despite the mistakes and unintended consequences, the resulting innovative deals suggest that the new player, albeit staffed by veteran dealmakers, was able to innovate and close aggressively, showing the potential of lawyers and dealmakers when they are partially unconstricted by normal agency and signaling costs to create more-efficient structures. In the process the government has created its own new precedent to follow for future government bailouts.

Venture Capital Versus Private Equity Deal Models. There are other ways to think about deals, even outside of the context of what lawyers and negotiators can do to negotiate and improve them. For example, as the government has gradually become accustomed to taking stock in distressed financial institutions, it has turned away from the role of dealmaking middleman, a traditional role for investment bankers and the one it took in Bear Stearns, and toward the actual role of investment and investor.

Investor dealmaking has often been examined in two ways: through the venture capital model and through the private equity model.[341] We think it

339. *See* Davidoff, *supra* note 12; *see also* Gilson, *supra* note 13, at 257–58.

340. For a technical discussion, see David T. Robinson & Toby E. Stuart, *Network Effects in the Governance of Strategic Alliances*, 23 J.L. ECON. & ORG. 242 (2007).

341. For background on private equity and venture capital, and the differences, see JACK S. LEVIN ET AL., STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS (2006); ANDREW METRICK, VENTURE CAPITAL AND THE FINANCE OF

is useful to understand that the government has been acting more as a venture capitalist than as a private equity investor, even though private equity might have been thought to be the more prominent dealmaking paradigm. Moreover, we mildly posit that the government's response to the financial crisis underscores the differences between the two paradigms through which nonstrategic deals can be analyzed; in short, we suspect that the financial crisis can tell us something useful and illustrative about dealmaking models.

The role of the investor–dealmaker, of course, varies with the type of transaction completed. As David Weisbach has explained, "Venture capital funds invest in start-up companies with the hope of a public offering sometime in the future. Leveraged buyout funds," the private equity approach, in our typology, "purchase existing companies and take them private, with the hope of restructuring the business and selling it at a profit."[342]

Private equity dealmakers, then, tend to take control of the firm with an eye to restructuring it and selling it off later for a profit. The government's financial crisis approach has looked a little like this—but not a lot like it. The government took warrants in some of its transactions before the passage of EESA and in most of them after it. Stock warrants are preferred private equity instruments—they have a future exercise date and are accordingly often how the private equity investors structure their payout and exit. But otherwise the government during this period stayed away from taking control of the financial institutions it bailed out, which private equity investors, unless they are supporting a management buyout, tend not to do. Private equity investors rather prefer maximum control in order to have flexibility to restructure the corporate enterprise for a future sale.

Instead, the government's deals have looked a bit more like a venture capital model. "Venture capital is a substantial equity investment in a non-public enterprise that does not involve active control of the firm," as George Dent has explained.[343] Instead venture capitalists leave the management of the firm in place—think technology companies with a new idea and management with a vision—but offer money and expertise to the venture. They also tend to structure their funding through a series of rounds that puts the owners and operators of the venture on a schedule that

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INNOVATION (2007); JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS (2009).

342. David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 721 (2008).

343. George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1031 (1992). For more on the model, see Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003).

they must meet to obtain more funding.[344] This timeline tends to leave the private equity investors with a great deal of control over the company, even as ownership is left in the hands of the original owners and operators.

The venture capital model is the one that the government has chosen to make its dealmaking paradigm, while the private equity model—which would look more like outright nationalization—is the one it eschewed, at least as the crisis evolved. It has provided money and its reputation (in lieu of the ordinary venture capital infusion of expertise) to financial institutions in exchange for an ownership stake in many of them. It has even set a schedule for repayment, as venture capitalists tend to do, with penalties in the form of high interest for repayments that are delayed. But it has left the management of financial institutions in place to continue to run their enterprises, as is common for venture capitalists.[345]

The result is not a particularly happy marriage of venture capital dealmaking principles and a reality in which the management of the bailed-out institutions has been left in place despite having few similarities with the technology start-ups most associated with venture capital. Many of the financial institutions that have suffered most during the crisis, to the point of needing government assistance, have management that has not distinguished itself regarding its oversight of their company's balance sheet and careful parsing of risk. These management teams do not all have the potential of the owners and operators of promising technology start-ups, yet the government has stood by them, other than to intermittently urge them to loan out the money the government has disbursed to them.

Moreover, the tasks for financial institutions bailed out by the government—restructuring, deleveraging, shrinking, and, eventually, a spin-off—are the sort of tasks that one would ordinarily think a private equity deal would be best suited to do, rather than one modeled on a venture capital paradigm. The result has placed the government in a difficult situation. As an outside investor, one who has in most cases left management in place, its ability to steer policy in the financial institutions in which it has taken a stake is limited.[346] This model was no doubt adopted purposefully in order to hamper future, political government

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344. *See* Gilson, *supra* note 343, at 1073.

345. It replaced the management teams at Fannie Mae, Freddie Mac, and AIG.

346. *See* D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1046–57 (1996) (describing some of the limitations of activist investing). *But see* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* 2–3 (European Corporate Governance Inst. (ECGI), Finance Working Paper No. 139/2006; Vanderbilt Univ., Law & Econ. Research Paper No. 07-28, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=948907 (finding that activist shareholders, particularly hedge funds, tended to add value to publicly traded companies).

interventions, but it has had the perhaps more deleterious effect of depriving the government of an important ability to effect seemingly needed corporate change.

There is no question that executive and independent agencies have stretched their legal authority during the bailout crisis. In some cases they have done so beyond recognition; the Federal Reserve's broad interpretation of the set of candidates to whom it could open its discount window during the crisis has made a mockery of the view that the law should not be interpreted to disturb the settled expectations of those affected by it.[347] Part of this was driven by the statutory constraints on the government, failings which may point to possible legislative reform to allow the government to act in future financial crises. But in other contexts, agencies like the Federal Reserve were turned to precisely because they had the legal authority to act. Deals were selected because they also loosened the government from its regulatory constraints. Rather than concluding that legal constraints have no purchase in emergencies, we think that perhaps the conclusion should be that settled expectations are quickly unsettled in crises, creating opportunities for novel legal interpretations, rather than that crises mean that the rule book no longer applies. And we think that in future emergencies the government may manage its authority limitations through regulation by other means when it is unable to turn to a legislative response due to political, timing, or other constraints. This may be regulation by deal.

347. *See, e.g.*, Daniel B. Rodriguez, *Of Gift Horses and Great Expectations: Remands Without Vacatur in Administrative Law*, 36 ARIZ. ST. L.J. 599, 622 (2004) (recommending that we "give some deference to these settled expectations in designing remedies in administrative law").

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THE COMING DEMISE OF DEREGULATION II

THE HONORABLE RICHARD D. CUDAHY*

In 1993, I published an article with the rather grandiose title *The Coming Demise of Deregulation*.[1] This was an impressionistic discussion of some of the unattractive legacies of airline deregulation—specifically of the bankruptcies of some airlines and their bitter consequences. While accurate as to some of the seamier side of airline deregulation and failure, this was, I am afraid, far from a convincing demonstration why deregulation of the "regulated industries" would turn out to be a failure and would have eventually to be abandoned. As a matter of fact, this article appeared fifteen years after "deregulation" (also known in some contexts as restructuring) was applied to airlines, was in the process of being applied to telecommunications and natural gas, and was about to be applied to electric power. At that time, deregulation, or restructuring, was a mixed success, seemingly appropriate for the rapidly changing technology of telecommunications, apparently incompatible with solvency in the airlines (although seemingly not at risk of abandonment for that reason), not notably controversial in natural gas, and not as yet manifesting evident problems in electricity applications. So, at least the title of my article, although potentially prophetic, was strikingly premature on the basis of the existing evidence. A few years later, of course, developments in electricity—leading off with the California fiasco—furnished abundant ammunition for the critics of deregulation, although its supporters were also not slow to rise to its defense.

California, ever striving to be the leader, had adopted electric deregulation legislation in the middle 1990s, which contemplated full retail choice of generation—the most advanced stage of deregulation. Unfortunately, the results of the deregulation experiment in California were not only unfavorable but slightly short of catastrophic. Not only was there no easing in the price of electricity (which instead rose to record highs), but

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* Senior Circuit Judge, United States Court of Appeals for the Seventh Circuit. Judge Cudahy wishes to express his appreciation to his law clerk David M. Finkelstein for invaluable assistance in the composition of this Article.

1. Richard D. Cudahy, *The Coming Demise of Deregulation*, 10 YALE J. ON REG. 1 (1993).

service was severely impacted, with numerous and extensive blackouts and other forms of power failures.[2] At this point, industrial and other very large users probably still had some support for electric deregulation in California, and particularly for its feature of choice of generator, but whatever support residential customers had for it was hopelessly lost. The demise of deregulation in California was followed by an upheaval in government—the recall of the Governor and the election of a Hollywood figure. Later, the collapse of deregulation was ascribed to manipulation by Enron and other electric suppliers, which allegedly had employed improper and fraudulent techniques to milk profits from the system.[3] This may have been part of the problem, but the California experience was generally also taken by many to demonstrate the inherent weaknesses of the deregulatory approach even when manipulators were not abusing the system.

More recently, events in the financial arena have eclipsed whatever was happening in the regulated industries. In finance, a crisis in the availability of credit has evolved into a severe recession in the economy. In light of this financial crisis, it may behoove us to remind ourselves of the principal lessons of our various experiments in deregulation. And, like the catastrophe in electricity in California, the recent financial and economic disaster has been blamed in significant part on deregulation. There seems to be no doubt that, as a result of the financial crash, regulation as a response to economic difficulties will enjoy a resurgence of popularity. It is a good guess that this attitude favoring regulation will carry over into the arena of regulated industries and elsewhere, and will powerfully affect attitudes toward regulation generally.

The financial industries in recent decades had treated regulation as a loathsome disease. Where proposed, regulation had often been rejected in the expectation that market forces and self-regulation could accomplish the same goals, furthering desirable public objectives. These developments in the financial industries have also been called deregulation and have shared much in common with the equivalent process in the regulated industries. Perhaps the most highly visible of these developments in the financial area was the repeal of the Glass–Steagall Act, the purpose of which originally had been to keep commercial banking separate from investment banking or,

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2. *See* Richard D. Cudahy, *Electric Deregulation After California: Down but Not Out*, 54 ADMIN. L. REV. 333, 343 (2002) (outlining the development of deregulation legislation and the subsequent problems involving power shortages and wholesale price increases).

3. *See, e.g.*, Jonathan Peterson & Dawn Wotapka, *Lockyer Sues Enron; FERC to Review Tapes*, L.A. TIMES, June 18, 2004, at C1 (discussing audio tapes of Enron energy traders chortling over the company's successful manipulation of the California energy market and reporting that two Enron traders had pleaded guilty to federal charges for market manipulation in California).

phrased differently, to keep the banks out of the securities business.[4] The repeal of this New Deal legislation permitted commercial banks to acquire investment firms and to put themselves in a dominant position in investment activity.[5] The repeal of Glass–Steagall was the culmination of a long campaign and removed a well-known restriction that had a broad impact. Responsibility for the financial crisis of 2008 was ascribed in part to consolidation in the financial arena permitted by the repeal of Glass–Steagall.[6] This consolidation was illustrated, for example, by Bank of America's acquisition of Merrill Lynch, a broker and investment house.[7] Bank of America had developed adequacy-of-capital problems in part from the developing demands of Merrill Lynch. It is interesting to see how the original concern of Glass–Steagall, that banks would dominate the investment business, has now been transformed into a situation where banks are struggling to survive when burdened with the capital demands of an investment firm.

The absence of regulation of certain important credit derivatives—primarily collateralized debt obligations (CDOs) and credit default swaps (CDSs), which were not traded on exchanges and not subjected to regulation—was also identified as a key source of instability in the credit crisis.[8] The primary purpose of the discussion here is to explore the extent to which lack of regulation as an element of the credit crisis may affect the formulation of future regulatory policy rather than to examine in detail exactly how regulation could have avoided the present crisis. This may be a subtle distinction of purpose, but it is important in establishing an appropriate perspective. An irresistible public demand for regulation is likely, even without an explanation of how exactly earlier regulation could have prevented the current crisis.

It is not difficult to outline the pros and cons of regulation as a theoretical matter in our economy. The essence of capitalism, as expounded by its very early exponent and apologist Adam Smith and by

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4. *See* Jonathan R. Macey, *The Business of Banking: Before and After Gramm–Leach–Bliley*, 25 J. CORP. L. 691, 716 (2000) (explaining the impact of the repeal of certain sections of the Glass–Steagall Act).

5. *See, e.g.*, Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 7–8 (2005) (discussing the impact of Gramm–Leach–Bliley on the financial services industry).

6. *See* Brishen Rogers, *The Complexities of Shareholder Primacy: A Response to Sanford Jacoby*, 30 COMP. LAB. L. & POL'Y J. 95, 95 (2008) (observing that the repeal of Glass–Steagall, together with the largely unregulated derivatives market, encouraged excessive risk taking throughout the markets).

7. *See* Louise Story, *Stunning Fall for Main Street's Brokerage Firm*, N.Y. TIMES, Sept. 15, 2008, at A1.

8. Dorit Samuel, *The Subprime Mortgage Crisis: Will New Regulations Help Avoid Future Financial Debacles?*, 2 ALB. GOV'T L. REV. 217, 220 (2009).

many others, was its alleged proclivity to transmute self-interest into the interest of society primarily through the mechanism of competition. According to free market theory, the system needed no intervention from the state or other external agent to work toward benign results, which instead were guaranteed by an "invisible hand."[9] And this remains the view of a very large body of economists. Over the years, their view has been bolstered by scholars who have, without necessarily concluding that regulation is generally detrimental, pointed out various ways in which it can go astray—notably under the "capture" theory, which sees the regulator as captive to the interests of the regulated.[10]

Starting from the thesis that capitalism contains benign tendencies that tend to move economies to socially desirable outcomes, most opponents of regulation see it as a retardant force, stifling initiative and innovation and inhibiting natural inclinations and, by the same token, good economic performance. On the other hand, advocates of regulation are much less persuaded of the market's tendency to regulate itself and to automatically provide social benefits. These regulatory enthusiasts see regulation as a crucial imposition of social needs on an otherwise anarchic economic process. Therefore, the debate between exponents of regulation and supporters of laissez-faire tends to remain mired in the fundamental conflict between a benign and a malign interpretation of the basic tendencies of markets.

The factors that move opinion back and forth between regulation and laissez-faire are (1) whether the regulation in question has been recently invoked in response to a crisis or an ongoing depression, or both, and (2) how it is thought to have performed in restraining the crisis or depression. Thus, as recent economic history demonstrates, many of the regulatory measures that have been recently considered for adoption (and, for the most part, rejected) were offspring of the New Deal period, which was a time of severe economic depression following a dramatic economic crisis, when capitalism itself was under scrutiny, and regulatory measures were thought to be the answer to every economic problem.

Later, after the period of depression passed and the economic crisis became more remote, the reputation of regulation as a cure-all declined and there came a movement to lighten the hand of regulation, which eventually

9. *See* 1 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 456 (R.H. Campbell et al. eds., Liberty Fund 1981) (1776) (predicting that society will benefit more from actions taken in self-interest, which incidentally help society, than it will from actions taken expressly for society's benefit).

10. *See generally* H.D. Vinod, *Conflict of Interest Economics and Investment Analyst Biases*, 70 BROOK. L. REV. 53, 57 (2004) (explaining that powerful financial institutions were able to capture and co-opt the regulatory authority created by the Gramm–Leach–Bliley Act).

evolved into a movement for deregulation. As this evolution progressed, the antiregulatory arguments about the need to stimulate the natural juices of capitalism, which have been described above, once more became dominant academically, and the thrust of development in the law moved against regulation. Interestingly, this development equally affected policy in the financial arena and in the regulated industries, and in both, as I have noted, the movement away from regulation was called deregulation. But, sooner or later, the time came for events to cause the pendulum to begin to swing the other way.

The credit crisis that began in 2007 and gained unexpected momentum in 2008 was notable for one perhaps unusual feature: like a Florida hurricane, it gained strength as it advanced. Although some causes could be detected, the full process of collapse that led to an extreme unavailability of credit was surprising. It all seemed to begin with what was called the subprime mortgage crisis.[11] A subprime mortgage is one assumed by a borrower having a high debt-to-income ratio, an impaired or minimal credit history, or other characteristics correlated with a high probability of default in comparison with borrowers with good credit history. Typically, this means that the borrower in question had a less-than-reassuring credit history: that is, had a record of multiple bankruptcies, frequent periods of unemployment, or did not regularly command a salary capable of reliable repayment of the mortgage principal.[12] Widespread subprime lending was largely predicated on the expectation of rising home prices. The circumstances of a subprime mortgage, particularly when home price appreciation is flat or negative, could trigger defaults and indicate conditions of higher risk.

Subprime mortgages were, of course, frequently introduced in efforts to broaden the market for home ownership and to provide credit to potential homeowners whose economic circumstances had earlier precluded them from buying their own house. This sort of mortgage also not infrequently contained adjustable-rate features, where, after applying a low fixed rate for a few years (a "teaser rate"), rates could become variable and escalate sharply for a time.[13] In summary, subprime lending involves the extension

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11. *See generally* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 13 (2009).

12. Put otherwise, a subprime borrower is one with a credit score below 620 on a scale of 300 to 850, with a lower score indicating greater risk of default. In addition to having lower credit scores, subprime borrowers typically had loan-to-value ratios in excess of 80%, suggesting a lower down payment. Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: A Primer*, *in* THE SUBPRIME MORTGAGE MELTDOWN: WHO, WHAT, WHERE AND WHY . . . INVESTIGATIONS & LITIGATION 89, 92 (PLI Corporate Law & Practice, Course Handbook Series No. 15783, 2007).

13. *Id.* at 93.

of credit under conditions where the chances of default exceed those associated with normal business practices. This sort of lending practice may, as has been suggested, be associated with a desire to make mortgages more available to a broader spectrum of homeowners, or it may simply represent lenders who incur additional risks to increase the volume of lending without a realistic appreciation of the levels of risk. In the recent credit crisis, the risk inherent in subprime mortgages began to infect the financial system generally because the mortgages were resold in various forms.[14]

Whatever regulation was applied to retail mortgage lending has probably pressed lenders predominantly in the direction of liberality, by making mortgages more available to more homeowners, not reducing the chances of default. Legislators might well have concluded that the self-interest of lenders would have moved them to *tighten* mortgage practices, so it is not clear what increased regulation would or should have done to forestall default and foreclosure, except to increase truth and accuracy in promotional statements and activity. Nonetheless, since these initial defaults at the retail level first introduced the potential for increased risk into the credit system, regulation seeking to forestall defaults would be helpful in precluding a credit crisis. Such regulation would be in the interest of the consumer as well as the lender to the extent that it helps to reduce the risk of default and foreclosure—a benefit to neither the borrower nor the lender.

But, of course, credit crises do not arise out of isolated defaults in mortgage loans alone; they are basically the product of suspect credit at various points in the financing system and with respect to various institutions involved in the financing process. When banks or other savings institutions enter into mortgage loans, they typically do not retain them but transfer their risk to other financial institutions through the process of securitization. Securitization is the creation and issuance of debt securities whose payments of principal and interest derive from cash flows generated by pools of assets—in this case home mortgages. Securitization is not new, but its widespread application to home mortgages, and to subprime mortgages in particular, has been widely cast as the villain in the recent financial crash. In this process, home loans are "pooled," which is to say that thousands of mortgages are placed in trust, and securities backed by these mortgage pools are sold to investors.[15] Mortgage-backed securities (MBSs) are in some respects like derivatives (because their yield is based

14. Samuel, *supra* note 8, at 241–43.

15. *E.g.*, Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 69 (1996).

on the value of another asset), but they are not true derivatives.[16] MBSs, in turn, were "re-securitized." That is to say, they were purchased by new special purpose entities, which issue CDOs backed by specific classes of MBSs.[17] CDOs are true derivatives.

The issue of risk thus became central and came to dominate the behavior of the various parties in the financing process in hedging or offsetting their own risk, or in at least attempting to appreciate it with an adequate degree of confidence. In the case of cash-flow CDOs created from pools of bonds based on mortgage loans of varying degrees of risk, the debt might be split into pieces by issuing new securities linked to each piece. Some of the pieces are of higher quality and some of lower. Credit rating agencies give investment-grade ratings to most or all of these so-called tranches, with the exception of the most junior "equity" tranche.[18] Possibilities exist here for the mispricing of risk either by credit rating agencies or by hedge funds and other sophisticated investors, which are able to manipulate the pricing and structure of CDOs. "CDOs . . . are an opaque market . . . dominated by a handful of interests. And CDOs pose systemic risks, including the risk that a default on one or more bonds would generate a ripple effect of defaults in CDOs."[19]

The extensive credit crisis that we have undergone, based initially on subprime mortgages, was the cumulative product of the effort of banks and other financial institutions to provide home mortgage and other financing and to diffuse risk through the participation of other institutions and sources of credit. Apparently, in the workings of this process, the most dangerous and unacceptable condition was the undertaking of unknown or unmeasured risk. The possibility of encountering uncalculated risk induced financial institutions to refuse credit to new borrowers or decline to accept risk from a suspect quarter. The financial institutions were, as noted, in the process of hedging their own risks—of attempting to transfer all or part of those risks to other parties. But this sometimes led to their being exposed to new or unknown risks.

In addition to CDOs, another credit derivative that has played a major

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16. *See id.* at 69–70, 74 (explaining that mortgage-backed securities (MBSs) are not derivatives because they transfer rights to promised payments at the time of the sale of the MBSs, not at some future point).

17. *See* John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1386 (2008); *see also* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1022 (2007) (explaining how certain special purpose entities purchase portfolios of outstanding debt); STANDARD & POOR'S, GLOBAL CASH FLOW AND SYNTHETIC CDO CRITERIA 4 (2002), http://www2.standardandpoors.com/spf/pdf/fixedincome/cdo_criteria2002_FINALTOC.pdf.

18. Lynch, *supra* note 17, at 1386.

19. Partnoy & Skeel, *supra* note 17, at 1040.

role in the financing process is the CDS, "a private contract in which private parties bet on [the probability of a borrower's] bankruptcy, default, or restructuring."[20] In a sense, this is insurance against a bad-credit event of a borrower. Thus, a financial institution which makes a loan and wishes to hedge its risk enters into a CDS with a third party with respect to the credit of the party to whom it has made the loan. In the case of a credit-impairing event, payment by the CDS protects the financial institution against loss on the transaction.[21] CDSs may sometimes be acquired for nonhedging purposes, essentially as speculative vehicles in their own right—a practice perhaps especially ripe for regulatory control.[22]

Through the use of CDSs, it is not necessary to buy any actual bonds or mortgage-based securities in order to create what are called synthetic CDOs.[23] These are created by aggregating CDSs based on whatever securities are intended, so that if and when the banks, for example, run out of MBSs, they can sell synthetic CDOs to investors.[24] It has been the practice of some banks to retain MBSs on their own balance sheets and to buy protection against default by these MBSs through the purchase of CDSs, and then to sell synthetic CDOs to investors. These transactions, however, are essentially variations on basic hedging operations and have added little fundamentally to the process but may represent a high volume of transactions.[25]

A little something further might be said about CDSs, since they have become so pervasive in the modern credit system and, together with other credit derivatives, have been called "financial weapons of mass destruction."[26] The benefits of CDSs as hedging mechanisms have been widely proclaimed by Alan Greenspan and others, and they acted as "shock absorber[s]" in some of the recent corporate crashes.[27] Many of the lenders to Enron and others had heavily hedged their risks, so that, with the failure of the borrowers, the corporate scandals did not spread to the banking

20. *Id.* at 1021.

21. *Id*. at 1021–22.

22. Michael Santoli, *Where Pricing Anomalies Abound*, BARRON'S, Mar. 9, 2009, at 9; Paul M. Jonna, Comment, *In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation*, 45 SAN DIEGO L. REV. 989, 1005 & n.88 (2008).

23. Partnoy & Skeel, *supra* note 17, at 1022.

24. *Id*. (explaining that special purpose entities may issue financial instruments backed by credit default swaps).

25. Besides these basic credit derivatives, certain instruments provide a wide variety of variations on these basic conceptions, with new innovations being introduced all the time. *See* Lynch, *supra* note 17, at 1387–89 (discussing target annual review notes, constant proportion portfolio insurance, and constant proportion debt obligations).

26. Letter from Warren Buffett, Chairman of the Bd., Berkshire Hathaway, to Berkshire Hathaway Shareholders 13, 15 (Feb. 21, 2003), http://www.berkshirehathaway.com/letters/2002pdf.pdf.

27. Partnoy & Skeel, *supra* note 17, at 1023–24.

industry. Systemic benefits such as these persuaded Greenspan that the market in CDSs should not be regulated but should remain unfettered and encouraged to grow. Other observers felt that credit derivatives and other risk management techniques provided new opportunities for the banking industry, which could deal easily with ordinary risks such as interest-rate risk and, therefore, focus fully on more complex borrower-specific risk.[28]

Later, after the crash, Greenspan partially recanted, saying,

> The whole intellectual edifice, however, collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today, in my judgment.[29]

Thus, practices based on successful experience of high risk taking did not provide protection in more-sober circumstances.

By lowering the risks of bank lending, CDSs increase the liquidity of the banking industry. This effect is similar to the impact of securitization on home mortgage lending. The ability to sell a mortgage sharply reduces the risk of undertaking it in the first place, and risk reduction is the key to volume in mortgage placement.[30] But all these and other advantages in CDSs and other credit derivatives can also reveal potential sources of danger when viewed from other perspectives. Two of these problems arise from the disincentives which, for example, CDSs offer to financial institutions in the monitoring of borrowers and from the opacity of the CDS market.[31] Enron is cited as an example of loss of incentive to monitor and oversee a customer through massive hedging of loan debt. Enron borrowed billions of dollars from some of the country's leading banks, but these amounts were hedged by what is estimated to have been 800 swaps. Presumably, for this and other reasons the creditors provided little direction to the floundering energy upstart. Obviously, financial backers would prefer to have their wards survive and flourish, but with enough hedging of the debt, the creditor's anxiety is bound to be muted.[32] It is not easy to see how this particular effect of the use of CDSs could be reversed or improved by regulation, but the existence of a regulatory authority might play a role

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28. *Id.* at 1024.

29. *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 3–4 (2008) (testimony of Alan Greenspan, former Chairman, Board of Governors of the Federal Reserve System), *available at* http://oversight.house.gov/documents/20081023100438.pdf.

30. Partnoy & Skeel, *supra* note 17, at 1024–25.

31. *Id*. at 1032, 1036.

32. *See id*. at 1032–33 (observing that several banks, including JPMorgan Chase and Citigroup, had a reduced interest in oversight of Enron because hundreds of swaps significantly reduced their exposure).

in keeping a financing agency awake and alert to the activities of its client.

Opacity is a different matter since disclosure is usually at the heart of securities regulatory philosophy. The hidden character of hedging is an obvious outcome of the use of CDSs. There is no way for the outside observer to know whether a given financier's risk is hedged or, in a complex arrangement, what entity bears the ultimate risk.[33] The International Swaps and Derivatives Association "has actively resisted disclosure of credit default swap documentation, insisting that this information is proprietary."[34] In addition, one party to a swap frequently sells its interest to someone else without notifying the other party to the arrangement. "Record-keeping, documentation and other practices have been so sloppy . . . that no firm could be sure how much risk it was taking or with whom it had a deal."[35] All this opacity leads to significant problems in interpreting the behavior of other actors in the market. For example, if a lender makes concessions, it may mean one thing if that party is fully hedged and quite another thing if the lender is unhedged. "The opacity of the market may also make it more likely that hedge funds or other parties will manipulate default" in various ways to the detriment of stability.[36]

Before leaving the financial crisis and its implications, it would be appropriate to mention the savings and loan crisis of a somewhat earlier period. In part, this crisis was based on the lifting of limitations placed by law and regulation on interest payable on deposits in savings and loan institutions. These limitations made it difficult for these institutions to compete for deposits with banks, which had been freed of such limitations. When the limitations on the savings and loans were removed, these institutions raised their interest payments. The institutions correspondingly raised their revenue requirements and began to search for more-profitable investments than the home mortgages in which they traditionally invested. Of course, in line with normal expectations, pursuit of more-profitable investments implied acquisition of riskier investments, and for the savings and loans this meant investments in commercial development projects, hotels, resorts, and the like. When times turned bad, these investments meant higher losses and a crisis in the industry attributable in part to a relaxation of regulation—not unlike the current credit crisis.

All this leads us to wonder whether a monstrous tide of regulation is coming back to the American financial system like the ocean tide to the

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33. *Id*. at 1036–1037.
34. *Id*. at 1036.
35. *Id.* (quoting David Wessel, *Wall Street Is Cleaning Derivatives Mess*, WALL ST. J., Feb. 16, 2006, at A2).
36. *Id*.

Bay of Fundy. Examination of the technical details of credit derivatives and their usefulness or dangerousness does not provide an answer. We know that the economic setback following the credit crisis of 2008 has been and will continue to be stunning. We know, as described earlier, how the crisis grew out of the bourgeoning use of credit derivatives following a vigorous placement of subprime mortgages. What we do not know for sure is whether aggressive government regulation of either the mortgage business or credit derivatives could have avoided the problem, or at least weakened its impact. Following well-established precedent in the securities laws, effective regulation could at least have required transparency and eliminated the mystery that enshrouds the present use of credit derivatives. More-effective regulation could also have affected reserve requirements based on risk. But, at this point, there is no unanimity as to precisely what sort of regulation is required.

Most commentary on regulation of credit derivatives puts it within the context of securities regulation in general and emphasizes the need for centralization of responsibility and for increased efficiency, usually to make the industry in the United States more competitive with its counterparts elsewhere.[37] And most regulatory proposals rely on self-regulation and sometimes refer to guidelines laid out by the Major Dealers in meetings held to discuss improvements in the infrastructure of the industry.[38] But the dire circumstances under which regulation now may become an active issue seems to rule out any major reliance on self-regulation. After numerous failures on Wall Street requiring bailouts[39] and the Bernard Madoff scandal, there is little likelihood of any enthusiasm for committing regulation of Wall Street to the tender mercies of its denizens. It seems more likely that Congress would put arms-length regulators without strong ties to the Wall Street operators in charge.

Returning at last to the status of regulation in the regulated industries, we find that after California the push to deregulate in the electricity sphere lost force. In some states efforts went forward with vigor; in others there was a slowdown or freeze and little effort to press on with restructuring. In a few places, there was even some backsliding and withdrawal from arrangements already tentatively undertaken as steps toward deregulation. These tendencies were not entirely the result of the well-publicized failures in California, but that was certainly a turning point in a movement which,

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37. *E.g.*, Lynch, *supra* note 17, at 1431–35.

38. *Id*. at 1396–1405. The Major Dealers are a group of fourteen Wall Street firms that meet regularly with the goal of creating self-regulation to improve the markets' structure. *Id.* at 1396–97.

39. *See* David Cho & Binyamin Appelbaum, *Historic Market Bailout Set in Motion: President Cites Urgent Need for Sweeping Intervention*, WASH. POST, Sept. 20, 2008, at A1.

up to then, had things going pretty much its way.[40] At that point, deregulation, or restructuring, seemed to be most successful in applications where few natural monopoly characteristics were in evidence and capital intensiveness was not overwhelming, such as in the airlines and motor carriers. In these applications, the economic characteristics of the activity seemed alien to efforts to prescribe prices and services administratively, which could be left to private arrangements between shipper or passenger and the carrier, with competition to enforce reasonableness. Currently, deregulation of the airlines seems successful in terms of route structure, fares, flight frequency, and other traditional concerns. The only major problem is that the airlines, taken as a whole, seem incapable of making money.[41] In 1938, the same deficiency was a prominent factor in the imposition of regulation. Presently, there is no clamor for re-regulation, but this might be imposed if all else fails. The price of fuel seems a dominant element in financial performance, but the ultimate impact of this is unpredictable.

On the other hand, in heavily capital-intensive industries where natural monopoly characteristics had traditionally been emphasized—like electricity—restructuring to emphasize choice and competition seems to have been least obviously and least consistently successful. In industries lying somewhere in the middle of this range of characteristics—like telecommunications, where innovative technology is prevalent—restructuring has been carried out with claimed success but not without some major difficulties.[42]

In light of this mixed performance, there seems to be no compelling reason why dire circumstances involving credit derivatives in the financial industry should reawaken interest in re-regulating the formerly regulated industries. The best answer is that in popular parlance and understanding both these areas of regulatory activity had been subjected to deregulation. This was literally true in the case of regulated industries. Here, control of price and service by regulatory agencies had indeed been lifted on a broad basis with degrees of success and failure that I have noted. However, credit derivatives were never regulated because they were not traded on an exchange as were, for example, futures and options (also derivatives).[43] So credit derivatives had not been literally deregulated, although the term was extensively applied to them after the credit crisis arrived.

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40. Cudahy, *supra* note 2, at 335.

41. Richard D. Cudahy, *The Airlines: Destined to Fail?*, 71 J. AIR L. & COM. 3, 7 (2006).

42. Natural gas is another industry where an approach favoring competition has been workable.

43. Lynch, *supra* note 17, at 1375–81.

That there will be strenuous efforts to regulate credit derivatives and anything else connected with the credit crisis seems virtually certain, and I would anticipate the regulatory tide's lifting all boats, including the one supporting the regulated industries. The era of deregulation is over and the sentiment that it is more important to let the juices of capitalism flow than to be sure they are flowing in precisely the right channel is no longer dominant. The pendulum has swung from the extreme of liberation to the extreme of restraint, and the ideology of the New Deal will be ascendant. This is almost sure to be the reaction to a widespread collapse of the economy based in part on negligence and in part on greed. The specifics of exactly what is to be regulated (although transparency is a likely candidate for high priority) will probably be less of a concern than simply a demand for a stern regulator to be in charge.[44] In the case of credit matters, the most popular proposal is to list CDOs and CDSs on an exchange and require the reporting of all trades.[45] This would supply complete transparency. In addition to requiring the reporting of transactions involving derivatives, the Treasury Department has proposed adopting registration requirements for hedge funds and stricter rules for large, interconnected financial firms, including increased reserve requirements.[46] Great interest also exists in altering the compensation arrangements of credit rating agencies to eliminate conflicts of interest. And, as indicated, I suspect that the newfound popularity of regulation will be felt almost equally in what were traditionally known as regulated industries. This is perhaps not as certain, but public psychology being what it is,

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44. *See id.* at 1434–36 (recommending the creation "of a single regulator which oversees all financial markets, but delegates to those market participants the authority to formulate the rules and practices by which each market will operate"); *see also* Samuel, *supra* note 8, at 256–57 (advocating a flexible regulatory system that promotes full disclosure and results in severe penalties for noncompliance).

45. This proposal was the centerpiece both of the Senate's proposed Derivatives Trading Integrity Act of 2008, S. 3714, 110th Cong. (2008), *available at* http://216.40.253.202/~usscanf/index.php?option=com_content&task=view&id=1812&Itemid=2, and of the House of Representatives' proposed Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. (2009), *available at* http://agriculture.house.gov/inside/Legislation/111/PETEMN_001_xml.pdf.

46. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 10–12 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. Some liberal critics have argued that the Treasury Department's proposals do not go far enough, and that more in particular should be done to consolidate the functions of the different regulatory agencies. *See* DOUGLAS J. ELLIOTT, THE BROOKINGS INSTITUTION, REVIEWING THE ADMINISTRATION'S FINANCIAL REFORM PROPOSALS 10 (2009), *available at* http://www.brookings.edu/papers/2009/0617_financial_reform_elliott.aspx. Conservative critics, by contrast, argue that the proposal increases the power of regulators in ways that would stifle innovation. *See* Posting of James Gattuso to Foundry, http://blog.heritage.org/2009/06/17/obama-financial-regulation-plan-empowering-regulators-not-consumers/ (June 17, 2009, 16:49 EST).

disillusionment with deregulation should sweep across the board and reach far beyond financial matters, and even into unrelated areas like food processing, airplane safety, and commodity trading.[47] The impulse to apply social restraints will generally outweigh the demand to unshackle the dynamics of markets.

The deregulation movement in all its forms was energized for many years by academics and others deeply persuaded of the thesis that the unregulated operation of competitive markets worked to further stability and socially beneficial economic outcomes. This broad school of thought regarded intervention in markets as generally undesirable and disruptive of the natural equilibrium that markets tended to achieve when undisturbed. Carried to an extreme, this non-intervention school of thought would have eschewed tinkering, even to repair the damage of a major crash leading to an abrupt recession. Just as these laissez-faire advocates stepped back from vigorous measures to stimulate a lagging economy (à la Keynes), they would be suspicious of a regulatory regime designed to guide an economy around the shoals of crisis and slowdown. The same tendencies apply to the regulated industries where the deregulators want nothing to interfere with the natural and self-restorative rhythms of the market. But all of these sentiments are bound to fall before the harsh realities of a major credit crisis leading to a severe recession. Just as deregulation, based on a deep faith in markets, has dominated theory and practice in all areas for so long, now terrible damage to the economy has destroyed the underlying faith and replaced it with a penetrating mistrust.

This is certainly not to say that the swing toward regulation will last forever. Once the crisis is passed and remains passed for a long time, the beauties of laissez-faire will again be visible and influential. But that is a day beyond this one and far beyond it at the moment, and the old and somewhat shopworn arguments against regulation will fall on deaf ears. At last fulfilling the forecast in 1993, the demise of deregulation is now virtually guaranteed.

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47. *See Congress Says FDA Faulty in Audits*, NEWSDAY (N.Y.), May 19, 2009, at A26 (discussing salmonella outbreaks due to contaminated peanut butter); Andy Pasztor, *Airline Safety Gap Cited in Crash Probe*, WALL ST. J., May 15, 2009, at A3 (discussing commuter airline crashes); Edmund L. Andrews, *U.S. Weighs Curbs for Speculators in Energy Trades*, N.Y. TIMES, July 8, 2009, at A1 (discussing proposals to curb speculation in commodity futures).

FAITH-BASED FINANCIAL REGULATION: A PRIMER ON OVERSIGHT OF CREDIT RATING ORGANIZATIONS

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INTRODUCTION

In light of the present economic crisis and their role in it, the world seems suddenly keen to know more about the handful of private corporations—variously known as bond rating agencies, credit rating agencies, credit rating organizations (CROs), or the like—that rate the creditworthiness of corporate and government debt securities. By most accounts, these companies hold extensive sway in public capital markets, and for about thirty years, a few of them have enjoyed literally de jure delegation of federal regulatory oversight over much of the U.S. financial sector. With that power their ratings have value regardless of their accuracy, and they have used this power to earn substantial profits. The regulatory use of credit ratings is particularly troubling because the CROs have been implicated in some of that sector's worst problems and, by most accounts, were intimately tied up in the present mess.

Despite the CROs' privileged status, they have never been especially popular with observers, and during the past several years, they have increasingly been blamed for financial-sector failures. In particular, they have been blamed for failing to warn of major bond defaults since at least the mid-1970s, the calamitous losses throughout the 1990s associated with various derivative products, and the corporate collapses of 2001 and 2002.[1] Some observers see them as actively complicit in the current meltdown in

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1. *See infra* notes 9, 53–54 and accompanying text (recounting the numerous alleged failings of CROs).

structured finance.[2] Possibly for the first time, CRO insiders are now blowing the whistle on what appears to have been significant internal wrongdoing.[3]

A flurry of U.S. government investigation has surrounded the CROs during the past two decades,[4] and overseas they are under scrutiny by

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2. *See infra* note 56 and accompanying text.

3. Notably, two former high-level executives of the ratings firm Standard & Poor's (S&P), Frank Raiter and Richard Gugliada, spoke candidly with documentary news reporters acknowledging that while the CROs could not meaningfully predict the soundness of many structured products, they rated them anyway because rating them was so profitable. *NOW*: *Credit and Credibility* (PBS television broadcast Dec. 26, 2008) (transcript available at http://www.pbs.org/now/shows/446/transcript.html). Raiter, in particular, confided that his entire department of analytical experts believed that some structured finance ratings were "guess[es]" and doubted that some of them could really be making money at all "because the general premise to some of us behind what [these products] were—was a mystery." *Id*. Their accounts are supported by anecdotal but fairly glaring evidence turned up by the Securities and Exchange Commission (SEC) staff in 2008, which included internal correspondence among analysts at the CROs indicating their doubts about their ratings of structured products, as well as evidence of substantial pecuniary conflicts of interest affecting analytical personnel. *See* SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf [hereinafter SEC 2008 STAFF REPORT].

4. Congress and the SEC have been investigating the CROs off and on since at least the late 1980s. With the exception of the light regulatory touch applied in legislation and rules that took effect in mid-2007, the chief result of all that work was just published criticism of the agencies. In light of the recent crisis and their apparently central role in it, both Congress and the SEC have recently undertaken major new regulatory steps. First, the Congressional Oversight Panel, a commission of outside experts established by the Troubled Asset Relief Program (TARP) legislation, recently released a report scathingly critical of deregulation and reliance on private-sector forces to constrain risk. *See* CONG. OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM; RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY (2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf [hereinafter COP REPORT 2009]. Among other things, the report recommends creation of a government Credit Rating Review Board that would audit ratings and actively oversee the CROs. *Id.* at 44. The SEC also undertook a major investigation of the CROs' practices immediately after the beginning of the subprime meltdown, producing one of the best exposés of the CROs' inner workings, especially of their function during the structured finance era. *See* SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (2003), *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf. The SEC has also issued a new set of proposed rules that, although still pending, appear to be more invasive than anything undertaken before. *See* Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212 (proposed June 25, 2008) (to be codified at 17 C.F.R. pts. 240 & 249b) (enhancing the disclosure and comparability of credit rating performance statistics).

Until recently, state governments have mainly stayed out of the CROs' affairs, with the limited exception that state tort claims have sometimes been asserted by disappointed investors and issuers. *See infra* note 179 and accompanying text. In light of the recent crisis, however, the Attorney General of Connecticut has sued the CROs in antitrust on behalf of Connecticut municipalities injured by the ratings process for their debt issues. *See infra* note 9. Further, the Attorneys General of Ohio and New York have both begun investigations of the CROs' role in both subprime lending abuses and the larger credit crisis

several intergovernmental[5] and nongovernmental organizations.[6] Much of

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generally. *See* Katie Benner & Adam Lashinsky, *Subprime Contagion?*, FORTUNE, July 23, 2007, *available at* http://money.cnn.com/2007/07/05/news/economy/subprime.fortune/index.htm?postversion=2007070511; Press Release, Conn. Attorney General's Office, Attorney General Says His Broader Investigation into Credit Rating Agencies Continuing Aggressively (June 5, 2008), http://www.ct.gov/ag/cwp/view.asp?A=2795&Q=416772; Press Release, Office of the Attorney General of N.Y., Attorney General Cuomo Announces Landmark Reform Agreements with the Nation's Three Principal Credit Rating Agencies (June 5, 2008), http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html.

The Government Accountability Office (GAO) has been a frequent critic, and a harsh one lately. *See* GOV. ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 30–32 (2009), *available at* http://www.gao.gov/new.items/d09216.pdf (asserting that the existing regulatory system has failed to identify and manage the risks associated with CROs). More generally, GAO has argued since at least the early 1990s that U.S. financial regulation is dangerously fragmented and uncoordinated, and has repeatedly urged various reforms, although to little avail. *See generally* GOV. ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUCTURE (2007), *available at* http://www.gao.gov/new.items/d0832.pdf; GOV. ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE (2004), *available at* http://www.gao.gov/new.items/d0561.pdf; *Testimony Before the Comm. on Banking and Financial Servs.*, 104th Cong. (1995) (statement of James L. Bothwell, Director, Financial Institutions and Markets Issues, General Government Division, Government Accountability Office), *available at* http://www.gao.gov/archive/1996/gg96117t.pdf; *Testimony Before the Subcomm. on Capital Markets, Securities and GSEs, House Comm. on Banking and Financial Servs.*, 104th Cong. (1995) (statement of James L. Bothwell, Director, Financial Institutions and Markets Issues, General Government Division, Government Accountability Office), *available at* http://archive.gao.gov/t2pbat1/154163.pdf.

5. Several intergovernmental coalitions have taken acute interest in the CROs, especially in the wake of the present crisis. The thrust of their efforts has been to develop a body of hortatory guidance to better contain the CROs' misbehavior, mostly consisting of structural tweaks and disclosure rules to improve transparency.

There are a few important recent efforts. First, an April 2008 report of the Financial Stability Forum (FSF), a task force of the Group of Seven finance ministers, placed CROs at the heart of the crisis, particularly for their role in structured finance products. The FSF recommended substantially revised ratings methodologies and conduct standards, and recommended reconsideration of the use of CROs' ratings in regulation. These recommendations were in addition to a raft of other recommendations to improve system-wide transparency and risk management. *See* FIN. STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 5–11, 32–39 (2008), *available at* http://www.fsforum.org/publications/r_0804.pdf [hereinafter FSF 2008 REPORT] (discussing the underlying causes and weaknesses and recommendations to address them). Second, an international consortium of regulators, the International Organization of Securities Commissions (IOSCO), first attempted to address some of the CROs' problems in 2004 and then studied the problem anew in the wake of the credit crisis. See TECHNICAL COMM., INT'L ORG. OF SECS. COMM'NS, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES (2004), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf, for the initial report. See TECHNICAL COMM., INT'L ORG. OF SECS. COMM'NS, THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS: FINAL REPORT (2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf, for the final report. Third, the Committee of European Securities Regulators (CESR), a task force of European Union regulators set up to advise the European Commission (EC), has actively monitored the

the domestic soul-searching has been driven by the outright delegation of federal regulatory power and virtually nonexistent legal oversight.[7] Aside from a fleeting and uneventful antitrust investigation in the late 1990s,[8] the

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CROs for years, but so far has only urged that CROs voluntarily adopt the CROs' code of conduct. CESR has affirmatively urged the EC *not* to regulate the CROs. *See* COMM. OF EUROPEAN SECS. REGULATORS, CESR'S TECHNICAL ADVICE TO THE EUROPEAN COMMISSION ON POSSIBLE MEASURES CONCERNING CREDIT RATING AGENCIES 52 (2005), *available at* http://www.cesr.eu. Fourth, the Bank for International Settlements' Basel Committee has studied the CROs fairly extensively and recommended reforms. *See* COMM. ON THE GLOBAL FIN. SYS., BANK FOR INT'L SETTLEMENTS, THE ROLE OF RATINGS IN STRUCTURED FINANCE: ISSUES AND IMPLICATIONS (2005), *available at* http://www.bis.org/publ/cgfs23.pdf [hereinafter BIS STRUCTURED FINANCE REPORT]. But more ominously, the Bank's Basel Committee on Banking Supervision (Basel Committee), whose guidance efforts have largely laid the foundation for current capital market structure, has recommended international adoption of the American model of credit assessment. As will be explained more fully later in this Article, for many years U.S. regulation has made use of CROs' ratings by incorporating them by reference in a variety of mandatory rules imposed on financial institutions. The Basel accord currently in force contemplates adopting such a system worldwide. The Basel Committee's approach, inasmuch as it invites all the problems of the American one, has been the focus of harsh criticism. *See, e.g.*, Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 41 (Richard M. Levich et al. eds., 2002).

Some other international efforts have addressed the CROs but with somewhat different purposes and likely effects. For example, the Association of South East Asian Nations (ASEAN) Forum on Credit Rating Agencies, an intergovernmental group of South Asian countries, adopted a hortatory code of ethics for CROs in those countries, but the code seems mainly driven by the countries' desire to grow domestic ratings industries. The code evinces little concern for investors or substantive quality. *See* TIMOTHY J. SINCLAIR, THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS 125–26 (2005).

6. Notably, the International Group of Treasury Associations (IGTA), a coalition of a few dozen national trade associations for corporate finance professionals, collectively representing tens of thousands of financial managers on both the buyer and issuer sides, has lobbied the SEC for some time for stricter regulation of CROs. *See* Press Release, Ass'n for Fin. Prof'ls, Thirty International Treasurers Organizations Urge SEC to Act Now on Credit Rating Agency Reform (Dec. 8, 2004), http://www.afponline.org/pub/pr/2004/pr_20041208_igta.html. IGTA, along with its member organizations from the United States, United Kingdom, and France, has also developed a hortatory ethical code for CROs. *See* ASS'N FOR CORPORATE TREASURERS ET AL., CODE OF STANDARD PRACTICES FOR PARTICIPANTS IN THE CREDIT RATING PROCESS (2005), *available at* http://www.afponline.org/pub/pdf/CSP_final.pdf. The drafters noted their general support for the previously issued IOSCO Code, and intend the IGTA Code to be a complement to the IOSCO Code. *Id.* at vii–viii.

7. *See infra* notes 24–32 and accompanying text (discussing the CROs' role in federal regulation of securities and banking markets).

8. The Antitrust Division of the U.S. Department of Justice has long had an eye on the CROs and formally investigated Moody's in the late 1990s on suspicion that it penalized issuers who used other services by issuing them unsolicited and improperly low ratings. The Antitrust Division ended its inquiry in 1999 without taking any antitrust action. *See* Charles Gasparino, *Inquiry into Moody's Ratings Practices Ends as U.S. Agency Takes No Action*, WALL ST. J., Mar. 12, 1999, at A4. Though an antitrust suit was not filed, Moody's pleaded guilty in 2001 to obstruction of justice in that investigation, admitting that it destroyed damning documents relevant to the investigation. Moody's paid nearly $200,000

federal government *never* directly regulated the powerful, hundred-year-old industry until June 2007. However, even the 2007 effort imposed virtually no constraints.[9]

Current circumstances have shaken faith in the CROs, and the question seems not whether the regulatory approach will change, but only how much, in what ways, and with what consequences. Several academic endeavors are afoot to understand the CROs better,[10] and many of them

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and agreed to three executive resignations to settle the matter. *See* Queena Sook Kim, *Moody's Pleads Guilty to Destroying Documents During Antitrust Investigation*, WALL ST. J., Apr. 11, 2001, at B8. Moody's conduct also resulted in unsuccessful antitrust litigation by an issuer that claimed Moody's penalized it with a lowered bond rating when the issuer chose to use a lower priced CRO. *See* Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848 (10th Cir. 1999). Late last year, apparently in response to the meltdown in subprime mortgage-backed securities, Connecticut's Attorney General opened a new investigation, which focused on the CROs' alleged ability to charge supracompetitive prices to Connecticut municipal bond issuers for ratings services. *See* Rupini Bergstrom, *Bond Raters Get Subpoenas: Connecticut Presses Antitrust Inquiry; Firms Cooperating*, WALL ST. J., Oct. 27–28, 2007, at B2. In July 2008, the investigation resulted in the first of several planned suits against the CROs. *See* Press Release, Conn. Attorney General's Office, Attorney General Sues Credit Rating Agencies for Illegally Giving Municipalities Lower Ratings, Costing Taxpayers Millions (July 30, 2008), http://www.ct.gov/ag/cwp/view.asp?a=2795&q=420390.

9. After years of study and agitation, Congress finally adopted legislation to regulate the CROs in 2006. *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 4(a), 120 Stat. 1329 (2006) (codified at 15 U.S.C. § 78*o*-7 (2006)). The Credit Rating Agency Reform Act of 2006 (CRARA) was adopted explicitly in response to the collapse of Enron and other corporate failures in 2001 and 2002, and to the CROs' perceived role in them. *See* S. REP. No. 109-326, at 1–2 (2006), *reprinted in* 2006 U.S.C.C.A.N. 865, 865–66. Because CRARA depends on voluntary registration, it had little real effect before its implementation by SEC rules in June 2007. *See* Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564 (June 18, 2007) (adopting implementing regulations and making them effective as of June 2007). Currently pending new CRARA rules, which were quickly proposed after the subprime meltdown, are admittedly more invasive. *See supra* note 4.

10. *See, e.g.*, John Ammer & Nathanael Clinton, *The Impact of Credit Rating Changes on the Pricing of Asset-Backed Securities*, *in* STRUCTURED CREDIT PRODUCTS: PRICING, RATING, RISK MANAGEMENT AND BASEL II 159 (William Perraudin ed., 2004); Frank Partnoy, *The Paradox of Credit Ratings*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65 (Richard M. Levich et al. eds., 2002) ; Konan Chan & Narasimhan Jegadeesh, *Market-Based Evaluation for Models to Predict Bond Ratings*, 7 REV. PAC. BASIN FIN. MARKETS & POLICIES 153 (2004); Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43 (2004); Stéphane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L.J. 617 (2006); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1; Patrick Bolton et al., *The Credit Ratings Game* (Nat'l Bureau Econ. Research, Working Paper No. 14712, 2009); Daniel M. Covitz & Paul Harrison, Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate (Fed. Reserve Bd., Working Paper, 2003); Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 8 N.C. L. REV. 1011 (2009); Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* (Soc. Sci. Research Network, Working Paper No. 1027475, 2007), *available at* http://ssrn.com/abstract=1027475; Vasiliki Skreta &

recommend fairly strong regulatory medicine.[11] While this activity comes with a renewed vigor, it also comes against a long history of study concerning the CROs[12] and financial-market gatekeepers more generally,[13] much of which had already been fairly skeptical about those institutions.[14] Nevertheless, as recently as late 2007, influential observers still argued that CROs did not need oversight because they were already effectively regulated by market forces.[15]

Laura Veldkamp, Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation (Nat'l Bureau Econ. Research, Working Paper, 2009), *available at* www.nber.org/papers/w14761; Lawrence J. White, *Good Intentions Gone Awry: A Policy Analysis of the SEC's Regulation of the Bond Rating Industry* (N.Y. Univ. Law & Econs. Working Papers, Paper No. 69, 2006).

11. The best known suggestion is from Frank Partnoy's influential early article, which calls for removal of all regulatory reliance on the CROs' ratings, and instead recommends using market generated "credit spreads" as measures of risk. *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 704–07 (1999). Less-stark suggestions come in many varieties, usually calling for retention of the Nationally Recognized Statistical Rating Organization (NRSRO) designation, but with mandatory registration, some light oversight, and increased competition. *See, e.g.*, Hill, *supra* note 10; Rousseau, *supra* note 10; Manns, *supra* note 10. One interesting suggestion from a truly impressive student is to retain NRSRO but empower the SEC to issue nonbinding "writ[s] of review" to call on the CROs to revise any rating thought to have become inaccurate. *See* Francis A. Bottini, Jr., Comment, *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 SAN DIEGO L. REV. 579, 613 (1993).

12. Careful study of the CROs began as early as 1938. See GILBERT HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE: AN APPRAISAL OF THEIR EFFECTIVENESS (1938), for an example of one such study. Many other studies have been conducted by lawyers and other market watchers and will be considered *infra*. Economists have studied the CROs' performance as an empirical matter since the late 1950s. *See infra* note 101 and accompanying text.

13. A foundational paper on the subject attempted to put some institutional flesh on the bones of the efficient capital market hypothesis. *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). As Gilson and Kraakman observed, it is one thing to assert and empirically prove that markets price efficiently, but another to explain how they manage it. *See id.* at 550–53 (explaining that, while the efficient capital market hypothesis was widely accepted, there was an absence of a unified explanation of market efficiency at that time). Since then, voluminous literature in economics and law has studied the question both theoretically and empirically.

14. *See, e.g.*, JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006); Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269 (2003); Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035 (2003) (challenging the notion of securities analysts as independent gatekeepers while evaluating analysts' behavior and impact on market efficiency); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001).

15. *See* Posting of Joellen Perry to Real Time Economics, http://blogs.wsj.com/economics/2007/09/23/greenspan-slams-ratings-agencies (Sept. 23, 2007, 12:59 EST) (recounting media interviews with former Chairman Greenspan, in which he urged against regulation of CROs: "[CROs are] 'already regulated,' he says, because investors' loss of trust means the agencies are likely to lose business. 'There's no point regulating this. The horse is out of the barn, as we like to say.'"); Schwarcz, *supra* note 10,

The situation is not good. The debate has been, and should be, dominated by two policy concerns: whether private credit ratings improve capital-asset pricing efficiency, and whether they reduce systemic risk. At the moment, neither current events nor the extensive empirical literature on the CROs gives much reason for optimism as to either question. To whatever extent it may seem that private entities ordinarily need to not defend themselves on these grounds, the CROs must because they currently act as our main substitute for official supervision of significant aspects of financial markets.

However, the purpose of this Article is not to argue, as others have done and will do in the future, that the CROs have lacked oversight for too long or that their behavior has been suboptimal. This Article also does not urge any particular policy tweak to solve the industry's problems, although it is clear that a necessary (but not sufficient) step is removing regulatory reliance on the CROs. The Article will instead assert two more-general propositions. First, the industry in its current posture cannot be meaningfully regulated, despite the near-universal agreement that if it is to persist in its current quasi-governmental role, it must be regulated. Second, the industry's performance is likely to remain seriously disappointing under any conceivable change in policy or in an industry structure that still contemplates a major private role in formal assessment of credit risk. This will be shown in several ways. This Article will suggest reasons not to be too sanguine about any of the short-term regulatory solutions available at the moment, including legal and voluntary constraints currently in place and those that are currently pending before policymakers. The regulatory efforts that have recently been brought to bear on CROs are mainly structural tweaks and disclosure requirements meant to curtail conflicts of interest and increase CRO competition, which will not work. Controls were already in place to control conflicts and provide disclosure prior to the current economic catastrophe, and they have been shown to have been of no use. Likewise, while increased competition conceivably could improve the price competitiveness of ratings services, we will argue that it is unlikely to improve their quality. Indeed, all proposals so far suggested by academics and others, as well as a few developed in this Article, are fairly

at 15 (arguing that regulation of CROs is unnecessary because "the lack of official public scrutiny does not appear to affect ratings accuracy because of the de facto accountability of rating agencies through reputation"); *see also* Hill, *supra* note 10, at 44–45 (arguing that the need to protect "regulatory capital," the threat of potential competition, and the threat of potential regulation are all sufficient to ensure adequate CRO performance, and urging against new regulatory oversight); *id.* at 44 ("While the regime could be improved, it is certainly not in dire need of repair. Rating agencies certainly didn't do a spectacular job with Enron, but there is considerable evidence that in the normal course, they do a good, if not stellar, job.").

problematic, especially those that countenance some important continuing regulatory role for private, profit-making risk raters.

Ultimately, the CROs cannot be considered in isolation from the more fundamental problems of market intermediation, especially as it relates to financial innovation. On some level, debate about the CROs and how they should be regulated—and for that matter, debate about any informational intermediary—is somewhat superficial. The inherent problem of informational intermediation is basically one of industrial organization, and, as will be explained at length, it seems very thorny. No policy tool currently in force, and none of those with serious political feasibility, even comes close to dealing with it, and those more abstract proposals that might are both fairly politically implausible and raise serious problems of cost and uncertainty. The problem is not the CROs themselves nor the details of any regulatory policy set up to constrain their abuses, but rather the problem is a combination of factors inherent in the market for privately organized production of financial market information. Critically, we will stress that informational problems in financial markets would not simply resolve themselves if the government stopped relying on CRO ratings in its regulation of those markets. In short, the purpose of this Article is to argue that capital markets currently contain a much more serious institutional flaw than has been recognized.

I. THE RISE OF THE CROS

A. *How the CROs Came to Be*

Careful histories of the CROs exist, so this Article sets out only relevant background.[16] Coming up with credit ratings[17] is an old business, finding

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16. Among the best histories of the agencies are Frank Partnoy's influential article, *The Siskel and Ebert of Fiancial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 636–54 (1999), and Richard Sylla, *An Historical Primer on the Business of Credit Rating*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 19 (Richard M. Levich et al. eds., 2002), and, as to the industry's early history, a book on which other histories rely heavily, HAROLD, *supra* note 12. Also very good are COFFEE, *supra* note 14, at 283–314, SINCLAIR, *supra* note 5, at 22–49, and Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED. RES. BANK OF N.Y. Q. REV., Summer–Fall 1994, at 1.

17. A "credit rating" is an assessment of the likelihood that the issuer of a fixed income security will meet its obligations according to the terms of the security and in a timely manner. *See* Standard & Poor's, About Credit Ratings, http://www2.standardandpoors.com/aboutcreditratings (last visited June 14, 2009). CROs do not typically rate equity securities. The CROs predominantly rate (1) the general creditworthiness of particular issuers, and (2) publicly traded debt securities, preferred shares, and privately placed securities issued by structured finance issuers.

antecedents in the United States in the mid-nineteenth century.[18] It has remained a predominantly American phenomenon, not only because of the American ratings firms' size and competitive advantages, but because until recently, U.S. capital markets were quite different than those overseas.[19] In any case, the two dominant U.S. CROs, Moody's Investors Services (Moody's)[20] and Standard & Poor's Ratings Services (S&P),[21] currently face meaningful competition only from a third and much smaller U.S.-based firm, Fitch Ratings (Fitch).[22] The number of large, general-purpose

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18. "Mercantile" credit rating agencies reported on merchant creditworthiness as early as the 1840s. Several of them later combined to form what is now Dun & Bradstreet. Other forms of widely disseminated, financial-data publications began at about the same time. *See* Partnoy, *supra* note 11, at 636–37. But, as Sinclair observes, the CROs began to take their modern form only in 1909, when John Moody first began issuing ratings that actually made judgments about creditworthiness. Sinclair says the transition to this process of informed appraisal was a response to the financial panic of 1907. Overall, Sinclair describes this period—from the mid-nineteenth century to about World War I—as an "information explosion" in American finance. *See* SINCLAIR, *supra* note 5, at 23–24. Moody claimed to have taken his model from a predecessor in Austria, but no trace of it has been found. *Id.* at 24 n.11. Thus, the business of systematic risk assessment of debt securities appears to have an American origin.

19. In fact, for the most part, borrowing from capital markets rather than banks was itself essentially an American practice until the 1960s. Though government-issuer bond markets have existed since the early seventeenth century, corporate bond markets only emerged around 1850 in the United States, with the need to finance the expanding railroads. *See* Sylla, *supra* note 16, at 22–24. White speculates that the dominance of bank lending in most other places may reflect their smaller geographic size, allowing for better borrower oversight through branching. *See* White, *supra* note 5, at 58 n.21.

20. Moody's currently exists as a publicly traded holding company, Moody's Corporation, which provides credit rating services through its subsidiary Moody's Investors Service. A separate subsidiary, Moody's Analytics, sells various nonratings services. John Moody was not the first to publish reports on corporate creditworthiness, nor was he even the first to systematize bond ratings into simple symbols, but he was the first to establish it as a going business. Interestingly, he also aspired to muckraking journalism and public service generally, and wrote a treatise on abuse and power on Wall Street that is still read today. *See* SINCLAIR, *supra* note 5, at 6 (discussing John Moody, *The Masters of Capital: A Chronicle of Wall Street*, *in* 22 GREAT LEADERS IN BUSINESS AND POLITICS: THE CHRONICLES OF AMERICA SERIES 1 (Allen Johnson ed., 1919)); SINCLAIR, *supra* note 5, at 23–24 (laying out early history of the Moody's enterprise). John Moody's original business was acquired by Dun & Bradstreet in 1962 and was spun off in late 2000. It has remained a freestanding publicly traded corporation ever since. *See* Moody's Corp., Annual Report (Form 10-K), at 1–2 (Feb. 29, 2008), http://sec.edgar-online.com/moodys-corp-de/10-k-annual-report/2008/02/29/Section1.aspx [hereinafter 2007 Annual Report Form 10-K].

21. S&P arose from the 1941 merger of the Standard Statistics Bureau and Poor's Publishing, but both companies had been in the business of securities analysis long before that. Poor's published financial data since Henry Varnum Poor's 1860 publication of *History of Railroads and Canals in the United States.* S&P's debt-rating business began in 1916 when Standard began publishing them. S&P has been a subsidiary of the McGraw–Hill publishing enterprise since 1966. *See* Standard & Poor's, Company History, http://www2.standardandpoors.com (follow "Company History" hyperlink in "About S&P" drop-down menu) (last visited July 28, 2009).

22. Since 1997 Fitch has been wholly owned by a French holding company, Fimilac, S.A. Until 2006, Fimilac had been diversified in a range of manufacturing businesses but

ratings firms has mainly fluctuated between three and five throughout the industry's entire history,[23] though many smaller CROs exist around the world.[24]

The history of the CROs cannot be understood apart from their relation to various governments. Since 1936 the U.S. government has imposed requirements on financial institutions and investment managers that prospectively incorporated CRO ratings into investment rules. Similar state requirements quickly followed.[25] While this regulatory partnership plainly aided the CROs financially, the number and effect of the regulatory incorporations blossomed in the early 1970s with the Securities and Exchange Commission's (SEC's) decision to make special regulatory use of ratings in setting capital requirements for securities firms. Thus arose the SEC's now-familiar "Nationally Recognized Statistical Rating Organization" (NRSRO) designation.[26] Since then scores of federal and

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has now divested all but Fitch and a related firm, the Toronto-based risk-management outfit Algorithmics. The History of Fitch Ratings, http://www.fitchratings.com/jsp/corporate/AboutFitch.faces?context=1&detail=3 (last visited July 28, 2009) (providing a brief history of the foundation and reorganization of Fitch). Fitch's predecessor was founded as an independent publishing firm in New York in 1913 and issued its first bond ratings in 1924. *See* Partnoy, *supra* note 11, at 639 (recalling Fitch's entry into the bond rating market)

23. *See* White, *supra* note 10, at 1–2 (discussing the historical dominance of a select group of rating firms). At times some other nontrivial competitors have flourished, and there remain a few firms with significant roles in niche ratings specialties. *Id.* at 2. Specifically, A.M. Best Company persists as a rater of insurance companies and was given limited NRSRO designation in 2005 to rate their likelihood of paying claims. *See* A.M. Best Co., Inc., SEC No-Action Letter, 2005 WL 678,901 (Mar. 3, 2005), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/am030305.htm. (granting tentative, limited authority). Prior to their acquisition by Fitch in 2000, the English firm IBCA and the Canadian firm Thomson BankWatch had enjoyed a long history as raters of banks and financial institutions. *See* The History of Fitch Ratings, http://www.fitchratings.com/jsp/corporate/AboutFitch.faces?context=1&detail=3 (last visited July 28, 2009) (commenting on the postmerger proliferation of Fitch Ratings).

24. As of September 1999, the Bank for International Settlements identified as many as 130 CROs worldwide. *See* Arturo Estrella et al., *Credit Ratings and Complementary Sources of Credit Quality Information* 14 (Basel Comm. on Banking Supervision, Working Paper No. 3, 2000), *available at* http://www.bis.org/publ/bcbs_wp3.pdf (conservatively estimating the total number of rating agencies, but indicating that that number could be as high as 150).

25. Beginning in 1931 with an explicit capital requirement for federal banks imposed by the Comptroller of the Currency, the federal government began "incorporating credit ratings into substantive regulations." *See* Partnoy, *supra* note 10, at 70 (arguing that implementation of credit ratings as a means for determining the caliber of bank holdings created a high-demand market for ratings agencies).

Since the mid-twentieth century state regulators of banking and insurance have used bond ratings in capital adequacy regulation. *See* THOMAS R. ATKINSON, TRENDS IN CORPORATE BOND QUALITY 52–53 (1967) (noting the 1949 adoption by National Association of Supervisors of State Banks and the 1951 adoption by National Association of Insurance Commissioners).

26. This designation has been one significant barrier preventing competitive entry into

state laws have come to incorporate NRSRO ratings,[27] and CROs have also been given other regulatory advantages.[28] Similar use of ratings has been made by courts,[29] investment-fund designers,[30] other private parties,[31] and increasingly by foreign governments.[32]

The history likewise cannot be understood without some attention to the revolution that appears to have surrounded an unexpected liquidity crisis in

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the CRO market (and we will make the case that there have been others). In 1973, the SEC adopted a rule requiring that certain regulated securities firms' minimum capital reserves be calculated by using different "haircuts" for securities with specific NRSRO ratings. *See* SEC, *supra* note 3, at 6. As White observes, U.S. regulators had long incorporated ratings in various ways, but prior to 1975, regulators generally referred only to "recognized ratings manuals." It was only in the SEC's regulation of 1975 that specific firms were identified whose ratings must be used. *See* White, *supra* note 10, at 3–6 (inferring that the pre-1975 language was nonetheless "probably understood to mean Moody's, S&P, and Fitch"). The SEC's move may have reflected the CROs' then-recent switch to the "issuer-pays" business model. *But see id.* at 3–4 (offering an opposing rationale for the switch). Given that model, the use of ratings in regulation would create a greater risk of unscrupulous raters selling investment-grade ratings to any issuer willing to pay. *See id.* at 6–7 (noting that because the new SEC rule essentially guaranteed demand for ratings, the newly designated NRSRO had little motivation to improve the quality of their product). *See generally* Partnoy, *supra* note 11, at 690–91 (citing 17 C.F.R. § 240.15c3-1 (1998) (discussing the promulgation of SEC Rule 15c3-1 and the "cascade of regulation" that followed)).

27. As of 2002, the NRSRO concept was explicitly incorporated in eight federal statutes and sixty federal regulations, mostly in banking and securities regulation. *See* Partnoy, *supra* note 11, at 74–75. Partnoy also notes that, if anything, CROs enjoy even more influence through the informal use that state and federal regulators make of the NRSRO concept in the many orders, releases, and letters of their day-to-day business. *Id.* at 75.

28. Notably, the CROs are explicitly exempted from the Regulation Fair Disclosure (FD) ban on selective disclosure of material nonpublic information, and are sometimes privy to such information when making their ratings. *See* Regulation FD, 17 C.F.R. § 243.100(b)(2)(iii) (2008) (making disclosure requirements inapplicable "[t]o an entity whose primary business is the issuance of credit ratings"). While material nonpublic information could theoretically increase the accuracy of ratings, the CROs claim they can produce accurate ratings without this special dispensation.

29. Since the early twentieth century, courts considering fiduciary litigation against trustees and other investment managers found investment in highly rated instruments to weigh in favor of the fiduciary. *See* Partnoy, *supra* note 11, at 640–41 (providing a brief survey of cases from the 1920s and 1930s that utilized ratings to determine liability).

30. Since at least the early 1930s, many trusts and other institutional investors have explicitly limited their managers' investments by reference to CROs' ratings. *See id*. at 644 (discussing early use of ratings to craft principles).

31. Explicit references to CROs' ratings, often using the NRSRO designation, have been included in an unknown but unquestionably massive number of private contracts and financial instruments. Typically those terms provide that in the event of an NRSRO downgrade of a party to the transaction or some instrument that underlies it, certain consequences follow, such as constructive default or accelerated repayment. *See* Partnoy, *supra* note 11, at 676–81 (explaining the operation of CRO ratings in the credit derivatives market).

32. The CROs enjoy some overseas regulatory benefits with the incorporation of U.S. NRSRO ratings in the laws of other countries, and with the gradual implementation of the Basel II External Credit Assessment Institution initiative. *See supra* note 5 (summarizing the impact of foreign regulations on CROs).

1970,[33] prior to which U.S. corporate debt markets had performed well.[34] The calamity of 1970 happened to roughly coincide with certain worldwide monetary changes.[35] The major consequence for the CROs would turn out to be a very profitable change in their business model. Apparently to take advantage of a substantial increase in demand for analytical risk intermediation, the major CROs each, within the space of a few years, switched from selling subscriptions to the so-called issuer-pays model: when one of the major CROs rates an issuer or its debt securities, *the issuer almost always pays for the rating that is issued.*[36]

By all accounts, the worldwide CRO industry is a massive duopoly,[37] and given the so-called two-ratings norm—most issuers seek the ratings of both Moody's and S&P, even though they are not required to do so—[38]

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33. In a well-known story, the Penn Central Railroad unexpectedly defaulted on $82 million in commercial paper in 1970, which was followed by other short-term defaults and a general short-term liquidity crisis. *See* White, *supra* note 5, at 47 (characterizing the defaults as "a defining moment that has focused both issuers and investors on the risks of such issuances").

34. In what remains the most comprehensive study of U.S. corporate bond performance, National Bureau of Economic Research (NBER) economist Braddock Hickman found that during the first half of the twentieth century investors in U.S. bonds enjoyed a net loss rate of almost exactly zero—a result Hickman called "a tribute to the ability of domestic business corporations to service their long-term obligations . . . ." W. BRADDOCK HICKMAN, CORPORATE BOND QUALITY AND INVESTOR EXPERIENCE 7–8 (1958) [hereinafter HICKMAN, INVESTOR EXPERIENCE]. By "zero net loss," Hickman meant that the overall capital gains earned by increasing bond prices in secondary trading almost exactly set off losses from defaults. *Id.* Sylla expresses some doubts as to Hickman's optimism. As he observes, on the basis of his own work, U.S. interest rates began at an already low rate in 1900 and gradually declined throughout the period of Hickman's data to near all-time lows around the end of World War II. He says that this "trend may account for a good part of the capital gains on bonds that offset losses from defaults." Sylla, *supra* note 16, at 26.

Hickman's work appeared in three separate volumes. W. BRADDOCK HICKMAN, STATISTICAL MEASURES OF CORPORATE BOND FINANCING SINCE 1900 (1960); W. BRADDOCK HICKMAN, CORPORATE BOND QUALITY AND INVESTOR EXPERIENCE (1958); W. BRADDOCK HICKMAN, THE VOLUME OF CORPORATE BOND FINANCING SINCE 1900 (1953).

35. As will be discussed, the late 1960s and early 1970s saw a significant increase in exchange and interest-rate volatility associated with the breakdown of the Bretton Woods monetary system. Certain new trends arose in innovative, experimental financial products that were meant to help firms smooth their risks in part to address that new volatility. *See infra* notes 74–75 and accompanying text (discussing the development of the novel practices).

36. White argues, by contrast, that this transition merely reflected the rise of low-cost photocopying, which posed a free-rider problem for the rating firms, which they attempted to avert by switching to the issuer-pays model. *See* White, *supra* note 10, at 3–4.

37. As of 2006, Moody's and S&P had 80% of the market as measured by revenue, but they rated as much as 99% of publicly traded debt issues and preferred stock in the United States. *See* S. REP. NO. 109-326, at 4 (2006), *reprinted in* 2006 U.S.C.C.A.N. 865. In fact, an early version of CRARA was titled the "Credit Rating Agency Duopoly Relief Act of 2005." H.R. 2990, 109th Cong. (2005).

38. Issuers obtain both ratings in part because some of the regulatory and private-contract provisions requiring investment in rated securities require that an issue receive a minimum rating from two NRSROs. However, even though most regulatory rating

some observers characterize them as a "partner monopoly."[39] They also retain unrivaled dominance overseas.[40] While several new foreign agencies have risen, they frequently have operating partnership arrangements with the U.S. firms or are owned by them. Such independent agencies mostly remain small, and in some cases there is reason to doubt their independence and veracity. Again, as it does here in the United States, Fitch holds a fairly distant third-place position overseas. The dominance of the major CROs likely has more than one cause. It is frequently explained by the NRSRO designation and the need of most institutional investors for NRSRO-rated securities. But it seems likely that even if NRSRO rules were to be repealed, entry now would be severely impeded by the need to establish reputation as a seasoned CRO.[41] The privilege of duopoly has been very profitable.[42]

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requirements do not call for more than one rating, the vast majority of issuers voluntarily acquire ratings from both Moody's and S&P anyway. *See* Richard Cantor & Frank Packer, *Multiple Ratings and Credit Standards: Differences of Opinion in the Credit Rating Industry*, FED. RES. BANK OF N.Y. STAFF REP., Apr. 1996, at 3–6, *available at* http://www.newyorkfed.org/research/staff_reports/sr12.pdf (explaining the prevalence of issuers acquiring both Moody's and S&P ratings).

39. One important entity that characterized the situation as a partner monopoly is the Antitrust Division of the U.S. Department of Justice. *See* Jonathan R. Laing, *Failing Grade*, BARRON'S, Dec. 24, 2007, at 19, 20 (alluding to the designation of "partner monopoly" used by unnamed Justice Department staffers).

40. Moody's and S&P both cover European bond ratings extensively, and have extensive coverage in Latin America and Asia, although S&P is more dominant in the former and Moody's is more dominant in the latter. White, *supra* note 5, at 44–45.

41. Partnoy observes that entry costs appear to have been quite low in the industry's early years, as the process of analyzing even a large amount of publicly available financial data should not, in principle, entail extraordinary costs or sunk investment, or pose regulatory hurdles. *See* Partnoy, *supra* note 11, at 636–40 (asserting that low overhead costs and ease of entry allowed agencies the ability to quickly gain—or lose—"reputational capital"). Times now seem significantly different.

42. In 2006 Moody's earned $1.1 billion on only $2 billion in revenue, and until recently, Moody's operating margins ran typically to more than 50% per year. Laing, *supra* note 39, at 20. Evidence for prior years is comparable. *See* White, *supra* note 5, at 49 (reporting that for the years 1995 to 2000 Moody's average after-tax net income was 42%). Though S&P's performance results are not as publicly available, it stands to reason that its performance has been similar. The two firms have long enjoyed comparable market shares and have near-identical pricing structures. These results are often taken to reflect the privilege of NRSRO status, as their performance and pricing structure are hard to explain without some strong assumption of market power associated with regulatory rules. As White observes, Moody's and S&P impose almost identical, flat-fee structures that are keyed to the size of the issues under review. Both firms offer discounts for repeat business, though the details of those discounts have not been made public. *See id.* at 47–48 (asserting that although Moody's and S&P automatically rate "all[] SEC-registered corporate bonds," an overwhelming majority of issuers pay for the service, allowing the agencies to set lower fees). He argues at length that their fee structure is best explained as the result of a substantial amount of market power, unconstrained by even potential entry.

White points out a certain mystery surrounding the CROs' pricing and coverage behavior. Given the apparently rigid two-ratings norm, each major may have fairly little to fear from unilateral price increases. *See supra* notes 37–38, 41 and accompanying text

There is reason to expect that Moody's and S&P could still command substantial market share even without the NRSRO designation because of the two-ratings norm, and because of the periods prior to the dominance of NRSRO in which ratings from the majors severely constrained access to debt markets.[43] These facts are theoretically somewhat difficult to explain. Many have claimed that some part of the explanation is due to the substantive value issuers find in ratings,[44] though that in itself seems unlikely to explain their massive, sustained profits.

The CROs earn their revenues overwhelmingly from issuer-pays ratings fees.[45] CRO reform proposals sometimes suggest abolishing the issuer-pays model and frequently call for repeal of the NRSRO concept, which might drastically reduce demand for issuer-paid ratings. The CROs probably could not persist at their current scale of operations without the issuer-pays model, and may not survive its loss. Securities research is difficult to support on subscription fees alone, which is shown by the decline in the equity-securities analysis field since its major scandal a few years ago,[46] by the financial difficulties suffered by the CROs themselves

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(discussing the causes and likely continuation of Moody's and S&P dominance). On these facts they ought to be able jointly to raise profits by reducing output. White considers this a "puzzle to which we can only supply some partially satisfactory answers." *See* White, *supra* note 5, at 48 (addressing, but ultimately not adopting, four possible explanations for the status quo of the firms' pricing parity).

43. A credit crunch in 1974 and 1975 foreclosed many issuers from bond markets entirely if they could not secure high investment-grade ratings. The crunch seems to have reflected the liquidity tightening following the Penn Central default in 1970 and the generally difficult circumstances of the early 1970s. *See* Marilyn Much, *The Rating Game: When Baa Spells Bah*, INDUSTRY WK., Jan. 8, 1979, at 44 (describing the condition of the credit markets in the 1970s).

44. *See, e.g.*, Hill, *supra* note 10, at 64–90 (arguing that the two-ratings norm is perpetuated not by issuers seeking "favorable regulatory treatment," but by the informational value provided by the ratings of Moody's and S&P).

45. While most CROs sell products other than the ratings they provide (e.g., most produce various periodicals, sell subscriptions, consulting services, nonratings analytical software, and the like), the CROs earn almost all of their revenues from ratings fees charged to the rated issuers. Partnoy, *supra* note 11, at 652 n.162 and accompanying text.

46. At one time, most major investment banks and brokerages employed in-house securities analysts, as they found them to be profitable adjuncts to their other businesses. The analysts were heavily subsidized by those other business units—as was necessarily the case because their analysis was distributed free to firm clients—but when legal intervention by the SEC and the New York Attorney General famously forced the banks to disentangle and isolate their analysts from conflicts of interest, those departments quickly shriveled. The business of securities analysis is now a shadow of what it was during that period, such that proposals are now being made to prop it up with subsidies of various kinds. *See* COFFEE, *supra* note 14, at 245–73 (discussing the rise of firm use of in-house analysts and the likely causes of its decline); Choi & Fisch, *supra* note 14, at 312 (noting the downturn in the number of analysts employed by financial firms during the early 2000s); John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. U. L. REV. 1, 26–77 (2003) (recounting at length regulatory intervention in the industry and its drawbacks, and suggesting an SEC "warning label" on

during the 1940s, 1950s, and 1960s, before the adoption of issuer-pays,[47] and by the fact that only relatively small CROs currently operate on subscription fees. This is probably because securities research is expensive,[48] and because on even a semi-strong efficient-markets assumption, it should be difficult to extract sufficient subscription revenues.[49]

Finally, the CROs have been the focus of unceasing criticism that seriously calls into question policymakers' reliance upon credit ratings. There have been two central themes: (1) doubt that ratings add new information sufficient to justify their cost, and (2) alarm over their failure to predict financial distress involving companies that they rate. We will explore the former in detail later,[50] though it is worth noting that as far back as 1938, observers questioned the value of ratings.[51] As to the latter, catastrophic failures of CRO predictions go back thirty years or so and include several types of debt, beginning with the failure to predict the massive bond defaults by New York City in 1975 and the default by the Washington Public Power Supply System in 1983.[52] They also failed to predict several massive derivatives-related losses, which literally spanned the 1990s, [53] the Asian currency crisis that followed a few years later,[54] and

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securities analysis as an alternative).

47. *See* Partnoy, *supra* note 11, at 646–47 (recounting the effect of a relatively stable bond market on the demand for ratings); Richard House, *Ratings Trouble*, INSTITUTIONAL INVESTOR, Oct. 1995, at 245 (commenting that the adoption of issuer-pays has caused a "major schism in the industry").

48. *See* Orcutt, *supra* note 46, at 16 & nn.70–71 (citing Kent L. Womack, *Do Brokerage Analysts' Recommendations Have Investment Value?*, 51 J. FIN. 137, 138 (1996)) (noting the substantial costs to investment banks).

49. Assuming, as the semi-strong position does, that securities prices reflect all publicly available information, then as soon as a CRO distributes analysis to a few subscribers, the information should be reflected in bond and stock markets. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 404–09 (1970) (evaluating studies on stock splits and earnings reports to explain the semi-strong form theory underlying the efficient-markets hypothesis and ultimately concluding that the theory has the highest potential for future empirical use). Therefore most investors will not have much incentive to pay CRO subscription fees—any gains to be made on the basis of CRO recommendations should be captured too quickly for most investors to exploit.

50. *See infra* Part III (addressing the missing theoretical basis for both CROs and the potential for added value in ratings).

51. *See generally* HAROLD, *supra* note 12 (examining the already widespread and vital role bond ratings played in investment decisionmaking during the early twentieth century).

52. *See* Bottini, *supra* note 11, at 584–87 (summarizing the criticisms of Moody's and S&P's perceived slow responses to the numerous red flags preceding the two major bond defaults).

53. The highest profile losses of this period were (1) Gibson Greetings, Inc.'s $16.7 million loss and Proctor & Gamble's $157 million loss, both involving complex interest-rate derivatives traded with Bankers Trust; (2) the $2.5 billion loss suffered by Orange County, California on several complex derivatives arrangements with Merrill Lynch and other banks; and (3) the $1.5 billion loss suffered by Barings Bank as a result of the trading

the corporate collapses of the early twenty-first century.[55] Their role in the current credit crisis is better characterized as active complicity, as they helped create the market for subprime residential mortgage-backed securities (RMBS) and related derivative products.[56] This did not stop until these markets collapsed all at once, on the day when Moody's and S&P simultaneously downgraded large numbers of subprime structured bonds, the day now known as "Pearl Harbor Day."[57]

B. *How They Do What They Do*

The standard rating process has been recounted extensively elsewhere,[58]

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activity of a twenty-seven-year-old trader named Nick Leeson. *See generally* FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 49–53, 112–115 (2003) (providing an in-depth explanation of Gibson Greetings' losses); SINCLAIR, *supra* note 5, at 157–60 (recalling the failed investment portfolio of Orange County Treasurer Robert L. Citron and the unsuccessful lawsuit the County brought against S&P); Lynn A. Stout, *Betting the Bank: How Derivatives Trading Under Conditions of Uncertainty Can Increase Risks and Erode Returns in Financial Markets*, 21 J. CORP. L. 53, 53–54 (1995) (discussing the substantial losses sustained by Proctor & Gamble and Barings).

54. This crisis has been attributed in large part to derivative instruments that attempted arbitrage against the currency of Thailand, which for some years had been arbitrarily maintained by that country's central bank. *See* SINCLAIR, *supra* note 5, at 160–67 (detailing the two stages of the 1997 Asian financial crisis and the wave of criticism directed at the major rating agencies).

55. *See id.* at 167–72 (discussing the 2001 Enron bankruptcy, ensuing legislation, and inquiries into additional SEC oversight of NRSROs).

56. Structured securities are deliberately designed so that some portion of the securities issued by any structured entity will enjoy the highest or a very high investment-grade rating. This fact drove the intense demand of institutional investors for structured securities with the riskiest underlying collateral because top-tranche bonds pay regularly and typically at a rate higher than other similarly rated bonds. Further, they satisfy the requirement of many institutional investors to purchase mainly investment-grade instruments. CROs helped securitizers to prearrange securitizations by selling consulting services to ensure highest possible ratings for top-tranche securities, and even helped repackage parts of the lowest rated tranches into new securitizations, turning a significant portion of them into highly rated derivatives. *See generally* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008) (critiquing the legal bases of securitization and providing a comprehensive study of its prevalence). Structured finance ratings were by far the CROs most profitable business for many years. *See infra* note 108 (noting the 2002–2006 revenue). They were also the most plagued with conflicts of interest, and they bore a frightening resemblance to those in the accounting industry prior to its collapse, when firms like Arthur Andersen were selling management consulting services to firms they audited.

57. On that day, July 10, 2007, Moody's and S&P simultaneously announced credit downgrades as to $20 billion worth of subprime mortgage-backed bonds. *See* Laing, *supra*, note 39, at 19 (describing the onset of a series of downgrades). No less than a month later, SEC staff launched a formal investigation pursuant to statutory authority, and it is perhaps a sign of changing times that the three major CROs complied so fully in the investigation, producing millions of pages of internal documents, communications, and e-mails. *See generally* SEC 2008 STAFF REPORT, *supra* note 3.

58. *See, e.g.*, YARON ERNST, MOODY'S INVESTORS SERV., THE COMBINED USE OF

and an outline of the process has been disclosed by the CROs in publicly accessible documents.[59] In the broadest terms, it resembles the judgments lenders ordinarily make about the creditworthiness of their counterparties,[60] though in many cases CRO procedures contain internal controls and appeal opportunities for issuers.[61] Accordingly, if the CROs really do possess some genuine comparative advantage, it is likely not in the substance of their rating methodologies. Theoretical approaches to credit risk assessment are extensively studied by academics and other professionals,[62] and a substantial body of empirical evidence shows that credit ratings can largely be predicted on the basis of simple financial ratios generated from

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QUALITATIVE ANALYSIS AND STATISTICAL MODELS IN THE RATING OF SECURITISATIONS 6–8 (2001), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/20/2001200000348392.pdf (providing an overview of the qualitative and quantitative analyses employed by Moody's); BIS STRUCTURED FINANCE REPORT, *supra* note 5, at 14–16 (contrasting components of the rating process for bonds with that of structured finance products); SEC 2008 STAFF REPORT, *supra* note 3, at 7–10; Partnoy, *supra* note 11, at 651–52; *Hearing on Credit Rating Agencies Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 5–8 (2008) (testimony of Raymond W. McDaniel, Chairman & Chief Executive Officer, Moody's Corporation) [hereinafter *McDaniel Testimony*] (outlining Moody's credit rating process).

59. *See, e.g.*, MOODY'S INVESTORS SERV., UNDERSTANDING MOODY'S CORPORATE BOND RATINGS AND RATING PROCESS (2002), *available* at http://v2.moodys.com/moodys/cust/research/MDCdocs/06/2001400000389218.pdf; JAY SIEGEL, MOODY'S INVESTORS SERV., MOODY'S MORTGAGE METRICS: A MODEL ANALYSIS OF RESIDENTIAL MORTGAGE POOLS (2003), *available at* http://v2.moodys.com/cust/content/Content.ashx?source=StaticContent/Free%20Pages/Products%20and%20Services/Downloadable%20Files/m3%20special%20report.pdf; STANDARD & POOR'S FIN. SERVS., GUIDE TO CREDIT RATING ESSENTIALS (2009), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/SP_CreditRatingsGuide.pdf.

The precise process each CRO uses is proprietary and its details are typically kept secret. *See* SINCLAIR, *supra* note 5, at 33–34 (stating that not only are the criteria important to the CRO, but also that publishing criteria would distort expectation among issuers); Partnoy, *supra* note 10, at 73 (noting the unexpected nature of the CROs' secretive and qualitative process).

60. *See* Partnoy, *supra* note 11, at 651 (noting that "the process agencies use today to generate ratings does not provide any obvious advantages over those used by competing information providers and analysts").

61. Initially, a lead analyst assigned to the given issue or issuer undertakes both a quantitative and qualitative analysis of the default risk posed, including, as a major component, quantitative credit-risk modeling. The analyst then presents a proposed rating for a vote to a "ratings committee," which is composed of other analytical staff. After the committee has decided on a rating, the issuer can review it before the rating is published. If the issuer feels the rating is based on incorrect information, the issuer may disagree with the rating and appeal to the committee to change it. This appeal will not necessarily be granted. Some CROs allow issuers to veto the release of the rating. *See Who Rates the Raters?*, ECONOMIST, Mar. 26, 2005, at 68. Once a final rating has been settled on, it is published and subsequently monitored. *See generally McDaniel Testimony*, *supra* note 58, at 5–8; SEC 2008 STAFF REPORT, *supra* note 3, at 9.

62. *See* Til Schuermann, *A Review of Recent Books on Credit Risk*, 20 J. APPLIED ECONOMETRICS 123 (2005) (surveying literature discussing the diverse set of issues surrounding credit risk).

publicly available data.[63] In any case, ratings fees are typically negotiated up front and include break-up fees should the issuer ultimately choose not to have the rating issued by that particular CRO.[64]

The process for rating structured products, such as mortgage-backed securities (MBSs), is somewhat more involved, and has posed special problems.[65] Issuers approach CROs with pools of asset-backed securities (ABSs) to be rated, typically having prestructured them using software that the CROs themselves create and sell to ensure a desired rating for the highest tranches in the pool.[66] The arranger then indicates its desired target rating and discusses with the CRO how the pool's structure may be adjusted to achieve that rating.[67] Quantitative factors considered include the degree of credit enhancements in the pool[68] and the historical performance of similar assets created by the originators.[69] The qualitative

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63. *See infra* note 102 and accompanying text.

64. BIS STRUCTURED FINANCE REPORT, *supra* note 5, at 14; SEC 2008 STAFF REPORT, *supra* note 3, at 9 (stating that rating agencies may not receive payment if no rating is eventually published).

65. Rating other structured products, such as collateralized debt obligations (CDOs), is similar. When CDOs are rated the only assets investigated are the MBS and not their underlying asset pools. Because CDOs are actively managed, their composition changes over time. Thus, CDO ratings are not based on pool composition, but rather on the covenanted limits for each asset the CDO can hold. SEC 2008 STAFF REPORT, *supra* note 3, at 9. One of the puzzling aspects of CDO ratings is how analysts believed they could provide accurate ratings without investigating the assets underlying the ABS in the CDO. Indeed, some smaller CROs refused to rate CDOs because their composition made little sense.

66. *See McDaniel Testimony*, *supra* note 58, at 12 (explaining Moody's role in the mortgage securitization process); SEC 2008 STAFF REPORT, *supra* note 3, at 8 (examining the steps analysts take when rating securitized mortgages).

Thus, for example, if the preliminary rating is based on the pool's structure, the arranger may restructure the pool to ensure the highest possible rating. The majority of adjustments that have to be made to the pool to achieve an investment-grade rating, however, take place in the initial back-and-forth between the CRO and the issuer or via use of CRO software. BIS STRUCTURED FINANCE REPORT, *supra* note 5, at 26.

67. BIS STRUCTURED FINANCE REPORT, *supra* note 5, at 26. Importantly, the conflicts of interest that arise when a CRO sells advice on structuring a product to improve its rating and then rates that same product are almost identical to the conflicts of interest that plagued accounting firms at the turn of the century. In fact, the conflicts inherent in accounting firms selling management consulting services to a corporation and then auditing that same corporation are often cited as a root cause of the failure of the largest accounting firms and their largest clients. The primary difference between the two is that the CROs have not failed due to their behavior, even though their structured finance ratings did.

68. Credit enhancements may take a number of forms. For example, they could include an originator guaranteeing portions of losses in certain tranches or insurance companies insuring against some losses.

69. *McDaniel Testimony*, *supra* note 58, at 6. One wonders how this was possible with some new and innovative assets, such as pay-option adjustable-rate mortgages, securitizations of which grew from $1.8 billion in 2002 to $154 billion in 2005. AMITA SHRIVASTAVA & TODD SWANSON, MOODY'S INVESTORS SERV., RATING U.S. OPTION ARM RMBS—MOODY'S UPDATED RATING APPROACH 2, fig. 1 (2007), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/04/2006800000450911.pdf.

factors considered also differ in the structured context and have caused concern.[70]

II. THE ENTANGLED GROWTH OF INNOVATION, DISINTERMEDIATION, AND DEREGULATION

The fate of the CROs, in some part by their own doing, has been bound up with two significant developments in recent history: (1) the evolution of new financial products, a process commonly called financial innovation, and (2) the process of disintermediation, which is the gradual transition from indirect investment through bank deposits to direct investment in securities, with a resulting erosion of the buffer that once existed between investors and borrowers. Innovation and disintermediation have been central to the CROs' very profitable business model of the past few decades because as products grow both more opaque and increasingly

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The main quantitative inputs into each agency's ratings methodology are the probability of default of individual obligors in the pool, recovery rates or losses given default, and default correlations within the pool. Default correlations deal with systematic risk and reflect the sensitivity of probabilities of default to common factors. Modeling default correlations is an analytical challenge for most CROs. BIS STRUCTURED FINANCE REPORT, *supra* note 5, at 17, 30. With regard to the default correlations among MBSs, the high rates of home-loan refinance instead of default from the late 1990s through 2006 may have hidden the default correlation of mortgage loans.

70. Theoretically, the CROs considered three primary qualitative factors: (1) the "bankruptcy remoteness" of the entity holding the assets from the firm that originally contributed them to the holder; (2) the quality of the management of the issuer and the services provided by the entity that services the loan (including factors such as the origination process and the comprehensiveness of loan underwriting); and (3) the integrity of the legal structure of the underlying assets. *McDaniel Testimony*, *supra* note 58, at 6. *See* ERNST, *supra* note 58, at 6 (discussing the benefits of qualitative analysis in obtaining accurate results); BIS STRUCTURED FINANCE REPORT, *supra* note 5, at 16–21 (discussing structured finance rating methodology).

There is reason to doubt that these qualitative considerations were seriously undertaken. The CROs' analysis of bankruptcy remoteness has been severely criticized. *See generally* Kettering, *supra* note 56, at 1671–1710 (criticizing CROs for their "too big to fail" mentality). Likewise, for legal judgments about the underlying assets the CROs have acknowledged that they relied on the arrangers' own "representations and warranties," despite their own recognition that those representations were suspect. *See McDaniel Testimony*, *supra* note 58, at 13; *see also* MARJAN RIGGI, MOODY'S INVESTORS SERV., THE IMPORTANCE OF REPRESENTATIONS AND WARRANTIES IN RMBS TRANSACTIONS 1 (2005), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/14/2003000000447014.pdf (stating that representations and warranties only provide a "small but important" loss protection). This happened despite groups within CROs that could have taken on this task (for example, the corporate finance group at Moody's qualitatively analyzes, among other things, business strategy and management quality) and had loan-level information on factors such as the level of documented borrower income, and the CROs could have required issuers to provide audits of the underlying assets. *See* KRUTI MUNI & DEEPIKA KOTHARI, MOODY'S INVESTOR SERV., MOODY'S APPROACH TO CODING SUBPRIME RESIDENTIAL MORTGAGE DOCUMENTATION PROGRAMS: UPDATED METHODOLOGY 1 (2006), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/28/2006200000425098.pdf.

available to investors that lack strong, in-house analytic capabilities, regulators and investors rely more and more on the advice of analytical intermediaries.[71] These two developments in turn have taken place against the background of another possibly epochal trend, the deregulation of the U.S. and international financial sectors and the voluntary migration of private assets to less-regulated sectors of the economy.[72] Not coincidentally, these are all implicated in the present financial crisis,[73] and for that reason most observers place the three major CROs at or near its center.

First, it seems acknowledged that a wave of creative new financial products began not all that long ago, and that it continues.[74] It is ordinarily said to have begun in response to increased exchange and interest rate volatility associated with the collapse of the Bretton Woods monetary system in the late 1960s and early 1970s.[75] As market participants faced new uncertainties, they sought both to hedge against them and to profit from them speculatively. Some have raised the fairly undertheorized suggestion that this trend is in some way "new," not just in the number or complexity of transactions, but in their substance.[76] But even if the change

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71. Moody's, for example, in its recent annual report for shareholders, predicts that "innovation and disintermediation will slow as capital market participants adjust to the recent poor performance of some structured finance asset classes," but "believes that the overall long-term outlook remains favorable." Moody's Corp., Annual Report (Form 10-K), at 9 (Mar. 2, 2009), http://ir.moodys.com/common/download/sec.cfm?companyid=MOOD&fid=1193125-09-41352&cik=1059556.

72. See COP REPORT 2009, *supra* note 4, for a discussion of the past thirty years of financial deregulation.

73. *See, e.g.*, FSF 2008 REPORT, *supra* note 5, at 5 (arguing that the causes of the crisis, in addition to long-running boom markets and very low interest rates, included "a wave of financial innovation, which expanded the system's capacity to generate credit assets and leverage, but outpaced its capacity to manage the associated risks").

74. *See* PETER L. BERNSTEIN, CAPITAL IDEAS: THE IMPROBABLE ORIGINS OF MODERN WALL STREET 269–306 (1992) (describing the invention of new financial products since the 1970s); MERTON H. MILLER, FINANCIAL INNOVATIONS AND MARKET VOLATILITY 3–21, 33–51 (1991) (providing an overview of financial innovations from 1970 to 1990 and describing their relation to market volatility).

75. Charles R.P. Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 SMU L. REV. 505, 549 (1998); *see also* SINCLAIR, *supra* note 5, at 26–27 (discussing the economic changes in the post-Bretton Woods world).

76. *But see, e.g.*, Pouncy, *supra* note 75, at 519–21 (noting innovative transactions dating back thousands of years). Though it is not much acknowledged, *financial* innovation is simply one facet of the larger phenomenon of *legal* innovations, which have been omnipresent in Anglo-American law. As an example, consider the development of the limited partnership with a thinly capitalized corporate general partner that is owned and controlled by the limited partners. That expedient combined flexible management, full and limited liability, and pass-through taxation at a time when that combination was supposed to be unavailable—and did so with the blessing of the courts. *See, e.g.*, Frigidaire Sales Corp. v. Union Props., Inc., 562 P.2d 244, 245 (Wash. 1977) (holding that limited partners are not liable to creditors even if the partners serve as officers, directors, or shareholders in the corporate general partner). The complexity of that scheme pales in comparison with more

is only one of degree, it seems that in their complexity,[77] in their vast numbers and dollar amounts,[78] and in the systemic risk they pose,[79] the

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recent transactional acrobatics meant to address multiple regulatory limits. *See, e.g.*, Thomas F. Blackwell, *The Revolution Is Here: The Promise of a Unified Business Entity Code*, 24 J. CORP. L. 333, 337 n.13 (1999) (describing a transaction where, in order to maximize limited liability, tax savings, and access to federal farm subsidies, a lawyer created seven separate, interrelated juridical entities to comprise a business that otherwise would have been a small three-man farming partnership with comparatively few assets). Having learned the hard way that lawyers will always be able to work their way out of boxes like these, most policymakers have now cried uncle, at least with respect to business-entity law. Business-entity statutes now mostly emphasize maximum possible flexibility. *See, e.g.*, MODEL BUS. CORP. ACT § 7.32 (2005) (allowing closely held corporations to do away with a board of directors, officers, and most other traditional trappings of corporate governance); REVISED UNIF. P'SHIP ACT § 103(b) (1997) (providing that just a handful of provisions throughout the entire Act are nonwaivable).

Legal innovations are also very ancient. *See* J.H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY (3d ed. 1990) (recounting the history of the common law as mainly one of lawyerly subterfuges meant to overcome rules, including not only tax and other financial regulation, but also procedural rules in litigation, constraints on alienation of real property, forms of action, and many other areas). Plentiful other ancient examples are easy to find, such as the development of a shadow law of agency in Rome to overcome the requirement of purely personal contracting and the long history of evasion of the medieval ban on usury. *See* Wolfram Müller-Freienfels, *Legal Relations in the Law of Agency: Power of Agency and Commercial Certainty*, 13 AM. J. COMP. L. 193 (1964); Brian M. McCall, *Unprofitable Lending: Modern Credit Regulation and the Lost Theory of Usury*, 30 CARDOZO L. REV. 549, 569–80 (2008).

All such innovations, financial and otherwise, reflect Pound's familiar distinction between "law in books and law in action." As he said, there sometimes comes to be a "distinction between law in the books and law in action"—some way in which the arid, theoretical law in the minds of judges and lawyers simply has not kept pace with changing society. Time and again the law has handled such a problem by adopting some new legal fiction, and Pound said that fictions "show where and how legal theory has yielded to the pressure of lay ideas and lay conduct." Roscoe Pound, *Law in Books and Law in Action*, 44 AM. L. REV. 12, 14–15 (1910).

77. A level of sophistication not previously seen appears to have surfaced in the 1970s. Admittedly, it was quite a while ago that Adolf Berle first wrote that the securities of his day had gotten so complex that they were difficult to value. ADOLF A. BERLE JR., STUDIES IN THE LAW OF CORPORATION FINANCE 110–13 (1928). But whereas Berle was talking about securities that now seem commonplace—convertible bonds and preferred shares with changing dividend and conversion rights—innovation since the 1960s has involved transactions that are difficult to even conceptualize. The change arose when financial economics finally came into its own because the computing power that first became available to financial firms at that time made it possible to model and estimate risks that humans could not otherwise manage. *See* BERNSTEIN, *supra* note 74, at 37–38; PARTNOY, *supra* note 53, at 15; Gilson & Kraakman, *supra* note 13, at 715, 717–20 (recounting the rise and professionalization of modern finance theory, which began only about mid-century).

78. *See* PARTNOY, *supra* note 53 (setting out extensive data on magnitude of recent innovation).

79. Additionally, as recent events suggest, the current wave of innovation poses risks not just to investors but to whole economies. Financial panics have come and gone throughout the history of capitalism and at one time were comparatively routine. *See generally* CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES (5th ed. 2005). However, since the 1970s events with systemic significance have become alarmingly frequent. In a recent speech, former Federal Reserve Chairman Paul Volcker estimated that since then they have occurred about every

deals that have now become commonplace are unlike anything that has come before. Theorists attribute the phenomenon to many causes. A popular explanation is that it helps evade regulation,[80] and although it explains much of the behavior, it cannot be the only explanation.[81] At a minimum, a theory of innovation as evasion should be expanded to include all changes in exogenous financial constraints both private and public.

In any case, this recent wave of financial innovation has posed major, unambiguous problems, and some of them are centrally relevant here. First, financial innovation has been implicated in the uncommonly large number of financial crises of the past twenty years. It seems acknowledged that systemic risk in financial markets has increased, and while debate will continue as to what role financial innovation has played in that increase, it seems intuitively obvious that the evolution of very risky instruments of extremely opaque complexity, also representing very large dollar values, bear some causal relationship to it.[82] Next, newness in and of itself necessarily frustrates risk assessment. Like all risk-assessment methods, the techniques currently available estimate risk on the basis of past performance.[83] Finally, the complexity of financial transactions now

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five years. *See* Paul A. Volcker, Address at the Economic Club of New York (Apr. 8, 2008), *available at* econclubny.org/files/Transcript_Volcker_April_2008.pdf. Prior to that time, there had been none since the Great Depression. *See* COP REPORT 2009, *supra* note 4, at 8; Michael Bordo et al., *Is the Crisis Problem Growing More Severe?*, 32 ECON. POL'Y 53, 56 & fig. 1 (2001). For example, the use of derivatives has connected scores of parties to the performance of individual pools of MBS. Reliance upon credit ratings as triggering events for these derivatives gave the downgrade of a single MBS pool systemic reach.

80. *See* MILLER, *supra* note 74, at 5–6; S.I. Greenbaum & C.F. Haywood, *Secular Change in the Financial Services Industry*, 3 J. MONEY, CREDIT & BANKING 571 (1971).

81. For example, innovations have frequently addressed shortages in existing forms of money that could not satisfy the needs of growth. Richard Sylla, *Monetary Innovation and Crises in American Economic History*, *in* CRISES IN THE ECONOMIC AND FINANCIAL STRUCTURE 23 (Paul Wachtel ed., 1982) (describing how financial innovations addressed money shortages throughout U.S. history); Mark B. Greenlee & Thomas J. Fitzpatrick IV, *Reconsidering the Application of the Holder in Due Course Rule to Home Mortgage Notes*, 41 UCC L.J. 225, 229 & n.11 (2009). *See generally* JAMES WILLARD HURST, A LEGAL HISTORY OF MONEY IN THE UNITED STATES, 1774–1970 (1973) (detailing government involvement). Likewise, the exchange and interest rates of the 1970s are thought to have encouraged innovation for hedging purposes and coincided with the first swaps agreements. *See* Pouncy, *supra* note 75, at 527–31 (discussing the use and rise of currency swaps to transfer surplus liquidity and for hedging purposes); *id.* at 548–56 (discussing the Bretton Woods collapse and its detrimental effect on foreign exchange and interest rates). Moreover, the argument is subject to this empirical counterpoint: U.S. financial innovation seems, by all accounts, to have exploded during the past few decades, while at the same time regulation of the U.S. financial sector has shriveled.

82. *See* PARTNOY, *supra* note 53, at 3 (arguing that risk is abundant and the "appearance of control in financial markets [is] a fiction"); COP REPORT 2009, *supra* note 4, at 3, 11–19 (noting the various ways that financial risk has not been adequately regulated).

83. *See* PARTNOY, *supra* note 53, at 399–402 (discussing "value at risk" simulation and other risk-forecasting models). This causes an obvious problem. If the risks of new

plainly represents an independent problem in and of itself.[84]

Second, disintermediation poses related problems. Bank loans were once the dominant means by which money was borrowed and lent. Banks therefore mediated between those who had funds to lend—depositors and shareholders—and those who sought to borrow them. Banks were also regulated as to their own soundness and were highly incentivized to exercise caution toward their loans because their own money was at risk. In the past few decades the picture has changed dramatically, with substantially less household wealth in traditional depositary institutions and much more of it moving to borrowers through investment funds and direct investment in debt securities and other financial instruments.[85]

This process is related to financial innovation in that banks find themselves, to a much greater extent than ever before, engaged in other financial-services businesses. Moreover, banks, their erstwhile depositors, and borrowers have found exposure to much more complex and risky financial products than was the case when lending was dominated by bank loans. Banks have also found innovative instruments—not only RMBS and other ABS, but also various derivatives—a more attractive means of freeing up their balance sheets and lowering regulatory capital.[86]

Admittedly, a case could be made that the CROs' role in the present crisis was idiosyncratic, and that the reason why CROs failed so significantly was because they had a special role in structured transactions that is unlikely to repeat itself. The very purpose of securitization is to raise money for less than would be possible if the underlying collateral were held on balance sheets. Thus, a high credit rating is a *sine qua non*—a fact that all participants and observers freely admit.[87] However, there is

products could be easily and accurately modeled based on past products, the new products would not likely be very innovative.

84. This obviously has been the case for retail consumers, but it also has been true to some significant degree for investors who should have been quite sophisticated. *See id.* Moreover, there is some evidence that, at least sometimes, complexity was generated for the very purpose of defrauding investors or concealing risk. *See id.*

85. *See* SINCLAIR, *supra* note 5, at 54–57 (discussing the change to disintermediation). *See generally* Biagio Bossone, *Do Banks Have a Future? A Study on Banking and Finance as We Move into the Third Millennium*, 25 J. BANKING & FIN. 2239 (2001) (discussing the future role of the banking industry in the context of banks' special ability to sell their own debt). A similar trend can be observed in the ways consumers save for retirement. In the past, they would collect a pension paid from a company-owned, professionally managed portfolio. Today consumers more often own, and largely design, their own investment portfolios.

86. SINCLAIR, *supra* note 5, at 57; *see also* Bossone, *supra* note 85, at 2265–66 (stating how banks adapted to decreased demand in their traditional services).

87. *See* Petrina R. Dawson, *Ratings Games with Contingent Transfer: A Structured Finance Illusion*, 8 DUKE J. COMP. & INT'L L. 381, 385 (1998) ("A structured financing seeks to insulate transactions from entities that are rated lower than the transaction, are unrated, or for which the rating is unable to quantify the likelihood of bankruptcy.");

no meaningful reason to believe either that innovation will somehow stop, or that CROs will fail to remain at the center of innovation and its various threats. Indeed, they will actively and aggressively encourage it. Ominously, Moody's told its investors in early 2008—*after* the current collapse was well under way—that the company's future profitability depended on "[r]estoring investor confidence in structured products" and continued "disintermediation of financial systems."[88]

III. OVERARCHING PROBLEMS: THE ECONOMICS OF INFORMATION AND THE MISSING EVIDENCE OF VALUE

Again, the most acute policy question in the CRO debate is whether private credit rating improves capital market efficiency or reduces systemic risk. As has now become apparent, the CROs drastically underestimated ABS risk, often because of facially apparent inadequacies in the assumptions and approaches of their risk-assessment models.[89] This was only the latest in a long series of failures. Even beyond the major systemic failures of traditional corporate ratings in 2000 and 2001 and structured finance ratings in 2007 and 2008, there is evidence of overarching problems with the CRO system. As this Article will now show, none of this should be unexpected. There is, first of all, a seriously lacking theoretical basis for the existence of the CROs and for the hope that their work will provide new information to markets valuable enough to justify their substantial costs. But even if there were such a theoretical justification, the extensive empirical literature on credit ratings has failed to find much evidence that it adds valuable information to capital markets.

The question why CROs exist and whether they are likely to perform well is basically a question of industrial organization. On the one hand, no

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Kettering, *supra* note 56, at 1564–80 (explaining the securitization process from the viewpoint of a critic).

88. 2007 Annual Report Form 10-K, *supra* note 20, at 3.

89. For example, CROs maintained that the default probabilities for residential mortgage-backed securities (RMBS) and CDOs were consistent with historic corporate bond performance. It was not until there were demonstrably significant differences in the performance history of RMBS and CDOs, when compared to corporate bonds, that CROs developed asset-specific default probability tables. *See* SEC 2008 STAFF REPORT, *supra* note 3, at 36.

This may have driven CROs to increase projected losses in 2008. For instance, in 2008 Moody's increased its projected losses on subprime RMBS significantly. In September 2008, Moody's increased its projected losses on 2006 vintage subprime pools by 22%. JONATHAN POLANSKY ET AL., MOODY'S INVESTOR SERV., SUBPRIME RMBS LOSS PROJECTION UPDATE 1 (2008), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/18/2007300000533405.pdf. The same report illustrated that nine- to twelve-month default rates on loans rose when they had been expected to taper off from the third quarter of 2005 through the second quarter of 2007. *Id*. at 2 fig. 1.

one actually knows how capital markets produce so much information and price assets so efficiently (most of the time), but it is taken for granted that it is costly for someone to gather and analyze the information. It seems to make sense that the job would involve returns to scale and that it might be best to centralize the various necessary investments in one or a few producers rather than maintain duplicative analytical capacity with each investor. This was a central claim of the original Gilson and Kraakman formulation,[90] and it has been a frequent theoretical justification for the CROs.[91] On the other hand, centralizing the job poses several predictable and thorny problems. An obvious problem is free riding on the public-goods nature of information, which is exacerbated by the fact that securities research is quite costly.[92] Therefore, a central difficulty is how to pay for centralized analysis. Conflicts of interest are severe when issuers pay, but collective action problems are severe when investors pay.[93] We have no experience with a government-pays model of securities information, but it would likely pose significant problems of efficient investment in information (even if it were politically feasible).

Regardless of who pays, however, there will also be a severe agency cost problem. Other things being equal, intermediaries would prefer to invest less in the quality of their product. While it is commonly argued that they will thereby be penalized when the poor quality of their information is disclosed, that argument presumes competitive markets. CRO markets have been highly concentrated during the industry's entire history, a fact that may be explained by reasons other than regulatory barrier to entry. There is also no particular reason to believe that this persistently concentrated market is likely to behave competitively. If returns to scale and scope are significant and established reputation is an important asset, entry barriers might ordinarily lead to oligopolies like the one presently observed. The agency problem also probably cannot feasibly be addressed by giving intermediaries some fiduciary obligation of care because the pool of plaintiffs potentially enforcing such a duty is the entire investing public.[94] Likewise, a duty of care could theoretically be enforced by the

90. *See* Gilson & Kraakman, *supra* note 13, at 592–609.

91. *See* White, *supra* note 5, at 43–44 (arguing that the complexity of the information needing analysis necessitates CROs); Gregory Husisian, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 415–25 (1990) (outlining the various rationale for CROs' existence).

92. *See supra* notes 46–49 and accompanying text.

93. *See* Choi & Fisch, *supra* note 14, at 278–83.

94. There is also the problem of the First Amendment as currently construed. *See infra* notes 134–35 and accompanying text. Admittedly, there is no reason that some sort of more enforceable civil liability scheme could not be part of an overall strategy for better intermediation. *Cf.* Greenlee & Fitzpatrick, *supra* note 81 (explaining how assignee liability can incentivize care); *see also infra* Part VI.C. The point here is that merely making it

government, perhaps by establishing minimum standards all CROs must meet when evaluating issues. This simple solution, however, ignores the immense challenge the government would face in reviewing the roughly 20,000 new ratings issued each year by each of the major CROs. Even if the government only investigated ratings about which it received complaints, which would still require significant resources, the issue of creating effective penalties for violations of a duty of care still poses a significant problem. In short, it is very hard to imagine how an intermediary service could be organized so as both to fully compensate an efficient amount of investment in analysis *and* ensure its quality.

An even more significant problem is that the basic argument above—the argument that information gathering is so costly and likely to favor scale that there must be institutional intermediaries—begs a serious empirical question. Markets themselves are machines for generating information, and from the viewpoint of some finance economists, they ought to be really good at it.[95] While the major CROs are often privy to nonpublic disclosures from the issuers they rate and have a special regulatory dispensation to receive it, the major CROs sometimes, and the smaller CROs almost always, base their ratings only on public information.[96] That

easier for individual investors to sue the CROs for negligent ratings will pose the same problems that have burdened shareholder securities litigation generally. It is extremely difficult, to say the least, to strike a balance between a penalty that is economically meaningful enough to discourage CROs from allowing the quality of their ratings to slack and not so economically burdensome that the business of issuing credit ratings would no longer be economically viable. In any case, economically meaningful penalties are likely to drive up the cost of credit ratings. Unless such penalties improve the accuracy of credit ratings, this increased cost will further diminish the actual value credit ratings add to markets. There also likely would remain the problematic need to make out a culpable mental state and the persistent judicial perception that shareholder suits are frivolous. *See infra* notes 157–67, 198 and accompanying text. Of course, any government-enforced standard does nothing to make whole those actors who rely on credit ratings when making investment decisions. The argument that relying on credit ratings when making investment decisions is inherently unreasonable, an argument which many courts inexplicably accept, is off base in a regulatory environment that *requires* investors to rely heavily on credit ratings when making investment decisions.

95. To wit, the unassailable orthodoxy among finance economists from the 1960s until fairly recently was that modern capital markets approximate perfect efficiency, meaning that the pricing of capital assets very quickly and very completely incorporated all relevant information. *See generally* ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 1 (2000). That hypothesis, as Shleifer explores at great length, is now in doubt.

96. The "dispensation," again, is that in the United States the NRSROs are exempt from Regulation FD. *See supra* note 28. Moreover, as to whatever nonpublic information they receive and incorporate into their ratings, they depend entirely on issuers for its reliability and have no mechanism for enforcing honest disclosure. For example, evidence is surfacing suggesting that arrangers did not disclose reports about the declining loan quality in pools of RMBS to CROs. *See, e.g.*, Chris Arnold, *Auditor: Supervisors Covered Up Risky Loans*, NAT'L PUB. RADIO, May 27, 2008,

is, there is not actually that much of a theoretical basis for the view that market participants cannot simply do for themselves what the CROs do, all on the basis of publicly available data.

In any case, wholly aside from the lack of a theoretical foundation, there is also a lack of empirical evidence of the value that is supposedly added by private credit ratings. While highly rated bonds have low default rates and enjoy yields consistent with low risk,[97] and while some commentators take this as evidence of the CROs' successful performance,[98] the evidence suggests that at best they just barely meet the markets' own success at predicting bond values. Hickman's pioneer study found that during the first half of the twentieth century, when the instruments under review were much simpler than they are now and bond markets were working extremely well, the CROs did only about as well at predicting defaults as did the markets themselves.[99] While arguably the results have been somewhat mixed, extensive empirical literature dating to the late 1950s has failed to find more than a small portion of bond price and yield performance that cannot be explained on the basis of simple, publicly available financial data.[100] Moreover, post-issue ratings changes are particularly uninformative. The single most robust and well-tested empirical result has

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http://www.npr.org/templates/story/story.php?storyId=90840958; Patrick Rucker, *Wall Street Often Shelved Damaging Subprime Reports*, REUTERS, July 27, 2007, http://www.reuters.com/article/businessNews/idUSN2743515820070727.

97. *See* HICKMAN, *supra* note 34, at 7–12; Louis H. Ederington & Jess B. Yawitz, *The Bond Rating Process*, *in* HANDBOOK OF FINANCIAL MARKETS AND INSTITUTIONS 41 (Edward I. Altman ed., 6th ed. 1987) (canvassing prior studies and concluding that approximately two-thirds of new issue ratings can be predicted on the basis of a handful of publicly available accounting measures); Richard R. West, *Bond Ratings, Bond Yields and Financial Regulation: Some Findings*, 16 J.L. & ECON. 159 (1973); *see also* Lawrence Fisher, *Determinants of Risk Premiums on Corporate Bonds*, 67 J. POL. ECON. 217 (1959) (finding that about three-quarters of risk premiums on corporate bonds studied could be explained by simple, publicly available financial data); Pu Liu & Anjan V. Thakor, *Interest Yields, Credit Ratings, and Economic Characteristics of State Bonds: An Empirical Analysis*, 16 J. MONEY CREDIT & BANKING 344 (1984) (concluding that while ratings themselves have a statistically significant, independent effect on yield, straightforward economic factors reliably predict municipal bond ratings).

98. *See, e.g.*, Rousseau, *supra* note 10, at 631; Schwarcz, *supra* note 10, at 13–14.

99. *See* HICKMAN, *supra* note 34, at 7–12 (determining that bond markets performed remarkably well during the first half of the twentieth century, notwithstanding its many disruptions). As a check on his results, Hickman matched them against CROs' predictions of default risk and found them to track closely with market-derived yield spreads. *See generally* Sylla, *supra* note 16, at 12–13 (summarizing Hickman's results and their significance for measuring the CROs' performance).

100. *See supra* note 96. The results are "mixed" only in that researchers have been unable to explain *all* bond performance variation. The as-yet unexplained variation *might* reflect some informational value in ratings. Importantly, even if the unexplained variation is associated with ratings, some of *that* effect is to be explained by the purely regulatory effect of "fallen angels"—bonds being downgraded from investment- to speculative-grade. *See* West, *supra* note 97.

been that bond prices and returns tend reliably to anticipate ratings changes some months *before* the change.[101] Furthermore, substantial literature shows that ratings changes can be predicted using simple ratios based on publicly available financial statements.[102] Even when ratings changes are not anticipated by the market, there is only a significant change in price when downgrades occur, which may simply reflect the increased funding costs that accompany lower credit ratings. Empirical evidence also suggests that investors find ratings to be of little intrinsic value.[103]

Finally, the operation of the dominant CROs under the two-rating norm and the issuer-pays model, along with the distortions caused by the NRSRO designation, have been very expensive. Even if CROs perform exactly as well as other market measures, any cost advantages of their particular form of organization would have to be truly significant to explain their large fees and justify their extensive use by policymakers.

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101. *See* Covitz & Harrison, *supra* note 10; John R.M. Hand et al., *The Effect of Bond Rating Agency Announcements on Bond and Stock Prices*, 47 J. FIN. 733 (1992); Gailen Hite & Arthur Warga, *The Effect of Bond-Rating Changes on Bond Price Performance*, 53 FIN. ANALYSTS J. 35 (1997) (arguing that other interesting effects that have repeatedly been shown are that the "pre-announcement effect" is much stronger for downgrades than for upgrades, and that the effect is much more pronounced as to bonds that are already poorly rated); Mark I. Weinstein, *The Effect of a Rating Change Announcement on Bond Price*, 5 J. FIN. ECON. 329 (1977). Ratings changes are similarly anticipated by stock price changes. *See* George E. Pinches & J. Clay Singleton, *The Adjustment of Stock Prices to Bond Rating Changes*, 33 J. FIN. 29 (1978) (stating that ratings changes are similarly anticipated by stock price changes). At least one recent study argues that CRO ratings add value by insuring against bad equilibriums, especially after a firm has been placed on a credit watch. *See* Arnoud W.A. Boot, Todd T. Milbourn, & Anjolein Schmeits, *Credit Ratings as Coordination Mechanisms*, 19 REV. FIN. STUD. 81 (2006). However, the authors concede a few points that significantly detract from this assertion. First, ratings only add value if a significant portion of institutional investors "agree" with the rating by purchasing the securities, suggesting that it is their participation, and not the rating, that adds information to the market. Second, they argue that credit ratings are most valuable when institutional-investor beliefs are divergent, while also pointing out that if beliefs are too divergent, credit ratings will no longer play a coordinating role. If it were truly the ratings rather than the institutional-investor behavior acting as a market coordinator, then the coordinating role of credit ratings should not break down when institutional-investor beliefs diverge.

102. *See, e.g.*, Chan & Jegadeesh, *supra* note 10, at 156–58, 163–68 (summarizing relevant literature and providing new findings on the different approaches used to predict bond ratings).

103. *See* H. Kent Baker & Sattar A. Mansi, *Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors*, 29 J. BUS. FIN. & ACCT. 1367 (2002) (reporting survey evidence that demonstrates that the majority of institutional investors rely more on in-house analysis than CROs' reports); David M. Ellis, *Different Sides of the Same Story: Investors' and Issuers' Views of Rating Agencies*, 7 J. FIXED INCOME 35 (1998) (noting survey evidence of investor skepticism of CROs' ratings).

IV. OTHER OVERARCHING PROBLEMS WITH THE CROS AS THEY EXIST

A. Conflicts of Interest

Policy discussions on the CROs usually begin with conflicts of interest. The issuer-pays model is the most frequently identified conflict, and indeed, the SEC nominally identifies issuer-pays as a "conflict of interest" as a matter of law.[104] As a matter of fact, notwithstanding that for many years the major CROs have all maintained procedures and internal conduct codes designed to constrain conflicts, new evidence suggests that, at least in recent years, conflict problems were rife.[105]

Changes in the concentrated, disintermediated U.S. banking industry have exacerbated these problems. It may be true, as the CROs often claim, that the fee charged for any one rating is too small a portion of overall revenue to create a conflict. However, U.S. investment banking is now so concentrated that a handful of firms are responsible for arranging and underwriting the bulk of large new debt issues, and they typically select the CRO.[106] This is borne out in internal CRO conversations about retaliation by issuers for unfavorable ratings treatment.[107]

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104. *See* Securities Exchange Act, 17 C.F.R. § 240.17g-5(b)(1) (2008) (prohibiting all "conflicts of interest" and defining issuer-pays as a conflict of interest, with the exception of conflicts that are disclosed in filings with the SEC so long as the NRSRO maintains some internal conflict-of-interest policy).

105. As highlighted in the SEC 2008 Staff Report, some CROs' analysts have still participated in fee discussions with issuers. Likewise, while bonuses are determined by individual performance and the overall success of the firm rather than ratings, analysts are aware of the CROs' interest in securing individual ratings deals and market share, and have considered these factors when making ratings methodology decisions. *See* SEC 2008 STAFF REPORT, *supra* note 3, at 24–26.

The SEC staff also found evidence of CROs' analytical staff taking specific actions possibly driven by such conflicts. For instance, CROs would also make adjustments outside of their ratings models without documenting the rationale for the adjustment. *Id.* at 14 (showing that these adjustments appear to have raised ratings, and "[o]ne rating agency regularly reduced loss expectations on subprime second lien mortgages from the loss expectations output by its RMBS model, in some cases reducing the expected loss"). CROs also failed to consistently document committee composition, actions, and decisions. Often missing from CROs' documents were vote tallies from rating-committee rating votes, documentation of any ratings surveillance, committee memos or minutes, or both, and other relevant documentation even when required. There was, at times, no documentation of committee attendees. *See id.* at 19–20.

106. As to structured products, for example, the CROs were heavily dependent on fees from a small number of arrangers within the concentrated U.S. investment banking industry. *See id.* at 32 (finding that twelve arrangers accounted for nearly all of one large sample of structured deals rated by the major CROs). The banking industry has already concentrated further since the downturn of early 2008, and yet more failures and consolidations are widely expected. Until the credit collapse that began in mid-2007, a huge and rapidly growing portion of the major CROs' revenues comprised fees from rating securitized bonds issued by a handful of major banks.

107. Privately, CROs express concerns that methodology or modeling changes will

Likewise, financial innovation introduces a wholly new conflict of interest, and at the same time it makes the job of prospective credit rating more difficult—or as some critics say, impossible. Financial-market acceptance of some innovative product can promise large returns to the CROs,[108] incentivizing CROs to encourage that acceptance. In the case of structured products, they have gone out of their way to do so.[109] Critics who have long claimed that the CROs overrated structured products may now be vindicated.[110] For instance, there is evidence that CROs themselves believed they should not have been rating some structured products.[111]

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drive away business, and they have considered revisiting ratings methodology in order to recapture market share from other CROs. *See id.* at 25–26. For instance, one employee stated "[w]e are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals." *Id.* (citation omitted). Another employee responded, stating that aspects of the ratings methodology would have to be revisited to recapture market share from another CRO. *Id.* Moreover, at least one CRO has allowed deals in the process of being rated to use old rating criteria when new rating criteria had been introduced. *Id.* at 32.

108. The revenues CROs received from rating RMBS and CDOs substantially increased from 2002 to 2006. In each year from 2004 to 2007, the three major CROs saw their revenue from such ratings increase between 50% and 150% when compared to the same revenue stream in 2002. *Id.* at 10–11. In 2006, when the revenue from rating RMBS and CDOs was at its highest, Moody's generated $6 million per employee. *See* Gerard Caprio, Jr. et al., *The 2007 Meltdown in Structured Securitization: Searching for Lessons Not Scapegoats* 19 (World Bank, Policy Research Working Paper No. 4,756, 2008); *Buttonwood: Credit and Blame*, ECONOMIST, Sept. 8, 2007, at 77 (noting that CROs experienced revenue increases of $754 million); *see also* Moody's Corp., Annual Report (Form 10-K), at 21 (Mar. 1, 2007), http://ir.moodys.com/common/download/download.cfm?companyid=MOOD&fileid=165514&filekey=E3CB9ABB-700C-46FF-B2CA-DF3296084E4F&filename=200610K.pdf (documenting that in 2006 more than 45% of Moody's revenue was generated from rating structured-finance products, such as RMBS and CDOs); Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping?*, N.Y. TIMES, Dec. 7, 2008, at A1 (reporting that fees received for rating structured-finance products far exceed other products, and that as such ratings increase, so do CROs' operating margins).

109. From 2003 to 2007, S&P, for example, actively publicized evidence that they much more frequently upgraded their ratings of subprime MBSs than they downgraded them, thereby urging investor confidence in these untried new products. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2055–56 (2006) (surveying S&P's own public statements as to its upgrade and downgrade activity). S&P's claims in this literature were doubly misleading. First, CROs in fact almost never changed their ratings of MBSs or other securitized products until mid-2007, when they downgraded masses of them. The few hundred ratings changes discussed in the 2003–2007 literature represented a tiny fraction of the tens to hundreds of thousands of such ratings they had issued. Second, as we shall see in some detail below, the CROs in fact did not make initial ratings that were at all conservative and, by and large, seem now to acknowledge that their ratings of these products were substantially over-optimistic. *See infra* note 116 and accompanying text.

110. *See, e.g.*, *AAAsking for Trouble*, ECONOMIST, July 14, 2007, at 77; *Sold Down the River Rhine*, ECONOMIST, Aug. 11, 2007, at 66 (showing that some of these tranches were originally rated only a year or two before the downgrade, prompting comments that the sudden downgrade was a "belated recognition that such ratings always were a bit dubious").

111. In April 2007, correspondence between two CRO analysts emerged. One analyst

Moreover, working relationships have been much closer in the context of structured finance ratings where CROs work with issuers to reach a rating satisfactory to the issuer.[112] This arrangement mirrors the way that accounting firms sold their clients management-consulting services before Sarbanes–Oxley prohibited the practice because of the conflicts of interest it created.

The CROs have sought to discount these problems on several grounds, but none so far seems availing, especially in light of their recent failures. They have long claimed that their internal procedures adequately contain conflicts, but recent evidence suggests those procedures were not effective.[113] They also defend their roles in various crises by pointing to their disclosures and warnings to investors,[114] but their warnings were apparently undercut severely by the fact that even as they issued warnings, they continued to rate very risky securities with very high ratings.[115] Other

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criticized a deal by calling it ridiculous and advising against rating it. While those statements seem responsible, the reply received was "it could be structured by cows and we would rate it." Another senior analytical manager wrote that CROs were creating an "even bigger monster—the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters." SEC 2008 STAFF REPORT, *supra* note 3, at 12.

112. Securities issuers have some incentive to ensure a range of ratings on any one pool of securities issued so tranches can be sold to investors seeking various levels of risk and return. There is a much larger market for investment-grade-rated senior tranches than there is for other tranches because that rating allows sales to portfolio-constrained institutional investors. *See The Use and Abuse of Reputation*, ECONOMIST, Apr. 6, 1996, at 18; *Who Rates the Raters?*, *supra* note 61, at 67. The senior tranches are also the least expensive to fund due to their low coupon rate. Thus, arrangers generally attempt to create the largest possible senior tranche. SEC 2008 STAFF REPORT, *supra* note 3, at 8.

Assuming a credit rating is in fact value added, it is theoretically not inappropriate for CROs to work with arrangers to structure products for high ratings insofar as CROs are simply explaining how to optimize the structure of pools. But many have persuasively argued otherwise. *See, e.g.*, *Who Rates the Raters?*, *supra* note 61, at 68 (citing to parallels to the conflicts to which the auditing industry fell victim in recent history).

113. *See supra* note 45 and accompanying text.

114. *See, e.g.*, *McDaniel Testimony*, *supra* note 58, at 1 (claiming that Moody's warned investors about deterioration in origination standards and inflated housing prices as early as 2003).

115. In March 2008, Bloomberg reported that Moody's and S&P were holding off on downgrading investment-grade-rated MBS pools. By the time of the article, Moody's and S&P downgraded nearly 10,000 subprime-mortgage tranches without publicly addressing investment-grade-rated tranches. At the same time, evidence suggested that nearly $120 billion in investment-grade-rated bonds should have been downgraded if the companies followed their own formulas. *See* Mark Pittman, *Moody's, S&P Defer Cuts on AAA Subprime, Hiding Loss*, BLOOMBERG, Mar. 11, 2008, http://www.bloomberg.com/apps/news?pid=20670001&sid=areM7a9s02ko. A month later, Moody's downgraded nearly 2,000 tranches in two days. *See* Paul Jackson, *Stick a Fork in It: Moody's Downgrades 1,923 Subprime RMBS Classes—In Just Two Days*, HOUSING WIRE, Apr. 22, 2008, http://www.housingwire.com/2008/04/22/stick-a-fork-in-it. The fact that such a high percentage of the mortgages in these pools were defaulting or going into foreclosure one to two years into a thirty-year maturity period calls into question their initial investment-grade ratings.

attempts to discount conflicts seem similarly flawed.[116]

Finally, the CROs argue that whatever its downsides, issuer-pays makes ratings available to the entire public at no cost, reducing the advantages of wealthy investors.[117] Whatever benefits that may produce, accuracy of the ratings is more important than their wide availability, especially given their incorporation into portfolio rules. Moreover, large investors will retain advantages, such as in-house analytical capabilities, despite the availability of credit ratings. Individuals would be better served by the availability of more accurate ratings to the institutional investment managers who invest on their behalves.

B. Doubts About "Reputational Capital"

The CROs and their defenders argue that the best assurance of their integrity is their need to preserve "reputational capital," an argument that is at odds with the recent evidence.[118] There are also several other reasons to doubt this argument. First, the major CROs have until very recently enjoyed the significant entry barrier of NRSRO designation and, as will be argued later, would probably enjoy significant entry protection in its absence as well.[119] Therefore, because of this lack of effective price

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116. Moody's, for example, argues that regardless of who pays for ratings, investors would be motivated to encourage inflated ratings to improve the marketability of their bonds, to improve their existing portfolio values, or to establish new portfolio positions. *See McDaniel Testimony*, *supra* note 58, at 8–10. This seems very implausible. Under an investor-pays model, even assuming investors could exert the same influence as issuers, different investors have different incentives and would thus pressure the CROs differently. Moreover, institutional buyers constrained by fiduciary duties would not desire artificially inflated ratings because paper gains have no intrinsic value to those investors, and may actually be liablilities.

Moody's argues that because investors are frequently also issuers, there is no meaningful distinction between them. *See id.* at 9. First, one cannot help but wonder why CROs have expressed such a strong preference to have issuer-pays if there is no meaningful distinction between investors and issuers. This position only makes sense if every issuer is the exclusive investor in its own issue. Otherwise, the issuer and investor are meaningfully distinct. As to more complex products, in particular, the issuer knows more about the quality of the assets than the investor, and CROs are supposed to help reduce that asymmetry. The investors most in need of guidance from CROs would seem to be those without sufficient in-house analytical capacity of their own, but that likely describes a large number of buy-side investors. Finally, a large number of investors simply are not issuers, and so Moody's argument really just begs a large empirical question: whether the interests of the buy side and sell side are evenly enough matched to make conflicts a wash. Impressionistically, it seems like the assumption implied is wrong.

117. *See id.*

118. *See supra* notes 104–07, 111 and accompanying text (documenting internal evidence from CROs of gross conflicts of interest and the rating of products that CRO staff believed to be unratable).

119. *See infra* note 148 and accompanying text. A minor puzzle might seem to be that, while reputational capital has not been a meaningful constraint on CRO behavior, the establishment of reputation works as an entry barrier. And yet both things seem to be the

competition, the lethargy characteristic of monopolies may shield them from competitive pressures that otherwise would encourage service quality.[120] Second, CROs are likely susceptible to the "herd" behavior for which there is now growing evidence in financial markets. Analytical intermediaries apparently fear individual mistakes much more than collective ones. Moreover, empirical evidence suggests that securities analysts' career prospects are improved more by systematic overoptimism than by accuracy, a fact that may influence the work of CROs' analytical staffers.[121] Third, the extensive documentation of conflicts of interest within the CROs is strong counterfactual evidence to the hypothesis that the need to preserve reputational capital is an adequate check on their behavior.

There is often no particularly good reason to believe that a given issuer needs a reputational intermediary at all, especially one as expensive as the major CROs. Major debt issuers can anticipate frequently repeated interactions in debt markets and will forecast the need for low-cost debt funding far into the foreseeable future.[122] Also, reputational constraints should have been important for the major auditing firms as well, but recent events have shown that to have not been the case.[123]

C. Resource Constraints: Coping with Complexity and Rapid Change

Resource constraints have been a running problem, and they may be to blame for some of the worst problems in the ratings of structured products. The long-standing criticism of inadequate analytical staff[124] became severe

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case. A likely explanation is based on network effects. Despite evidence that investors do not value the information content of ratings, *see supra* note 103, they incorporate the ratings of specific CROs in private contracts and private portfolio investment rules. While it remains an empirical question why precisely they do so, it seems likely that a CRO's "reputation" can have some consequences beyond any marketplace confidence in the informational value of its work.

120. *See generally* RICHARD A. POSNER, ANTITRUST LAW 18–22 (2001).

121. See David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465 (1990), for the preeminent research and discussion on "herding." See also COFFEE, *supra* note 14, at 252–53, for detailed empirical research on the subject. When rating complex derivative products, herding had a significant upside for the CROs, while failing to do so had a downside. For example, some smaller CROs did not rate CDOs because, they claim, CDOs made no sense. Yet, the major CROs profited immensely from rating CDOs until the market discovered how poorly the ratings reflected CDO risk characteristics. Since then the market has evaporated and the only effect not participating in the CDO rating market had on smaller CROs was that they had no opportunity to generate revenue from rating CDOs during the boom.

122. *See* Partnoy, *supra* note 14, at 500–01 (arguing that there will be a continuous need for low-cost debt financing).

123. *See* COFFEE, *supra* note 14 (describing the complicity of the major auditing firms in corporate accounting scandals since 2000).

124. *See, e.g.*, Partnoy, *supra* note 11, at 651–52 (discussing structural problems modern

during the explosion of structured finance, despite the CROs' substantial growth during the three decades prior.[125] Their due diligence as to these products was often poor or nonexistent,[126] and there is evidence that the CROs have sometimes been pressured by their clients into acting too quickly.[127] They also failed to devote sufficient resources to surveillance efforts.[128] All this suggests that even the major CROs cope poorly with

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CROs exhibit in the quest for reputational capital).

125. The growth of asset-backed securities from 2002 through 2006 created a demand for credit ratings that CROs could not match. *See* SEC 2008 STAFF REPORT, *supra* note 3, at 10. The SEC determined that limited resources were allocated to structured-finance groups that focused on rating RMBS and CDO issues. Internal CROs' e-mails describe the situation as tense. An e-mail from a senior business manager states that there was "too much work, not enough people." *Id.* at 12. An e-mail from an analytical manager fleshed out the picture, stating, "'[W]e ran our staffing model assuming the analysts are working sixty hours a week and we are short on resources . . . . The analysts on average are working longer than this and we are burning them out. We have had a couple of resignations and expect more.'" *Id.* (footnote omitted).

126. CROs acknowledge that originator practices could have a potentially large impact on loan performance. *See* SIEGEL, *supra* note 59, at 2 ("Moody's continues to believe that differences in originator practices and loan programs have the potential to have a large influence on loan performance . . . ."); *see also id.* at 7 ("[I]t is important to examine the quality of originator practices, particularly efforts to verify data through appraisals, credit checks, and other means."). Nonetheless, they argued that they could assess such risks through quantitative analysis, supplemented by superficial qualitative analysis. *See* MUNI & KOTHARI, *supra* note 70, at 1. In fact, the three major CROs did not engage in due diligence or otherwise verify the accuracy or quality of the loan data they reviewed. SEC 2008 STAFF REPORT, *supra* note 3, at 18. Instead, they relied on information provided to them by sponsors, which was provided to them without representations that the sponsors had performed any sort of due diligence. *Id.* at 18. Moreover, the documentation required for assets underlying rated structured securities fell over time—from 2002 to 2005, the percentage of subprime loans rated by Moody's that fully documented borrower income fell from 72% to 55%. MUNI & KOTHARI, *supra* note 70, at 2. It was not until 2008, after the SEC published a report that noted these missteps and RMBS issuance was nearly nonexistent, that CROs implemented more extensive reviews of originator practices. SEC 2008 STAFF REPORT, *supra* note 3, at 18.

127. *See* SEC 2008 STAFF REPORT, *supra* note 3, at 32. Arrangers, who are paid in part based on the volume of deals they put together, push for a fast ratings process. *See id*. This may have influenced a CRO to allow deals that were in the ratings process to continue to be rated with old criteria, despite the introduction of new criteria by CROs during the rating. *Id*.

128. *See, e.g.*, Kettering, *supra* note 56, at 1674. This played out in recent corporate bond markets, where Enron and WorldCom were rated investment-grade until days before the collapse of the companies. *Who Rates the Raters?*, *supra* note 61, at 68–69 (noting that by the time the Enron downgrade was issued, most bad news had come out and Enron's share price had dropped dramatically). A recent SEC report revealed that two of the three major CROs poorly or completely failed to document any monitoring of CDOs and RMBSs. SEC 2008 STAFF REPORT, *supra* note 3, at 21–22 (noting that CRO surveillance efforts were lacking in timeliness and diligence). This may not be surprising considering two of the big three CROs had not created internal documents containing the steps necessary to monitor CDOs and RMBS. *Id.*

In fact, as to structured products, the CROs apparently relied mainly on pool-level triggers to alert them that the credit quality of the pool had significantly declined. A rating committee will only be convened to reevaluate a rating if it appears that an issuer may be at

rapid innovation.[129]

V. WHAT CONSTRAINTS AT PRESENT?

Assuming there is something in the CROs' work that should be done better or be better constrained, it should first be asked whether any existing laws might be better suited to accomplish this. We think it is unlikely.

A. Big-Picture Basics, or What Exactly Are the CROs?

1. Are CROs the "Government"?

CROs perform functions that are government-like. In one respect, those CROs with NRSRO designation make what is literally de jure law: they decide, as a matter of law, whether particular assets may be owned by particular regulated entities. Likewise, in the structured-finance context, the NRSROs took on the special role of helping issuers prestructure their deals to ensure the desired ratings for top-tranche securities. In other words, they made essentially regulatory calls as to the internal structure of

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a credit rating inconsistent with its peers. The primary trigger used was an overcollateralization test, which measured a pool's total losses against the total dollar value of credit enhancements. *See id.* at 36. The pool was considered unimpaired by losses as long as the pool contained collateral in excess of the pool's total payment obligations to investors. Conceptually this is a puzzling trigger, as it asserts that a pool with a payment horizon of thirty years can lose 99% of its overcollateralization in the first year without being a bigger credit risk than it was when created. While defaults on mortgage payments tend to become less frequent with the passage of time, one would think a pool rapidly eating through overcollateralization would signal a potential downgrade, or at least land it on a so-called CRO watch list (which the major CROs maintain to publicize the fact that a downgrade is under consideration). When credit enhancements come in the form of issuers guaranteeing portions of the senior tranches, this trigger becomes even more tenuous. This is because the actual value of those guarantees, especially when given by a single issuer, may not equal the full amount of the guarantees. See BIS STRUCTURED FINANCE REPORT, *supra* note 5, at 28, for a discussion about the problems with mono-line issuers providing pool credit enhancements.

129. The complexity of structured products was apparently beyond even the largest CRO's ability to keep up. The process of arranging and rating a pool of assets creates information frictions at most steps in the process and poses a major lemons problem in the CROs' ratings. *See generally* Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit*, FED. RESERVE BANK OF N.Y. STAFF REP., Mar. 2008.

One other major problem with their handling of innovative products is lack of data. The fundamental objective aspect of their approach, quantitative risk assessment, depends heavily on historical data, but as to innovative products, such data will often be unavailable. For example, CROs were rating "affordability products" like pay-option adjustable-rate mortgages (ARMs) and interest-only (IO) loans when there was not much historical performance data on these loans from any originator. PETER MCNALLY, MOODY'S INVESTORS SERV., UNDERSTANDING METRICS FOR PERFORMANCE MONITORING, VOLUME 3: RESIDENTIAL MORTGAGE-BACKED SECURITIES 6 (2005), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/14/2004300000425487.pdf.

particular financial transactions. Therefore, a natural question is whether their quasi-government status renders them subject to any special liabilities, defenses, or privileges.

By prevailing orthodoxy, the answer is plainly no. All U.S. CROs and most foreign ones are private, profit-making entities, and the three U.S. majors are publicly traded corporations or subsidiaries thereof, organized under state corporate laws.[130] Therefore, despite their influence and the federal deputy stars they wear, it is basically inconceivable that they could be subject to the federal constitutional or administrative rules that govern proper agencies.[131] Likewise, because they are not federally chartered and do not formally advise or contract with the SEC or other agencies, they are free of the open-government constraints that bind some quasi-public entities.[132] This special status in between public and private is not unique to the CROs. In any number of other contexts, the government has fumbled around in search of a policy and has managed to deputize some private group to take care of it. In those cases the group will typically be neither democratically accountable, nor subject to public law constraints, nor especially well regulated by private law liability.[133]

2. *On the Contrary, They Are Just Regular Folks Speaking Their Minds*

Not only are CROs not the government in the eyes of the courts, but they enjoy some First Amendment protection for their ratings. Several courts have held that various claims of liability against CROs must fail as in

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130. *See supra* notes 20–22.

131. Even where an entity is created by federal statute and subject to some federal governance role, it may not be the "government" for constitutional and administrative law purposes. *Compare* Reg'l Rail Reorganization Act Cases, 419 U.S. 102 (1974) (holding that the Conrail entity, a corporation created by federal statute and subject to substantial federal control, was not a "federal instrumentality"), *with* Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374 (1995) (finding that the Amtrak entity, also a corporation created by federal statute and subject to substantial federal control, was a federal instrumentality and could be subject to the First Amendment). *A fortiori* the CROs have no direct government involvement at all.

132. For example, see the Government Corporation Control Act, 31 U.S.C. §§ 9101–9110 (2006), or the Federal Advisory Committee Act, 5 U.S.C. app. §§ 1–15 (2006).

133. *See, e.g.*, A. Michael Froomkin, *Wrong Turn in Cyberspace: Using ICANN to Route Around the APA and the Constitution*, 50 DUKE L.J. 17 (2000) (describing the improbable rise of the Internet Corporation for Assigned Names and Numbers as the U.S. federal government's wholly private means for controlling the very root systems of the Internet); Chris Sagers, *The Myth of "Privatization,"* 59 ADMIN. L. REV. 37 (2007) (describing the range of entities with quasi-governmental powers but comparatively little oversight); Chris Sagers, *The Evolving Federal Approach to Private Legislation and the Twilight of Government* (Cleveland–Marshall Coll. of Law, Working Paper No. 05-117, 2005), *available at* http://ssrn.com/abstract=610587 [hereinafter Sagers, *Twilight*] (describing the similar power of standard-setting organizations in many contexts).

violation of the First Amendment.[134]

The very fact of this constitutional result is a large enough problem in itself. A frequent problem when applying First Amendment protection to commercial behavior is the failure to consider the consequences of mischaracterization of the entity seeking protection.[135] However, even under the assumption that such protection exists, the problem for the rest of this analysis is that regulatory instruments must contend with the risk that they are unconstitutional as applied to privately generated credit ratings.

3. But Are They Standard Setters?

Finally, one interesting and different issue is that CROs fill a role similar to that of a whole class of other nominally private entities commonly known as standard-setting organizations (SSOs). Like most SSOs, the CROs establish a more or less codified policy that is binding on other private actors by establishing formal normative guidelines of their own and encouraging compliance with them.[136] The federal government has shown a fairly keen interest in SSOs, and the scattered body of policies and rules developed for them contain some slender limits that might marginally improve the behavior of the CROs.[137] But it seems unlikely that any of those policies would actually apply,[138] and while it might improve credit ratings in some respects, it would still leave the industry with serious problems.[139]

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134. These issues are pursued at greater length in Chris Sagers, Further Perversions in First Amendment Characterization and the Metaphysics of Corporate Nature: The Case of the Bond Rating Agencies (manuscript on file with the authors).

135. *See generally id.*; Christopher L. Sagers, *The Legal Structure of American Freedom and the Provenance of the Antitrust Immunities*, 2002 UTAH L. REV. 927, 951–57 (examining the negative unforeseen consequences of well-intended extensions of First Amendment protection to juridical persons).

136. See Sagers, *Twilight*, *supra* note 133, for a fuller account of federal oversight of private standard setting.

137. Namely, the federal government has provided that it will make use of privately adopted "standards" in both procurement and in regulation, but only if those standards are adopted according to "consensus" procedures. Consensus procedures are those in which affected persons are given an opportunity to participate in the standard-setting process and afforded fairly substantial procedural protections. *See* Sagers, *Twilight*, *supra* note 133. In a move only too familiar from CRARA and the SEC regulations under it, the consensus procedures effectively mandated by the government are *precisely* those that had already been in use by the most powerful SSOs for many years. *See id.*

138. This is so both because the work of CROs probably does not fit the definition of "standard" currently in use in federal policy and because CROs are now separately regulated by CRARA. *See* National Technology Transfer and Advancement Act of 1995, Pub. L. 104-113, §12(c)–(d), 110 Stat. 775, 783 (1996) (codified at 15 U.S.C. § 272 note); Federal Participation in the Development and Use of Voluntary Consensus Standards and in Conformity Assessment Activities, 63 Fed. Reg. 8,546 (Feb. 19, 1998) (implementing the Technology Transfer and Advancement Act).

139. Credit rating might be improved if CROs were forced to develop their

B. CRARA and SEC Oversight: Free-Market Competition Solutions Are Doomed

With regard to other currently existing laws, are there any that could constrain the CROs to better performance? The only law specifically addressing CROs is Congress's effort from a few years ago, the Credit Rating Agency Reform Act of 2006 (CRARA), which was inspired by the corporate collapses of 2000–2001.[140] CRARA is a pointedly free-market piece of legislation; it basically has two business ends, both devoted to decreasing concentration and improving price competition in the supply of ratings. First, its basic remedy for better credit-rating performance is simply to mandate the licensing of a larger number of NRSROs.[141] Shortly after implementation of CRARA's new and more permissive licensing process in mid-2007, the Commission granted NRSRO status to a handful of new registrants. Second, CRARA directs the SEC to prohibit some CRO behavior by rulemaking.[142] Congress directed the Commission to prohibit actions it "determines to be unfair, coercive, or abusive," but explicitly provided that the kinds of conduct to be prohibited should include specific exclusionary practices the majors had been accused of using to deter competition.[143] Finally, to cement its market approach, CRARA explicitly prohibits the SEC from regulating the "substance" of credit rating itself and preempts any state law that would do the same.[144]

methodologies by consensus procedures. *See* Sagers, *Twilight*, *supra* note 133 (explaining the federal requirement of "consensus" standard setting). Affected parties could participate in making the methodologies better. The problem is again the very idea of private credit rating intermediaries. The CROs have access to neither more nor less substantive knowledge about prevailing finance economics theory than other participants, and they have not demonstrated any inherent comparative advantage over other market participants in predicting credit risk, despite their first-hand experience rating the vast majority of debt issues. Moreover, opening their processes in such a way as to make them consensus operations would presumably upset their profit-making business model substantially. So while consensus procedures might improve their methodologies to some extent, the question remains whether they could really add value that would justify their expense.

140. *See supra* note 9.

141. By that statute Congress for the first time established a formal, objective process by which ratings entities could apply for NRSRO status, consistent with agitation by some for years that the real problem in credit rating has been lack of competition. *See* White, *supra* note 5, at 52 (discussing SEC criteria for designating NRSROs).

142. 15 U.S.C. § 78*o*-7(i) (2006).

143. *Id.* § 78*o*-7(i)(1).

144. CRARA sets a few other limits that are not directly competition-related, but they are flimsy and virtually afterthoughts. For instance, it requires an NRSRO to establish, maintain, and enforce policies and procedures "*reasonably* designed, *taking into consideration the nature of the [NRSRO's] business . . . and [that of] affiliated persons and affiliated companies thereof*, to address and manage conflicts of interest." 15 U.S.C. § 78*o*-7(h)(1) (2006) (emphases added). This provision is largely toothless, however, as the majors have all had formal ethical rules and internal conflict-of-interest controls for years, none of which prevented either the recent ratings disasters nor the gross abuses of the

The hope is that ratings criteria will continue to be developed privately by market institutions and that the discipline of competition will improve not only the price of ratings but also their substantive quality. Although new amendments to these rules have been adopted[145] and others remain pending,[146] the major goal remains merely to increase competition, leaving both the development of ratings methodology and the judgment of particular CROs' performance to the market.[147]

Competition as a solution will not work. Admittedly, effective price competition may at least bring down ratings fees and encourage some greater concern for quality, but several major problems suggest that CRARA's approach will be of little value. First, licensing more NRSROs does not result in more competition. Those second-tier firms that managed to get pre-CRARA designation were just acquired by the majors in a relatively quick fashion.[148] Competition authorities have seen little reason

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structured-finance era. Neither CRARA nor the implementing regulations require any safeguards beyond those the majors already have in place.

145. *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6,456 (Feb. 9, 2009) (to be codified at 17 C.F.R. pts. 240 & 249b) (amendments by SEC that went into effect in April 2009).

146. Proposals are still pending that would require ratings of structured securities either to use special ratings symbols or be published along with written reports, *see* Nationally Recognized Statistical Ratings Organizations, 73 Fed. Reg. 36,212 (proposed June 25, 2008), and, more significantly, proposals that would remove the use of the NRSRO references in securities regulations. *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. at 6,456 n.1 (referencing the several notices of proposed rulemaking in which these changes were proposed).

147. Specifically, the SEC's April 2009 amendments, *see supra* note 145, focus heavily on mandatory disclosures by the CROs of the accuracy of their own ratings over time. Commentators have urged such a requirement for some time, but it bears repeating that the Commission only requires disclosure of this information. It will remain for markets to determine whether to punish a given CRO for its bad performance, and no such thing has ever occurred, despite the many scandalous instances of poor CRO performance. Moreover, empirical evidence has existed for several decades examining the performance of the various CROs, and often explicitly comparing them. *See supra* notes 97–103. There is no reason to doubt that an empirical study of their performance will be any less available in the foreseeable future.

Admittedly, the new amendments and those still pending would add some other protections, including enhanced record-keeping requirements that might aid the Commission's increased examination efforts since the subprime meltdown. But it is hard to imagine that the added disclosure, record keeping, and conflict-of-interest rules will materially alter the internal rules that the CROs already maintain or the modest, additional requirements imposed by CRARA and the Commission's initial rules.

148. Even before CRARA, the SEC granted the designation to several firms outside of the three major firms, but each firm was either acquired or combined with another CRO within a few years, and all of them wound up eventually joining a major CRO. The Duff & Phelps firm, which was designated in 1982, and McCarthy, Cristani & Maffei, designated in 1983, merged in 1991 and then were acquired by Fitch in 2000. Thompson BankWatch, which enjoyed a limited designation for bank issues since 1992, was "upgraded" to general-purpose designation in 1999 and then almost immediately it too was acquired by Fitch in 2000. IBCA, a London-based firm, received limited designation for bank issues in 1997 and

to stop these moves, and one anticipates that given the authorities' basic theoretical approach to merger enforcement, the CRARA-engendered increase in the number of NRSROs will make it even easier for future acquisitions. While it is too early to predict the outcome of the CRARA experiment, there is no particular reason to believe those newly licensed NRSROs will not simply be acquired and will never meaningfully decrease concentration in the industry. Likewise, CRARA impliedly assumes that NRSRO designation is the market's only significant entry barrier. But smaller firms and new entrants face the significant problem of developing the very reputational capital that current NRSROs claim to be so central to their continued operation.[149]

Next, even if CRARA or some other legislative innovation managed to inject some price competition, there is no particular reason to believe that it will improve the *quality* of ratings. Competing CROs have existed for many years, both here and overseas, and while they are mainly much smaller than the major CROs, most of them do not charge issuer fees.[150] Until recently none of them were NRSROs, and so all they had to sell to their subscribers was information in competition with the majors. Many of these firms rate large percentages of issues throughout bond markets or within particular segments. Given their numbers, the breadth of their coverage, and the major CROs' poor performance of the past few decades, *some* of those firms should have had *some* opportunity to outperform the major CROs. And given the speedy dissemination of information in capital markets, that superior information would have been widely available. Yet, the existence of that competition has had no discernable impact on the performance of the majors.

But finally, one completely different and possibly very significant problem with competition as a solution—especially as it is embodied in CRARA, which simply increases the number of firms entitled to sell NRSRO regulatory licenses to bond issuers—is that it will likely *decrease the quality of ratings*. In their role as NRSROs, the agencies act literally as regulators because issuers will adjust their behavior to standards devised by CROs if they deem it necessary for a desired rating. A nicely documented historical record shows that where regulators share overlapping oversight of the same regulated entities, they will often "compete" for their subjects'

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then combined with Fitch in 1997. *See* White, *supra* note 5, at 46.

149. See TECHNICAL COMM., INT'L ORG. OF SECS. COMM'NS, REPORT ON THE ACTIVITIES OF CREDIT RATING AGENCIES 14–15 (2003), *available at* www.fsa.go.jp/inter/ios/20030930/05.pdf, for an explanation of this problem.

150. As of 2003, the IOSCO Technical Committee found that dozens of overseas CROs were neither affiliated with the majors nor charging issuer fees. *See id.* at 9.

"business" by loosening their standards,[151] and there is emerging empirical evidence that increased competition among CROs leads to ratings that are more "issuer friendly."[152]

C. International and Self-Regulatory Initiatives

Intergovernmental and nongovernmental organizations studying the problem have settled on one particular solution: the CROs' voluntary adoption of a hortatory code recently promulgated by International Organization of Securities Commissions (IOSCO) and the International Group of Treasury Associations (IGTA).[153] Rules of this nature, however, were not made to work, which is made evident by the fact that all of the major CROs implemented the IOSCO code by early 2007, well *before* the day on which the major CROs inaugurated the subprime meltdown.[154] Thus, even after their adoption of these codes, the majors rated extremely risky instruments very highly, in spite of evidence that they lacked confidence in their own ratings, and they did so under clear pecuniary conflicts of interest.[155] Moreover, general hortatory conduct rules focusing on transparency and independence are beside the point in light of CRARA

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151. In a careful study, Steven Ramirez showed that banks, in particular, who have long had their choice among various federal and state regulators, have played those regulators against one another, encouraging "regulatory competition" to achieve the most favorable regulation. *See* Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503 (2000). As he notes, regulatory experts recognized this problem as early as 1949. *Id.* at 534 (discussing U.S. COMM'N ON THE ORG. OF THE EXECUTIVE BRANCH OF THE GOV'T, THE HOOVER COMMISSION ON ORGANIZATION OF THE EXECUTIVE BRANCH OF THE GOVERNMENT (1949)). Other observers, prominently including the General Accounting Office, have, for this reason, urged consolidation of financial regulatory authorities for many years. *See* U.S. GEN. ACCOUNTING OFFICE, BANK OVERSIGHT: FUNDAMENTAL PRINCIPLES FOR MODERNIZING THE U.S. STRUCTURE 3–4 (1996). In the context of the CROs, the lack of meaningful government oversight or public accountability renders the regulatory competition problem potentially even more serious. For investigatory evidence of the CROs' "race to the bottom," see SEC 2008 STAFF REPORT, *supra* note 3.

152. Bo Becker & Todd Milbourn, *Reputation and Competition: Evidence from the Credit Rating Industry* (Harvard Bus. Sch., Working Paper No. 09-051, 2008). An excellent example is that in one of the rare well-documented instances of actual head-to-head competition among major CROs, Fitch managed to steal substantial early market share in structured ratings. For a time, it was considered the dominant CRO in that niche. There is reason to believe Fitch competed not on price but by lowering its rating standards, and that Moody's and S&P responded by lowering theirs. *See* Bolton et al., *supra* note 10 (reaching a similar result in a game theoretic model); Skreta & Veldkamp, *supra* note 10, at 22.

153. *See supra* notes 5–6.

154. *See* TECHNICAL COMM., INT'L ORG. OF SECS. COMM'NS, REVIEW OF IMPLEMENTATION OF THE IOSCO FUNDAMENTALS OF A CODE OF CONDUCT FOR CREDIT RATING AGENCIES 13 (2007). Though the majors did not adopt the IOSCO code verbatim, the Technical Committee found that each of them had "strongly implemented" almost all of it in their internal ethical codes. *Id.*

155. *See supra* note 56 and accompanying text (describing CROs' roles in the creation of the credit crisis).

and its implementing regulations, which already mandate such things, and will have no effect in any event.

D. Civil Liability

Even if existing U.S. and international regulatory rules do not work, CROs might be made to perform better through more successful *ex ante* lawsuits. But, as Partnoy points out, "[t]he only common element" in lawsuits challenging CROs for incompetence or malfeasance "is that the rating agencies win."[156] This has been partly for the First Amendment reasons stated above, but as we will now show, even without that protection, they would remain substantially underconstrained for substantive legal reasons, both under the handful of theories that have actually been brought against them and as to other theories we were able to devise.

1. Federal Securities Regulation

The only major federal securities laws that could be relevant are the Investment Advisers Act of 1940 (IAA)[157] and the Securities Exchange Act of 1934 (Exchange Act).[158] First, the CROs were traditionally subject to the IAA and appeared to comply with it without too much complaint,[159] even though a 1985 Supreme Court ruling probably exempts them from it for First Amendment reasons.[160] But more recently, CRARA amended the Act to explicitly exempt NRSROs from coverage unless they issued recommendations on purchasing, selling, or holding securities.[161] In any case, subjecting them to IAA liability would not be a desirable course of action, both because of the burden on the SEC[162] and because of the fact that most CRO ratings are not the type of personalized investment advice

156. Partnoy, *supra* note 10, at 79.

157. 15 U.S.C. § 80b-1 (2006).

158. *Id.* §§ 78a–78*oo* (2006). The Securities Act of 1933 (Securities Act) is not terribly relevant. Securities Act Rule 436(g)(1) exempts NRSROs from § 11 liability, and while §17(a) has language similar to the anti-fraud provisions of Exchange Act Rule 10b-5, §17(a) applies only to "sellers" of securities.

159. *See* Memorandum from Anette L. Nazareth to William H. Donaldson, Chairman, SEC (June 4, 2003), *available at* http://www.sec.gov/spotlight/ratingagency/baker060403.pdf.

160. *See* Lowe v. SEC, 472 U.S. 181 (1985) (holding that a completely disinterested publication regularly offered to the general public falls within the 15 U.S.C. § 80b-2(a)(11)(D) exception to Advisors Act coverage).

161. *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 4(b)(3)(B), 120 Stat. 1329 (2006) (amending 15 U.S.C. § 80b-2(a)(11)).

162. The SEC has sole authority to enforce most provisions of the Investment Advisors Act. *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 14 (1979).

that the Act seeks to regulate.[163]

Second, parties might seek liability under Exchange Act § 10(b) and Rule 10b-5.[164] However, a major hurdle will be proof of "a mental state embracing intent to deceive, manipulate, or defraud,"[165] which at summary judgment must be shown by a "strong" inference.[166] As Partnoy observes, the ratings are "extensively disclaimed and not . . . recommendation[s] to buy, sell or hold securities."[167] Without proof that a CRO had knowledge that would have changed the issued rating, it will not be liable for § 10(b) violations.

2. *Antitrust*

The level of concentration in the U.S. ratings industry might seem to call for an antitrust solution, and for that reason CRARA includes a competition-policy approach. Not only have market watchers suggested an antitrust solution, but the Justice Department once almost brought suit,[168] some others have sued,[169] and one state attorney general's federal antitrust suit remains pending.[170]

Antitrust will not work. First, a technical problem will confront antitrust claims before courts even reach the merits. There is a fairly solid chance that CRARA's oversight of the industry, and especially its evident insistence on expanded competition, actually preempts antitrust litigation

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163. *See generally Lowe*, 472 U.S. at 190–91, 204, 207–08 (discussing the reasons why the Act was crafted).

164. 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5(b) (2008). Private claims have been brought against CROs as aiders and abettors of §10(b) fraud, but the Supreme Court has twice shut the door on this theory. In *Cent. Bank of Denver v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 179–80, 190–91 (1994), the Court held that there is no private right of action for aiding and abetting a § 10(b) violation. The issue was raised again after the enactment of the Private Securities Litigation Reform Act of 1995, which gave the SEC authority to prosecute aiders and abettors of § 10(b) violations, and the Court again held that there was no private right of action. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 768–69 (2008). The SEC may still prosecute such aiders and abettors, as § 104 of the Private Securities Litigation Reform Act of 1995 gives the SEC authority to do so. Pub. L. No. 104-67, §104, 109 Stat. 737, 757 (1995) (codified as amended at 15 U.S.C. § 78t (2006)).

165. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, 194 n.12 (1976).

166. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007) ("To qualify as 'strong' . . . we hold, 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 . . . .").

167. Partnoy, *supra* note 10, at 79. Opinions can be actionable as § 10(b) fraudulent statements, but it must be shown that the speaker does not believe the opinion and that the opinion is not well-founded. *See, e.g.*, Mayer v. Mylod, 988 F.2d 635, 638–39 (6th Cir. 1993); *In re* Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 644 (S.D. Ohio 2008).

168. *See supra* note 8.

169. *See id.* (discussing Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., Inc., 175 F.3d 848 (10th Cir. 1999)).

170. *See id.* (discussing the pending suit by the Connecticut Attorney General).

entirely.[171] Even if it does not, an antitrust suit might also be fairly hard to bring as a substantive matter. Section 2 monopolization seems the only likely angle of attack because there is no obvious collaborative conduct,[172] and it is not clear that even the majors' massive market shares would support such a claim. Moreover, with the exception of some conduct by Moody's that appears to have abated,[173] it is hard to imagine how a plaintiff could establish the "exclusionary conduct" element of that cause of action. The major CROs will likely argue that their market power comes largely from government incorporation of their ratings. Of course, a Clayton Act § 7 challenge to any of the many acquisitions that have kept the major

171. Where a federal statute makes clear Congress's intent that antitrust not apply to some particular activity, even in the absence of explicit language in the statute, a court may hold that antitrust is "implied[ly] repealed" as to that activity. In fact, in four leading opinions, the Supreme Court has held antitrust impliedly repealed as to securities markets by prevailing federal securities law. *See* Credit Suisse Secs. (USA) LLC v. Billing, 551 U.S. 264, 275 (2007); Gordon v. NYSE, 422 U.S. 659, 682, 685−86 (1975); United States v. Nat'l Ass'n of Secs. Dealers, Inc., 422 U.S. 694, 734 (1975); Silver v. NYSE, 373 U.S. 341, 357, 371 (1963). By the Court's prevailing standard, antitrust will be held repealed as to some given activity if the antitrust complaint and the other federal law are "clearly incompatible." *Credit Suisse*, 551 U.S. at 275–76. The *Credit Suisse* Court, which considered this standard in the context of antitrust liability for conduct also subject to SEC regulation, strongly implied that there could be clear incompatibility wherever an antitrust complaint challenged activity that even *someday might* be subject to SEC regulation, merely authorizing conduct that otherwise would violate antitrust. *Id.* The SEC has power under CRARA to "prohibit any act or practice . . . the Commission determines to be unfair, coercive, or abusive," and has already used it to prohibit certain anticompetitive practices that might otherwise have been evidence for a § 2 monopolization plaintiff of "exclusionary conduct." *See* 15 U.S.C. § 78*o*-7(i)(1); 17 C.F.R. § 240.17g-6(a). Moreover, while the SEC's rulemaking power under § 78*o*-7(i) contains an explicit "savings clause" that preserves antitrust authority—that is, Congress directed that CRARA's oversight of the industry was not meant to "impliedly" repeal antitrust as to the CROs, *see* 15 U.S.C. §78*o*-7(i)(2)—in the recent past the Supreme Court has read similar clauses completely out of existence. In Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 411–15 (2004), the Court considered a § 2 monopolization claim against a phone company that refused to provide nondiscriminatory access to its phone-line facilities, despite a requirement in the Telecommunications Act of 1996 to do so. That Act even contained a savings clause providing that "nothing in this Act or the amendments made by this Act shall be construed to modify, impair, or supersede the applicability of any of the antitrust laws." Telecommunications Act of 1996, Pub. L. 104-104, § 601, 110 Stat. 56, 143 (codified as amended at 47 U.S.C. § 152 note (2006)). The Court nevertheless refused to entertain plaintiff's antitrust claim on the ground that the Telecommunications Act already contained provisions mandating competition, weighing the costs and unlikely benefits that the Court believed to be promised by the § 2 claim. *Verizon*, 540 U.S. at 411–15. The Court said this was appropriate, noting, "[The] regulatory structure [was] designed to deter and remedy anticompetitive harm. . . . [W]here, by contrast, '[t]here is nothing built into the regulatory scheme which performs the antitrust function,' the benefits of antitrust are worth its sometimes considerable disadvantages." *Id.* at 412 (citation omitted).

172. Without some evidence of an anticompetitive agreement, neither § 1 nor § 2 conspiracy to monopolize liability will be available. 15 U.S.C. §§ 1–2 (2006).

173. Specifically, Moody's apparently agreed with the Justice Department to no longer use unsolicited ratings as a punishment to issuers for failure to seek a Moody's rating. *See supra* note 8.

CROs in a dominant position would require no exclusionary-conduct showing, and concentration in the industry ought to be large enough at least to raise Clayton Act concerns. Still, not only have all domestic CRO acquisitions of the past several years received regulatory approval, but they were almost all acquisitions by Fitch or even smaller firms. Fitch remains a distant third-place challenger to Moody's and S&P, and the associated increases in concentration may be too small to challenge.

But more importantly, there is no especially promising reason to believe that even successful litigation against the CROs would remedy any problems of real concern. The best long-term benefit from any potential antitrust litigation would be increased price competition. For all the reasons mentioned in connection with CRARA, the entry of more CROs will not necessarily ensure either meaningful price competition or more accurate ratings.

3. State Law

State government regulation of CROs essentially does not exist, but if it did, it would face problems. CRARA specifically preempts all state or local registration, licensing, or qualification requirements for NRSROs.[174] Although states can investigate and bring enforcement actions against NRSROs for fraud or deceit,[175] CRARA also preempts any state or local regulation that regulates the "substance of credit ratings or the procedures and methodologies" NRSROs use to determine ratings.[176] And given the international scope of the problem, state-by-state regulation hardly seems desirable. Prospective state-level regulation might also face the problem of CRO "retaliation" in that CROs might refuse to rate products originating in states with laws unfriendly to those products. This happened in Georgia in 2002 when that state passed an anti-predatory lending law.[177]

Issuers or investors might raise any number of state law tort claims to challenge inaccurate ratings. However, willful violations—such as defamation, fraud, and the like—would be difficult to prove in all but the most extreme cases[178] and may also be barred by the First Amendment.[179]

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174. 15 U.S.C. § 78*o*-7(*o*)(1) (2006).

175. *Id*. § 78*o*-7(*o*)(2).

176. *Id*. § 78*o*-7(c)(2).

177. *See* Engel & McCoy, *supra* note 109, at 2099; Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2243–44 (2007); *see also* C. Lincoln Combs, Comment, *Banking Law and Regulation: Predatory Lending in Arizona*, 38 ARIZ. ST. L.J. 617, 628–29 (2006) (discussing the CROs' influence over a state anti-predatory lending law in Georgia).

178. Fraud claims encounter the same issues as Rule 10b-5 claims—the proof of scienter. That is, it is difficult to prove that CROs intended to defraud, because it is difficult to show that CROs had actual knowledge of some fact that would have changed the rating

Negligence claims, such as negligent misrepresentation, have a better chance of surviving until trial but only in limited situations.[180] Generally speaking the courts have found CROs owe no duty of care toward third-party investors when making ratings announcements public.[181]

VI. LIKELY FUTURE UNREGULABILITY

A. *Real Free-Market Solutions: Adopt Investor-Pays or Displace Intermediation Altogether*

One solution is to get the CROs more or less out of the credit rating business. Markets themselves generate information, and public capital markets are thought to do it fairly efficiently. Thus, probably the best known CRO-reform proposal is Frank Partnoy's long-standing recommendation to remove the CROs from any regulatory role. He would retain both private and public portfolio rules for institutional investors, but would replace NRSRO ratings with yield spreads, which, he says, are already readily available and should in principle measure risk at least as well as the CROs or any other analytical intermediary.[182]

Although removing regulatory reliance upon credit ratings is an important first step, a significant problem with Partnoy's solution is that calculating and implementing enforceable yield spreads will be more difficult than Partnoy implies. But more significant is his strong, implicit

assigned to the debt issue. There has been some success suing CROs for fraud and negligent misrepresentation, but only in the most egregious cases. For example, when CROs conspire with hedge funds to provide false reports to depress issuer equity pricing, they may "step[] over the line into defamation and other torts." *See* Overstock.com, Inc. v. Gradient Analytics, Inc., 61 Cal. Rptr. 3d 29, 33–34 (2007) (denying defendant's motion to strike the complaint).

179. *See supra* notes 134–35 and accompanying text; *see also* Sagers, *supra* note 134.

180. *See, e.g.*, *In re* Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 646–49 (S.D. Ohio 2008) (denying Moody's and Fitch's motions to dismiss claims for negligent misrepresentation when ratings were issued for a private placement and were assigned without the exercise of reasonable care).

181. *See supra* note 165 and accompanying text.

182. *See* Partnoy, *supra* note 11, at 624. One issue with relying on spreads instead of ratings is that spreads can vary significantly due to macroeconomic factors, just as they have in the wake of the recession of 2008. This is likely due to the fact that bond prices include more information than credit risk, which is supposed to be the sole concern of credit ratings. *See generally* Kose John et al., *Credit Ratings, Collateral, and Loan Characteristics: Implications for Yield*, 76 J. BUS. 371 (2003); Edwin Elton et al., *Explaining the Rate Spread on Corporate Bonds*, 56 J. FIN. 247 (2001); Edwin Elton et al., *Factors Affecting the Valuation of Corporate Bonds*, 28 J. BANKING & FIN. 2747 (2004). A related suggestion, which would replace a simple letter-grade credit rating with underlying assumptions or market measures such as the assumed default probability, loss given default, etc., would likely have the same effect as removing credit ratings from regulation, because categories of ratings would become more complex and less clearly defined as "investment grade."

free-market confidence. Despite what he implies, markets have sometimes measured risk poorly as it has with respect to the present crisis. However significant the role of the CROs and regulatory failures or any other particular factor may have been, one failure originating purely in capital markets themselves made a major contribution: long-standing, systematically underpriced risk premia.[183] There is no particular reason to believe that such a thing will not happen again.

A related suggestion to better harness incentives is to keep private intermediaries but mandate a return to an investor-pays business model. Investors might be better trusted to decide how much information to buy. They would pose neither the agency costs of the current system (corporate managers might pay for more than an efficient amount of analytical services) nor conflicting interests. Furthermore, they might better penalize intermediaries that perform poorly. The problem will be overcoming the tremendous free-riding and collective-action problems it would pose, which may have led to the issuer-pays system. Some means would have to be devised by which individual investors could fund analysis by pooling their resources for it at low cost while overcoming the public-goods nature of the information they purchase. Devising such a system seems extremely complex and rife with uncertainties that are presently unknown and possibly unknowable. For instance, the voucher system proposed by Choi and Fisch raises more questions than answers, despite their long, elegant, and detailed treatment of the system.[184] Such a system seems complex and costly enough to raise the question as to why it would not be better just to have the government act as the intermediary.[185]

B. Other Market Solutions, Sort of: Skin in the Game and Investor-Controlled CROs

Another market-based solution would be to retain an intermediary's analysis in portfolio rules, but to require that entity to have some stake in all the securities it rates. Obvious and critical problems would infect any proposal under which CROs themselves take pecuniary interests in rated

183. *See* FSF 2008 REPORT, *supra* note 5, at 5–6.

184. *See generally* Choi & Fisch, *supra* note 14, at 314–44. Other suggestions for altering payment models pose similar difficulties. For example, one proposal that ratings be paid out of bond coupons poses a pair of problems. It may discourage CROs from rating debt that is below investment-grade because full ratings fees would not necessarily be paid when debt defaults. It may also encourage CROs to deflate ratings to increase the amount or the rate at which they get paid, due to the larger coupon. For obvious reasons, it may also discourage CROs from rating long-term debt, or raising the costs of rating such debt, due to the increased probability of default over short-term debt.

185. *See infra* notes 195–98 and accompanying text.

firms,[186] but one more-elegant alternative would be to do away with ratings as such and instead give the job to insurers. Any such proposal would presumably resemble the Enron-era suggestion of Sean Ronen, an NYU accounting professor, that a system of "financial statement insurance" replace the auditing of publicly disclosed financial statements.[187] There is some reason to believe that parties with more skin in the game outpredict those who have less to lose. For example, some tentative empirical results show that professional short sellers have outperformed the market in predicting corporate accounting restatements.[188]

A solution proposed by Stanford law professor Joseph Grundfest at a recent SEC Roundtable event on CROs would involve the creation and mandatory utilization of investor-owned and controlled CROs (IOC CROs).[189] Issuers would continue to pay for credit ratings, but in addition to the ratings they purchase now, they would have to pay for an IOC CRO to rate their issue as well. This model, which is reminiscent of the independent research requirement of the Global Legal Settlement following the recent accounting scandals, would not solve the significant lack of price competition in the CRO market. While it would ensure that the major CROs have a counterpart that would be designed to have an opposing bias, it is not clear that this would improve the quality of ratings sufficiently to justify the added expense.

But there remains a major problem with both ideas, at least until there is better empirical evidence on how self-motivated market observers work and when they are likely to fail. Major players with plenty of skin in various games performed very poorly both in the present crisis and in other recent ones. Large institutional investors, for example, have expertise and

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186. Namely, (1) the intermediary would then have much bigger conflicts of interest, and (2) the major CROs rate far too many issues for them to invest in each one.

187. Ronen first suggested the idea in a *New York Times* op-ed piece. Joshua Ronen, Op-Ed., *A Market Solution to the Accounting Crisis*, N.Y. TIMES, Mar. 8, 2002, at A21. This was later elaborated with two coauthors. Alex Dontoh et al., Financial Statements Insurance 2 (NYU Stern Sch. of Bus., Working Paper, 2004), *available at* http://ssrn.com/abstract=303784.

188. *See* COFFEE, *supra* note 14, at 35–36 & n.76 (discussing evidence that a particular short-selling firm predicted the Enron collapse before any other observer and citing preliminary empirical evidence of similar performances by other short sellers).

189. *See* SEC, Transcript of Roundtable to Examine Oversight of Credit Rating Agencies 192–204 (April 15, 2009) (remarks of Joseph Grundfest), *available at* http://www.sec.gov/spotlight/cra-oversight-roundtable/cra-oversight-roundtable-transcript.txt. A different restriction arising from the accounting scandal at the turn of the century, requiring firms to rotate their use of accounting agencies, could effectively create some price competition. Requiring issuers to use a CRO for no longer than a limited period of years, then subsequently preventing them from using that CRO for the same number of years, could foster a cottage CRO industry. Of course, it could also just encourage issuers to alternate between the major CROs and do away with the two-ratings norm for every issue.

maintain their own in-house analytical capacity. Yet they failed to predict the subprime meltdown; indeed, they consumed securitized subprime assets voraciously right up until Pearl Harbor Day. Admittedly, there are reasons to believe that some institutional fund managers might continue buying a security even when they predict that it is overpriced,[190] but in this case they failed to heed plenty of advance warning of very dire consequences.

Other sophisticated investors made this same mistake. American International Group (AIG) and others exposed themselves extensively through guaranteeing a "non-insurance" subsidiary's credit default swaps (CDSs). Indeed, the massive wave of RMBS downgrades was the triggering event in numerous AIG CDSs, which eventually led to government intervention to keep AIG afloat. Similarly, insurers who provided credit enhancements to RMBS pools by insuring pieces of them were taken by surprise when default rates soared. Thus, it is not clear that replacing CROs with insurance companies would materially improve risk estimation.[191]

C. The Last Market Solution, We Promise: Internalize Risk Externalities

It is commonly thought that the moment after a regulation takes effect the private sector finds ways around it. As discussed, some attribute financial innovation itself as merely a response to regulation. When markets practice this avoidance behavior, regulations should seek to align market incentives to encourage the market to police itself. This course of action has worked most effectively in the regulation of financing consumer purchases of goods and services, where the government has placed liability on loan purchasers to ensure that they police the individuals from whom they purchased loans.

In the CRO market, the entities that could exert the necessary pressure on CROs are limited to the investment banks that select which CRO will rate the debt issues they underwrite. It is unclear if making debt underwriters liable to investors for overinflated ratings will have the desired corrective effect. While loan purchasers in consumer markets had knowledge of the unlawful practices of loan originators, debt underwriters may have little knowledge of or control over the underlying assumptions the CROs use in their quantitative modes that lead to overinflated ratings. There is one obvious benefit of this proposal: it should limit the effect of the conflict of interest that leads to ratings inflation by forcing underwriters to bear a corresponding cost for such actions.

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190. *See supra* note 121 and accompanying text (discussing evidence of "herding").
191. *A fortiori*, Partnoy's suggestion that reliance be made on the market for CDSs seems, in light of recent events, too risky. *See* Partnoy, *supra* note 11, at 679.

This upstream liability would have an interesting effect on financial innovation by counterbalancing the underwriter's financial incentive to sell as much as possible with the potential cost of liability. The problem is that risks of liability imposed by way of federal securities law have failed massively during the past few decades, and it is not clear whether they ever much improved capital market efficiency even when enforcement worked better. Moreover, while underwriter liability should prevent the reckless adoption of financial innovations, it has the downside of likely increasing the cost of innovation.

D. Anti-market Solutions: Substance Regulation or Outright Socialization of Analytical Intermediation

An obvious approach is simply to increase the regulation of CROs and, in particular, to regulate the substance of what they do. This has never been done before, and for the time being, the primary CRO regulator is prohibited by federal statute from doing so—at least as to the NRSROs, CRARA prohibits it.[192] But the air presumably is ripe for some reversal on that point and suggestions abound for it. The Congressional Oversight Panel, for example, made a comparatively drastic recommendation. The Panel proposed a public "Credit Rating Review Board" that could "sign off on any rating before it took on regulatory significance"—that is, before it would have the effect that NRSRO ratings have currently.[193]

The problem is that even in light of the current window during which regulation might be politically feasible, the Panel's recommendation would be extremely expensive and duplicative. The majors each rate on the order of 20,000 new issues per year, and the Credit Rating Review Board would presumably have to duplicate their work to some large extent. Under such a scheme, the natural question would be why the government does not simply do the job itself. Alternative oversight schemes that would be less costly because of reduced scope of oversight would be substantially less effective. For example, the Congressional Oversight Panel alternatively suggested structuring its Review Board as a licensure and oversight body, like the Public Company Accounting Oversight Board (PCAOB).[194] But PCAOB has hardly been a model of regulatory success.

That then leaves what is probably the least politically feasible

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192. CRARA provides, "Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." 15 U.S.C. § 78*o*-7(c)(2) (2006).

193. COP REPORT 2009, *supra* note 4, at 44.

194. *See id.*

alternative, which may be undesirable for other reasons: the government itself might simply rate private debt—either in competition with the CROs or in legally preemptive usurpation of them.[195] One benefit of a government informational intermediary is that it could charge user fees to issuers or investors, thereby solving both the public-goods nature of informational producers and the agency-cost problems sometimes said to affect intermediary services.[196]

Even aside from its patent absurdity from a political perspective—this solution would entail essentially killing off a multibillion-dollar industry and would be greeted as outright socialist treachery—a government informational intermediary would require a very costly new apparatus. Also, whatever might be its other costs and benefits, this approach is at odds with two other existing federal policies. First, the federal government has essentially prohibited itself from making any new "standard" where a "voluntary consensus standard" is available from the private sector that would do the job.[197] Likewise, by executive order dating to the Eisenhower Administration, the White House has consistently prohibited federal agencies from producing goods or services in competition with those available in the private sector. The policy is now codified federal law.[198]

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195. *See, e.g.*, White, *supra* note 10, at 14–15; Roger Lowenstein, *Triple-A Failure: How Moody's and Other Credit-Rating Agencies Licensed the Abuses that Created the Housing Bubble—and Bust*, N.Y. TIMES, Apr. 27, 2008, (Magazine), at 36, 39, 41 (stating that by adopting the NRSRO approach, "[i]n effect, the government outsourced its regulatory function to three for-profit companies" and suggesting that "if the Fed or other regulators want[] to restrict what sort of bonds could be owned by . . . anyone . . . in need of protection, they would have to do it themselves—not farm the job out to Moody's").

196. *See* Choi & Fisch, *supra* note 14, at 317–18.

197. Though the policy had various antecedents going back several years, it was formalized in the National Technology Transfer and Advancement Act of 1995, Pub. L. No. 104-113, § 12(d), 110 Stat. 775, 783 (1996) (codified as amended at 15 U.S.C. § 272 note (2006)), and implemented by Federal Participation in the Development and Use of Voluntary Consensus Standards and in Conformity Assessment Activities, 63 Fed. Reg. 8,546, 8,553 (Feb. 19, 1998). *See also supra* note 137 and accompanying text. *See generally* Sagers, *Twilight*, *supra* note 133.

198. The policy originated in an order of the Bureau of the Budget (predecessor to the Office of Management and Budget) under Eisenhower. *See* BUREAU OF THE BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, BULLETIN NO. 55-4 (1955) ("[T]he Federal Government will not start or carry on any commercial activity to provide a service or product for its own use if such product or service can be procured from private enterprise through ordinary business channels."). It has been in force continuously since then, codified for some decades now in OFFICE OF MGMT. & BUDGET, CIRCULAR A-76 (2003), and supplemented by the Federal Activities Inventory Reform Act of 1998, Pub. L. No. 105-270, 112 Stat. 2382 (1998) (codified as amended at 31 U.S.C. § 501 note (2006)). Its current thrust is that (1) federal agencies may never engage in "commercial" activities where the good or service in question is available from the private sector, and (2) they must conduct periodic reviews of their in-house activities to determine whether any of them ought to be farmed out. *See generally* Steven L. Schooner, *Competitive Sourcing Policy: More Sail than Rudder?*, 33 PUB. CONT. L.J. 263, 271–73 & n.39 (2004).

TENTATIVE CONCLUSIONS

Two policy objectives now dominating the CRO debate are to reduce systemic risk and to improve capital-market pricing efficiency. Those goals are not currently being met. There is no reason, given the nature of their business model and the financial pressures they face, to believe that the CROs will at any foreseeable time be able to operate on an issuer-pays basis without significant conflicting pecuniary interest. Furthermore, there is no reason to expect the substantive quality of their work to improve in such a material way that catastrophic failures like the present one will not occur again soon. Moreover, there is no reason at present to expect that any policies currently in place—including those voluntarily adopted by the CROs, those required by CRARA and its implementing regulations, and civil liability rules enforceable by private plaintiffs or government enforcers—will achieve either of these goals. For these reasons, it is imperative that policymakers end their regulatory reliance upon the CROs, even though doing so will not fix the CRO market.

It seems likely that some significant regulatory change will come fairly soon. Also, given the small number of major CROs and that several major intergovernmental bodies have worked on this in close collaboration—the SEC, the U.S. Congressional Oversight Panel, the Basel Committee's Technical Committee, the International Organization of Securities Commissions (IOSCO), the Committee of European Securities Regulators, the International Group of Treasury Associations (IGTA), and so on—it seems likely that whatever will happen will be internationally coordinated. Therefore, the most likely outcome is that a code consisting of the IOSCO and IGTA codes will be internationally adopted. Those rules will be augmented by some regulatory enhancements in the United States. But given that the SEC has already proposed somewhat tougher new regulations under CRARA[199] and has not requested new statutory authority, the likely U.S. response will simply be a tightening of existing rules to increase competition and improve transparency. We may see adoption of a CRO oversight body set up like the PCAOB, but it is hard to imagine its role will be anything more than a fairly passive one.

The analysis here suggests that these likely reforms will not be terribly successful. Capital asset pricing should be roughly as efficient as it was before. More importantly, none of these reforms has much hope of reining in the systemic risk of which we have already been victims, and importantly, they do nothing directly to constrain another CRO–issuer

199. *See* Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212 (proposed June 25, 2008) (to be codified at 17 C.F.R. pts. 240 & 249b).

partnership in lucrative innovative products like those of the structured finance era. But the analysis here also suggests that it may be quite hard to devise *any* regulatory approach that could constrain these sorts of problems without posing high costs and inviting new and unforeseen problems of its own. More-radical solutions have problems of political infeasibility. In short, capital markets currently contain a much more serious institutional flaw than has been recognized.

SYMPOSIUM

THE CHANGING LANDSCAPE OF FEDERAL ENERGY LAW

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INTRODUCTION

I recognize that some readers may believe the title of this Article, *The Changing Landscape of Federal Energy Law*, is inapposite. Energy law may be perceived as static or ossified, resistant to change. To some, the pace of change in federal energy law may appear to be geologic, advancing at a crawl. A closer look shows that the changes to federal energy law have been very significant in recent years, that the pace of change has been increasing, and that there is the prospect of sweeping change in the near future. Energy law truly is a dynamic area of law.

Energy law, as discussed in this Article, does not encompass the full range of energy laws, but instead is limited to the laws administered by the Federal Energy Regulatory Commission (FERC). Energy industries have existed for more than 100 years, and many energy laws were enacted decades ago. FERC administers five principal statutes: Part I of the Federal Power Act,[1] governing the licensing and operation of nonfederal hydropower projects; Part II of the Federal Power Act,[2] regulating wholesale power sales, the transmission of electric energy in interstate commerce, and the review of public utility mergers and acquisitions and other public utility corporate transactions; the Natural Gas Act,[3] providing a comprehensive scheme to regulate certain wholesale natural gas sales and interstate transportation of natural gas; the Natural Gas Policy Act of 1978,[4] authorizing certain transactions by interstate and intrastate natural gas pipelines; and the Hepburn Act, providing for economic regulation of crude oil and petroleum product pipelines. The youngest of these statutes, the Natural Gas Policy Act of 1978, is thirty years old. The oldest of the other four laws is the Hepburn Act of 1906.[5] Part I of the Federal Power Act was enacted nearly ninety years ago, while the others, Part II of the Federal Power Act and the Natural Gas Act, were enacted seventy years ago during the New Deal.

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1. 16 U.S.C. §§ 792–823d (2006).
2. *Id.* §§ 824–824w.
3. 15 U.S.C. §§ 717–717w (2006).
4. *Id.* §§ 3301–3432.
5. Hepburn Act, ch. 3591, 34 Stat. 584 (1906) (codified as amended in scattered sections of 49 U.S.C.). Although the Hepburn Act is the oldest of these four statutes, it was only entrusted to FERC administration relatively recently, in 1977. 42 U.S.C. §§ 7155, 7172 (2006). Interestingly, FERC administers the Hepburn Act as it existed in 1977, not as it exists today, under the terms of the Department of Energy Reorganization Act of 1977.

However, some of these four older laws have changed more significantly in the past fifteen years than in the prior half century or more. Part II of the Federal Power Act and the Natural Gas Act have changed from a regulatory scheme that controlled market power exercise by utilities, pipelines, and producers through classic rate regulation to a regulatory regime that controls the exercise of market power through reliance on a mixture of competition and regulation. This change was accomplished by congressional amendments to Part II of the Federal Power Act and the National Gas Act and through reinterpretation of the laws by FERC and the courts. It could be argued that more dramatic change was accomplished through reinterpretation than through enactment of legislative amendments.

Energy law is poised for even greater change in the future. The United States has a carbon-based economy, and our energy sector is founded on fossil fuel use. The likelihood is growing that the United States will commit itself to some manner of mandatory reduction in carbon emissions. Any carbon-reduction scheme will have profound implications for energy policy and law, because climate-change policy is as much energy policy as environmental policy.

Part I of this Article reviews the factors that cause the need to change energy law over time. Part II discusses the manner in which energy law has changed and likely will continue to change, including enactment of new legislation, court decisions that change interpretations of existing law, and agency reinterpretations.

I. THE REASONS ENERGY LAW IS SUBJECT TO CHANGE

Although the principal federal energy laws were enacted many years ago, energy law is not a static area. There are certain factors that cause the need to change energy law over time, including the dynamic nature of energy markets, technological developments, convergence of energy markets with other markets, and the rising tension between energy and environmental law and policy.

A. Dynamic Markets

A principal factor that drives changes in federal energy law is the nature of energy markets themselves. Energy markets are not static; they are highly dynamic. Two of the markets FERC regulates are the wholesale electricity and natural gas markets. There have been striking changes in electricity and natural gas markets since the principal laws that govern these markets, the Federal Power Act and the Natural Gas Act, were enacted seventy years ago.

Electricity markets today are remarkably different from those that

existed in 1935, when Part II of the Federal Power Act was enacted. In 1935, electricity markets were local in nature, with power plants located in major cities selling power to nearby areas through local distribution systems. There was very little interstate commerce in electricity. Today, with the development of the interstate power grid, electricity markets are not only interstate, but they are also international. Wholesale power markets in the United States are entwined with Canadian electricity markets. The level and volume of wholesale power trades have risen sharply in recent years.

In the 1930s, there was no interstate power grid and electricity delivery was local in nature. Congress did not anticipate the development of an interstate and international bulk power grid because Part II of the Federal Power Act provided for siting of transmission facilities under state law. However, that assumption proved false, and the bulk power system developed in the decades following enactment. Today, the power grid is not only interstate but is also international, fully interconnected with Canada and part of Mexico.

There have been major changes in wholesale natural gas markets as well. The U.S. natural gas pipeline network, which was interstate even in the 1930s, has become international as well, fully integrated with Canada and part of Mexico. Gas trading has become highly sophisticated, with regional pricing hubs and a range of standard products. There has also been a level of convergence between physical natural gas markets and financial energy markets, which is discussed below.

The nature of wholesale gas markets is changing in another respect. The North American natural gas market is becoming more international, becoming integrated to some extent with gas markets in Europe and Asia. The reason for this development is increased imports of liquefied natural gas (LNG) into the United States. The United States is competing with Europe and Asia for LNG imports, a competition we are not predestined to win.

The nature of natural gas production has also changed. In 1938, when the Natural Gas Act was enacted, natural gas production was limited to onshore areas; there was virtually no offshore natural gas production. This began to change soon after enactment, and U.S. natural gas production now extends well into the Gulf of Mexico and other offshore areas. Since Congress did not anticipate the shift in production to offshore areas, it did not provide for jurisdiction over offshore gathering in federal waters in the Natural Gas Act.

Not only are the markets different, the industry structure itself is different. In the 1930s, it was assumed there was a natural monopoly in electricity generation. Technological change destroyed that assumption

twenty-five years ago; instead of relying on vertically integrated utilities for electricity supply additions, the United States increasingly turned to independent power producers—a class of market participant that did not exist in the 1930s. Many of these new participants also developed new or improved technologies such as wind power, solar power, and other power sources. Electricity traders and marketers did not exist in 1935, but now they are some of the largest power sellers. Large parts of the interstate power grid are operated by regional transmission organizations and independent system operators, some of which also operate centralized power auctions. These entities also did not exist in 1935, and nothing in Part II of the Federal Power Act belies any anticipation by Congress that these institutions would develop. Wholesale gas markets are no longer strictly limited to producers, pipelines, and local distribution companies, as was the case in the 1930s when the Natural Gas Act was enacted, and traders and marketers now play an increasingly important role in these markets.

Congress did not anticipate these market developments and changes in industry structure when it enacted Part II of the Federal Power Act and the Natural Gas Act. That is reflected in the siting provisions of Part II of the Federal Power Act and the Natural Gas Act with respect to electric transmission facilities and interstate natural gas pipelines. Part II of the Federal Power Act and the Natural Gas Act both provided for siting of these facilities under state law. That was probably sensible in 1935, when there was no interstate power grid. If electricity delivery were to remain local in nature, state siting was entirely appropriate. Congress can hardly be faulted for not anticipating the development of the transmission grid in the ensuing decades. But that interstate grid developed nonetheless, while the Federal Power Act remains rooted in an implicit, but now false, assumption that electricity markets are characterized by local delivery. Congress recognized its error with respect to interstate natural gas pipelines and corrected the law. Recognizing that state siting of an interstate natural gas pipeline network was failing, Congress amended the Natural Gas Act in 1947 to provide for exclusive and preemptive federal pipeline siting.[6]

The real surprise is that the laws, conceived and drafted during the 1930s to regulate wholesale power and natural gas markets that have changed so dramatically, still work effectively. At one level, that is a tribute to how well many of the New Deal statutes were written. New Deal laws reflect a certain attitude toward regulatory agencies and toward regulation itself. Laws written during the New Deal generally grant a higher level of discretion to federal regulatory agencies than laws enacted during the past

6. Natural Gas Amendments of 1947, 15 U.S.C. § 717f(h) (2006).

thirty years. As a case in point, compare the Federal Power Act or the Natural Gas Act with the Clean Air Act Amendments of 1990[7] or the Telecommunications Act of 1996.[8] The newer laws evince an entirely different attitude by Congress toward regulatory agencies. Law enacted during the New Deal manifests a fundamental trust in regulatory bodies; many laws of a more recent vintage convey a lesser degree of trust in the exercise of discretion by agencies.

B. Technology

Another factor fostering change in regulated industries is technology, because technological change can introduce dynamic change in markets. This Article has already noted how technology destroyed the perceived natural monopoly in electricity generation. That technological change made possible a fundamental shift in federal electricity policy, namely the advent of competition policy and the introduction of competition into wholesale power markets.

Technological change was the predicate for competition policy, which relies on competitive forces and entry and the threat of entry by nonutility generators to assure adequacy of U.S. electricity supply at a reasonable cost, instead of complete reliance on rate-based generation additions by vertically integrated utilities. Part II of the Federal Power Act clearly anticipated some level of competition even in 1935, since the Act uses the term *contract* in a number of places, recognizing there was some level of wholesale power sales at the time of enactment, and an anticipation that commerce would continue.[9] Competition has been lawful in wholesale power markets since the 1930s, despite a number of legal challenges.[10] The courts found there is no constitutional right to be free from competition in wholesale power sales.[11]

However, until the development of improved gas-turbine technology, the level of competition in wholesale power markets was very low. In a very real sense, competition policy, the most important change in federal electricity policy over the past thirty years, was made possible by technological developments. In 1978, vertically integrated utilities

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7. Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2399 (1990) (codified as amended at 42 U.S.C. §§ 7401–7671 (2006)).

8. Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (codified at 47 U.S.C. §§ 151–161 (2000)).

9. Joseph T. Kelliher, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26 ENERGY L.J. 1, 6 & n.27 (2005).

10. *Id.*

11. *See, e.g.*, Tenn. Elec. Power Co. v. Tenn. Valley Auth., 306 U.S. 118, 139 (1939) ("The franchise to exist as a corporation, and to function as a public utility . . . creates no right to be free of competition . . . ."); *see also* Kelliher, *supra* note 9, at 6 & n.27.

controlled 97% of the electricity generation capacity in the United States.[12] Yet, over the last twenty-five years, independent power producers have accounted for most of the increase in the U.S. electricity supply. Competition policy in natural gas markets did not have the same technological spark, and the origins of competition policy as it relates to wholesale gas policy are rooted more in antitrust principles than technology development.

Competition policy was adopted as national policy for both wholesale power and natural gas markets thirty years ago. This policy was established through a series of federal laws enacted over that period, beginning with the Public Utility Regulatory Policies Act of 1978 and the Natural Gas Policy Act, then the Natural Gas Wellhead Decontrol Act of 1989 and the Energy Policy Act of 1992, and through the Energy Policy Act of 2005.

Future technological developments may also require changes in energy law. If the United States commits to a mandatory carbon-reduction regime, there will be vigorous efforts to develop a host of new technologies to achieve that end. These may include carbon capture and sequestration technologies. If the United States is successful in developing this technology, then in all likelihood there will be a need for a regulatory regime to site carbon dioxide pipelines and storage facilities, and to set rates governing operation of these facilities. No such regulatory regime currently exists in the United States. Congress has taken the first steps to discuss the possible framework for regulation of these technologies if they are developed.[13]

C. Market Convergence

As discussed above, markets change. However, markets can also converge, which in turn can drive changes in energy law. For example, it was not so many years ago that it could be said with confidence that energy and commodities markets were entirely separate domains[14]—with FERC

12. Kelliher, *supra* note 9, at 6.

13. *See generally Regulatory Aspects of Carbon Capture, Transportation, and Sequestration: Hearing Before the S. Comm. on Energy and Natural Resources*, 110th Cong. (2008) [hereinafter *Hearing*].

14. *See* STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, 110TH CONG., EXCESSIVE SPECULATION IN THE NATURAL GAS MARKETS 24 (Comm. Print 2007) ("In *recent* years, instead of using a published monthly index price derived from reported prices, buyers and sellers are increasingly referencing the relevant NYMEX futures contract for delivery of natural gas and using the price that is finally settled on for delivery of gas under that standard monthly contract.") (emphasis added); FERC, 2006 STATE OF THE MARKETS REPORT 48 (2006) ("As a practical matter, monthly cash physical and futures natural gas prices are and must be

regulating physical natural gas sales under the Natural Gas Act and the Commodity Futures Trading Commission (CFTC) regulating financial sales under the Commodity Exchange Act.[15] However, there has been some convergence between these markets so that these distinctions have become blurred, resulting in some friction between the agencies.[16]

Convergence between energy markets and commodities markets can be demonstrated in part by examining transactions. Some wholesale natural gas transactions are capable of being settled either financially or through physical delivery, so a bright line between a physical natural gas sale and a financial energy product is difficult to identify. Moreover, certain commodity transactions establish or shape the price of physical natural gas sales, such as the monthly futures product traded at the New York Mercantile Exchange.[17] If the pricing of physical and financial sales are linked, then some level of market convergence has occurred.

The level of convergence between physical and financial markets in natural gas markets is undoubtedly greater than in electricity markets at this point. But as wholesale power markets continue to develop, it is likely that there will be a steady increase in the level of power transactions that resemble other commodity markets, which, with increasingly liquid markets, will lead to a convergence similar to that which has already occurred in natural gas markets. The convergence of electricity and commodity markets will accelerate and grow much stronger if the United States adopts a cap-and-trade carbon-reduction regime, since wholesale electricity prices will be heavily influenced by the cost of carbon emissions allowances.

As long as these markets were entirely separate, it was tenable to regulate them by separate agencies operating under entirely different

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closely related to one another . . . . [A]ny material differences will be arbitraged away. . . . [B]ig changes in cash physical market values naturally affect futures trading, and vice versa.”).

15. 7 U.S.C. §§ 1–25 (2006).

16. For example, in *Amaranth Advisors L.L.C.*, 120 F.E.R.C. ¶ 61,085 (2007), FERC required various entities to show cause why they had not violated a Commission regulation which prohibits the manipulation of natural gas prices. The Commission explained,

> This case concerns the important nexus between the wholesale interstate natural gas markets subject to our jurisdiction and the New York Mercantile Exchange (NYMEX) Natural Gas Futures Contract (NG Futures Contract). In recent years, many market participants in the physical natural gas markets have used the NG Futures Contract as a significant benchmark for prices in physical natural gas. In this case, manipulation of Commission-jurisdictional prices resulted from manipulation of the NG Futures Contract.

Id. para. 2.

17. *See, e.g.*, *id.* para. 108 (“First, the settlement price directly sets the price for any contracts that ultimately go to delivery at Henry Hub. Second, the settlement price is directly incorporated into the price for physical basis transactions.”).

statutory authority. These legal and regulatory regimes were seen as separate areas of law, one labeled "energy law" and another labeled "commodities law." There was no reason for FERC and the CFTC to coordinate their actions when the markets were divergent and little reason for the agencies to understand each other's regulatory regimes. However, as some level of convergence has occurred, these legal domains have moved closer, and it has become increasingly necessary for FERC and the CFTC to coordinate investigations and market oversight.[18]

The agencies took an important step to improve coordination of investigations with the adoption of the Memorandum of Understanding between FERC and the CFTC to facilitate sharing of information relating to market oversight and ongoing investigations between the two agencies.[19] This memorandum recognized that the need for cooperation between the agencies was not temporary, but continuing, and that there was a benefit to formalizing arrangements for coordinating investigations. That has been borne out, since the number of joint and coordinated FERC–CFTC investigations has increased steadily in recent years.

This market convergence creates the prospect of market manipulation across product lines, manipulation of physical natural gas products to extract gains from transactions in financial products, or the reverse. FERC and CFTC investigations have identified possible manipulation across product lines.[20] This prospect is reflected in recent legislation amending energy law. For example, the Energy Policy Act of 2005 includes amendments to the Natural Gas Act that establish an express prohibition of the manipulation of wholesale power markets. Significantly, those provisions extend beyond the traditional universe regulated by FERC under the Act, namely "natural gas companies," to a broader universe of market participants.[21] That distinction recognizes the prospect of market

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18. *See* MEMORANDUM OF UNDERSTANDING BETWEEN THE FEDERAL ENERGY REGULATORY COMMISSION (FERC) AND THE COMMODITY FUTURES TRADING COMMISSION (CFTC) REGARDING INFORMATION SHARING AND TREATMENT OF PROPRIETARY TRADING AND OTHER INFORMATION 3 (2005) ("[T]he CFTC and the FERC may from time to time engage in oversight or investigations of activity affecting both CFTC-jurisdictional and FERC-jurisdictional markets.").

19. *Id.*

20. Amaranth Advisors L.L.C., 120 F.E.R.C. ¶ 61,085 (2007); Energy Transfer Partners, L.P., 120 F.E.R.C. ¶ 61,086 (2007); CFTC v. Amaranth Advisors L.L.C., 554 F. Supp. 2d 523 (S.D.N.Y. 2008).

21. Section 315 of the Energy Policy Act of 2005 added a new § 4A to the Natural Gas Act, prohibiting manipulation of wholesale natural gas markets. Energy Policy Act of 2005, Pub. L. No. 109-58, § 315, 119 Stat. 691 (2005) (codified as amended at 15 U.S.C. § 717c-1 (2006)). The prohibition on market manipulation applies to *any entity*, an undefined term, but a term broader than *natural gas company* as defined in the Natural Gas Act. Natural Gas Act § 2(6), 15 U.S.C. § 717a(6) (2006). FERC has defined *any entity* to include any person or form of organization regardless of its legal status, function, or activities.

manipulation across product lines and that to protect wholesale natural gas consumers from exploitation, it may be necessary to reach across product lines, in enforcement actions, without interfering with CFTC futures regulation.

Manipulation across product lines in turn creates the prospect of tension between FERC and the CFTC, each of which otherwise possesses exclusive jurisdiction to regulate wholesale natural gas markets and futures markets, respectively. That potential for tension has also been realized, unfortunately. At the same time as the number of joint and coordinated investigations has increased apace, FERC and the CFTC have been engaged in a jurisdictional dispute as to the extent of FERC's authority to sanction market manipulation of futures if it affects jurisdictional wholesale natural gas markets.

This market convergence is also reflected in the entry of financial-sector firms into energy markets. Over the past ten years, the financial sector has entered electricity and natural gas markets, and has become a significant market participant. In addition, the role of the financial sector in wholesale power and natural gas trading and marketing has grown considerably in recent years, and many of the largest power and gas trading and marketing firms are now financial-sector firms.[22] This is a significant change from only a few years ago, when trading and marketing was dominated by traditional energy companies.[23]

That has implications for FERC, given the recent turmoil in the financial sector. At the beginning of 2008, there were five large investment banks in the United States; today, there are none. Two of these banks have been acquired, one is in bankruptcy, and two converted to bank holding companies regulated by the Federal Reserve. The financial crisis has implications for FERC, and not just because it raises legitimate questions about the ability of electricity and natural gas companies regulated by FERC to raise capital to fund operations and necessary infrastructure development; it also may impair the participation of financial-sector firms in wholesale power and natural gas markets. Some of the former investment banks were large wholesale power and gas traders, and there are questions as to whether they can engage in the same level of FERC-regulated trading and marketing activity as bank holding companies as they

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Prohibition of Energy Market Manipulation, 71 Fed. Reg. 4244, 4248 (Jan. 26, 2006) (to be codified at 18 C.F.R. pt. 1c).

22. *Economy Fails to Stem Rise in Marketing Volumes*, GAS DAILY, Dec. 16, 2008, at 1, 5–7; *Leading Power Traders on Borrowed Time: Constellation and Big Banks Keep Q2 Lively*, POWER MARKETS WK., Sept. 29, 2008, at 1, 18–26.

23. *Top-Heavy Marketer Rankings Reflect Volatility*, GAS DAILY, Feb. 9, 2001, at 1, 8; *Merrill Lynch Now Among Big Sellers, May Augur New Role for Financial Firms*, POWER MARKETS WK., June 5, 2000, at 1, 18–19.

did as investment banks. To better understand how the Federal Reserve and financial regulators will govern bank activity in wholesale power and natural gas markets, FERC may have to pursue periodic discussions with the Federal Reserve, something that could hardly have been imagined before the crisis.

There is another form of entry by the financial sector into the energy industry, through passive ownership of energy company securities. Increasingly, investment firms are purchasing significant ownership interests in energy companies subject to FERC jurisdiction, particularly power companies. This has led to a series of FERC orders authorizing such transactions, in some cases with certain conditions.[24] In the course of some of these decisions, FERC has had to weigh the requirements of financial services laws such as the Investment Advisers Act of 1940. There may be a need for improved coordination between FERC and financial regulators.

D. Energy and Environmental Law

There is another area where the distinction between two different legal domains has become increasingly artificial, if not entirely abstract, namely energy law and environmental law. However, the notion that these legal domains are separate is deeply ingrained. In most respects, the notion that energy policy and environmental policy are separate domains is a workable fiction. But it is completely untenable when it comes to climate change.

I must admit I persisted in the abstraction that energy policy and environmental policy were separate for some time, and I was slow to recognize that climate-change policy was as much energy policy as environmental policy. I would shy away from discussions and deliberations on climate-change policy on the basis that it was environmental policy, and that it was either bad manners or bad form for an energy regulator to intrude into deliberations on environmental policy.

But climate-change policy is not just environmental policy—it is also energy policy. Climate change involves critical decisions such as the future level of U.S. electricity supply, the future price of electricity, and the future electricity supply mix of the United States, namely the extent to which the United States should rely on coal, nuclear, natural gas, and renewable energy to meet our future electricity supply needs. In my mind,

24. *See* Horizon Asset Mgmt., Inc., 125 F.E.R.C. ¶ 61,209 (2008); Entegra Power Group L.L.C., 125 F.E.R.C. ¶ 61,143 (2008) (rehearing pending); Legg Mason, Inc., 121 F.E.R.C. ¶ 61,061 (2007); Morgan Stanley, 121 F.E.R.C. ¶ 61,060 (2007), *clarified*, 122 F.E.R.C. ¶ 61,094 (2008); Goldman Sachs Group Inc., 121 F.E.R.C. ¶ 61,059 (2007), *clarified*, 122 F.E.R.C. ¶ 61,005 (2008); Capital Research & Mgmt. Co., 116 F.E.R.C. ¶ 61,267 (2006).

these are energy policy considerations, or at least as much energy policy as they are environmental policy.

Currently, there is uncertainty in the United States with respect to climate-change policy. That uncertainty has significant energy policy implications. The most direct effect relates to the U.S. electricity supply. Electricity generators in the United States have cancelled thousands of megawatts of planned coal-generating capacity. The total amount of cancelled coal-generating capacity exceeds 100,000 megawatts, more than the entire electricity supply of the United Kingdom. More importantly, these cancelled coal power plants have not been replaced by other planned electricity-generating facilities. The economic downturn associated with the financial and credit crisis has reduced demand and provided a respite.

President Barack Obama has called for a U.S. commitment to mandatory carbon reductions and endorsed the cap-and-trade approach. There is growing support in Congress for carbon-reduction legislation. U.S. climate-change policy will likely change. There are three avenues for change in U.S. climate-change policy: domestic legislation, rules and orders issued by the Environmental Protection Agency (EPA) under the Clean Air Act, and an international treaty entered into by the United States and ratified by the Senate. However, the timing of actions in these three areas remains uncertain.

In any event, when the United States does act, it is absolutely essential that U.S. climate-change policy reflect a balance between sound energy and environmental policy. Climate-change policy must work effectively on both levels. To illustrate, energy policymakers and environmental policymakers each have an interest in the future electricity supply of the United States. But their interests are different. Energy policy seeks to assure that the United States has an adequate electricity supply to meet the needs of consumers and a growing economy and that the price of that electricity is just and reasonable. Energy policy may also encourage fuel diversity in our electricity supply mix. Environmental policy, or more properly, climate-change policy, is interested largely in the future level of emissions from the electricity sector and other sectors.

These goals are different although not necessarily inconsistent. The tension is obvious—climate-change policy would be advanced by a relatively high-cost mix of electricity supply, which would reduce total emissions by decreasing demand. Climate-change policy would also be advanced by an electricity supply mix that produces the lowest carbon emissions levels—even if that mix is the high-cost mix. Energy policy that delivers low electricity prices may produce relatively high demand from an electricity supply mix that produces high emissions levels.

It is possible to strike a balance between energy and environmental

policy that achieves these different goals, but it will not be easy. A balanced approach can achieve significant carbon reductions at a reasonable cost while assuring the adequacy of the U.S. electricity supply. Climate-change policy that is unbalanced may impair the ability of the United States to assure adequacy of electricity supply at a reasonable cost. An unbalanced approach may also fail to achieve necessary carbon reductions and may produce unreasonable energy costs and unreliable energy supplies. Climate-change policy that produces unreasonable energy costs and unreliable energy supplies may be unsustainable politically and subject to reversal. Laws can be enacted; those same laws can be repealed.

A U.S. commitment to mandatory carbon reductions will likely require changes in energy law. For example, in my view the United States must revise its transmission siting regime if it is to develop an interstate power grid capable of delivering both large-scale renewable energy and nuclear energy. It is unlikely that the bulk power grid can be developed to the point where we can achieve our maximum wind potential in the United States under the current state siting regime. That would entail amending Part II of the Federal Power Act to provide for exclusive and preemptive federal siting of electric transmission facilities, modeled on the pipeline siting provisions in the Natural Gas Act. Congress did provide for some federal transmission siting jurisdiction in the Energy Policy Act of 2005, but this authority is very limited, has some serious flaws, and compares unfavorably to the pipeline siting model.

To some extent, pressures on grid development exist already because FERC is confronted by a host of proposals to build high-voltage transmission projects to accommodate large-scale wind electricity development. These wind projects are driven by adoption of renewable portfolio standards by many states, which to some extent serve as a proxy for carbon reductions pending continued deliberations on climate policy. The force of wind electricity development has already led FERC to revise its interconnection cost allocation policy,[25] and has sparked discussion of changes in policy relating to merchant wind transmission projects, transmission-to-transmission interconnection rules, transmission planning, and other areas.[26]

If the United States does change course on climate change, there will be a need to address a host of issues that are as much energy policy as environmental policy. There will be a need for a regulatory framework to regulate carbon trading in the United States and coordinate with regulators

25. Cal. Indep. Sys. Operator Corp., 119 F.E.R.C. ¶ 61,061 (2007).

26. *See generally* Transmission Barriers to Entry, 73 Fed. Reg. 61,854 (issued Oct. 17, 2008) (supplemental notice of technical conference).

of carbon-trading regimes elsewhere in the world. One leading legislative proposal would assign the task of regulating carbon markets and trading to FERC.[27] It will also be necessary to establish a regime to verify carbon offsets and to prevent or minimize leakage from a cap-and-trade system. Moreover, there will be a need for a U.S. regulatory regime for a carbon capture and sequestration network of pipelines and storage projects—siting, rates, liability, and safety—assuming the technology is developed. Congress has begun deliberations on a regulatory framework for this new infrastructure, and an expanded FERC regulatory role is being considered.[28]

II. THE MANNER IN WHICH ENERGY LAW CHANGES

These factors—dynamic markets, technological developments, market convergence, and the tension between energy and environmental policy with respect to climate change—at best create the need for changes in energy law, perhaps a desperate need. These factors do not actually effect change in energy law. But sometimes the need rises to the point where the law is changed. There are three principal ways energy law can change: enactment of new legislation, judicial decisions, and agency reinterpretation of existing law.

A. *Enactment of New Legislation*

The first way to change energy law or any other body of law, obviously, is enactment of new legislation. However, this is probably the most difficult way to effect change in any area of law. The legislative process in practice is much different than "How a Bill Becomes a Law."[29]

I worked as a congressional aide and a committee counsel, and have great respect for the institution. I have even gone so far as to describe myself as a "creature of Congress."[30] But it sometimes takes Congress a long time to enact legislation to address a problem, even a problem that is

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27. American Clean Energy and Security Act of 2009, H.R. 2454, 111th Cong. § 341 (2009).

28. *See generally Hearing*, *supra* note 13.

29. *See, e.g.*, Kids in the House, How Laws Are Made, http://clerkkids.house.gov/laws/index.html (last visited July 11, 2009). A far better description of the legislative process can be found in *The Dance of Legislation* by Eric Redman, tracing enactment of a minor law by a skilled legislator. ERIC REDMAN, THE DANCE OF LEGISLATION (1973).

30. *Joseph T. Kelliher Nomination: Hearing Before the S. Comm. on Energy and Natural Resources*, 108th Cong. 20–21 (2003) (statement of Joseph T. Kelliher) ("As I pointed out in my testimony, at one level I consider myself a creature of Congress. I have spent a lot of my career working for Congress, and I have a tremendous respect for Congress's role in energy policy.").

widely recognized. A case in point is enactment of legislation to establish mandatory electric grid reliability standards. A broad consensus developed around the need for legislation to provide for mandatory and enforceable reliability standards in 1998 after two regional blackouts in the summer of 1996. In 2000, the Senate passed mandatory reliability legislation by unanimous vote,[31] but it still took Congress until 2005 to enact legislation. The August 2003 blackout, which affected 50 million Americans, probably helped push legislation to final enactment.

But the need for legislation in this area was demonstrated many years earlier. There is an expression: "third time is the charm." Unfortunately, it took more than three major regional blackouts to convince Congress to pass mandatory reliability legislation. Altogether, it took eight large regional blackouts, all of which were caused in part by violation of voluntary reliability standards, over a period of thirty years, to convince Congress to pass mandatory reliability legislation.

As noted earlier, among the principal laws FERC administers are Part II of the Federal Power Act and the Natural Gas Act. While these laws remained largely unchanged for forty years, a series of important reforms took place over the subsequent thirty years, with the pace and degree of change increasing over that period.

The first significant changes to Part II of the Federal Power Act and Natural Gas Act occurred in 1978, when Congress enacted the Public Utility Regulatory Policies Act of 1978 and the Natural Gas Policy Act of 1978. The Public Utility Regulatory Policies Act added interconnection and wheeling provisions to the Federal Power Act, as well as provisions relating to continuance of service, while making revisions to ratemaking and interlocking directorate provisions.

The Natural Gas Policy Act took the first step toward decontrol of natural gas prices, a process that was completed with the enactment of the Natural Gas Wellhead Decontrol Act of 1989. The Natural Gas Policy Act also included significant provisions authorizing interstate natural gas pipelines to sell or transport natural gas on behalf of intrastate pipelines or local distribution companies without prior FERC approval.

The Energy Policy Act of 1992 made some important changes to the Federal Power Act, granting FERC effective authority to order "wheeling," or third-party transmission service upon application,[32] and providing FERC

31. 146 CONG. REC. 13,414 (2000).

32. Energy Policy Act of 1992, Pub. L. 102-486, §§ 721–722, 106 Stat. 2915, 2915–19 (1992) (codified as amended at 16 U.S.C. § 824j (2006)); *see also* Joseph T. Kelliher, Comment, *Pushing the Envelope: Development of Federal Electric Transmission Access Policy*, 42 AM. U. L. REV. 543, 589–91 (1993). Strictly speaking, the Energy Policy Act of 1992 did not grant wheeling authority to FERC; that authority had been granted by the

some civil penalty authority.[33] The law also amended § 3 of the Natural Gas Act to clarify regulation of certain natural gas imports and exports.[34]

The most recent law, the Energy Policy Act of 2005, made very significant changes to both the Federal Power Act and the Natural Gas Act. In my view, the Energy Policy Act of 2005 brought about the most significant change in the laws FERC administers since the New Deal and represents the largest single grant of regulatory power to FERC in the past seventy years.

The revisions to Part II of the Federal Power Act were very significant. The Energy Policy Act of 2005 included a number of major changes to FERC's economic regulatory authority. Specifically, these changes proscribed market manipulation and granted FERC the authority to define manipulation by rule or order,[35] improved FERC's ability to prevent market power exercise by strengthening the agency's merger authority,[36] expanded the agency's authority to order open access to the transmission system,[37] provided for more-timely refunds,[38] and granted FERC discretionary authority to require dissemination of information that would improve the transparency of wholesale power markets.[39] The Act gave FERC a new mission to assure the reliability of the bulk power system, authorizing the agency to establish and enforce mandatory reliability standards.[40] Finally, the Energy Policy Act of 2005 sought to strengthen the interstate power grid by granting FERC limited transmission siting authority[41] and encouraging transmission incentives to spur grid investment.[42]

The Energy Policy Act of 2005 also made major changes to the Natural

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Public Utility Regulatory Policies Act of 1978. But that law, which added § 211 to the Federal Power Act, was defective. Under § 211, as added by the Public Utility Regulatory Policies Act of 1978, FERC could not order wheeling if doing so would disturb "existing competitive relationships." 16 U.S.C. § 824j(c)(1) (1988). As a result of this provision, the wheeling provisions in the Public Utility Regulatory Policies Act of 1978 proved ineffective. Kelliher, *supra*, at 551. This subsection was deleted by § 721(4)(A) of the Energy Policy Act of 1992. If the Energy Policy Act of 1992 did not "grant" FERC wheeling authority, it is probably fair to say that it granted FERC "effective" wheeling authority.

33. Energy Policy Act of 1992 § 725(b). Curiously, the civil penalty provisions of the Energy Policy Act of 1992 were limited to violations of sections of the Federal Power Act added or substantially amended by the 1992 Act, namely §§ 211–214. *Id.*

34. *Id*. § 201.

35. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1283, 119 Stat. 594, 979–80 (2005).

36. *Id.* § 1289.

37. *Id.* § 1231.

38. *Id.* § 1285.

39. *Id.* § 1281.

40. *Id.* § 1211(a).

41. *Id.* § 1221(a).

42. *Id.* § 1241.

Gas Act. These changes granted FERC express authority to police the manipulation of wholesale natural gas markets,[43] gave FERC discretionary authority to require dissemination of information that would improve the transparency of wholesale natural gas markets,[44] and clarified FERC's exclusive authority to site LNG import and export projects.[45] The revisions also gave the agency discretion to approve market-based rates for natural gas storage projects, even, under certain circumstances, if such projects had market power,[46] and granted FERC authority to coordinate federal and state agency review of natural gas projects.[47]

However, perhaps the most significant changes to Part II of the Federal Power Act and the Natural Gas Act effected by the Energy Policy Act of 2005 were the anti-manipulation provisions and the enforcement provisions, notably the grant of authority to impose sizeable civil penalties, up to $1 million per day per violation.[48] Interestingly, these anti-manipulation provisions were expressly modeled on the anti-manipulation provisions of the Securities Exchange Act of 1934.[49]

The manipulation and enforcement provisions to a large extent can be viewed as a reaction to the California and western energy crisis of 2000–2001. In my view, that crisis resulted in part from the significant changes that had occurred in electricity markets since 1935, and the failure to ensure that FERC had the regulatory tools it needed to discharge its duty to guard the consumer from exploitation.[50] Congress recognized that FERC needed different regulatory tools to discharge its historic duty, given the changes in markets, and granted the agency the authority it requested to prevent and sanction market manipulation.[51]

B. Court Decisions

The second way to change energy law is through court decisions. Courts can change energy law and other areas of law through decisions that find those laws are unconstitutional. Constitutional challenges to energy laws

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43. *Id.* § 315.
44. *Id.* § 316.
45. *Id.* § 311.
46. *Id.* § 312.
47. *Id.* § 313.
48. *Id.* §§ 314(b), 1284(e).
49. *Compare* § 222 of the Federal Power Act, 16 U.S.C. § 824v (2006), *and* § 4A of the Natural Gas Act, 15 U.S.C. § 717c-1 (2006), *with* § 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (2006).
50. NAACP v. FPC, 520 F.2d 432, 438 (D.C. Cir. 1975) ("Of the Commission's primary task there is no doubt, however, and that is to guard the consumer from exploitation by non-competitive electric power companies.").
51. *See generally* Kelliher, *supra* note 9.

charged to the administration of FERC are unusual, but they have been leveled from time to time.[52] In the context of this Article, when I describe the courts as changing energy law, I refer to court decisions that change a settled or long-standing interpretation of the law. By unsettling that interpretation, a court decision can change energy law in the same manner as if Congress enacted a law to the same end.

A regulatory body charged with administering certain laws is obligated to interpret those laws. A particular interpretation may remain settled for many years. In my experience, it is not unusual for an agency to refrain from fully exercising its legal authority, and I believe there is significant unexercised authority in the laws charged to FERC's administration, particularly the Federal Power Act. Interpretation of a statute can be more of an art than a science, resulting in different possible interpretations that involve more or less legal risk.[53] The first instinct of a regulatory body will not always be to seize upon the most aggressive interpretation, the interpretation that is most likely to be challenged in the courts and involve the greatest legal risk. A court may reinterpret statutes in a manner that is more aggressive than the administering agency. The net effect can be to grant an agency additional regulatory powers that it did not think it possessed based on its more conservative reading of the statute.

1. Phillips Petroleum Co. v. Wisconsin

Court decisions have certainly brought about major changes in energy law. The best example relevant to FERC would be *Phillips Petroleum Co. v. Wisconsin* in 1954, where the Supreme Court held that the Natural Gas Act charged FERC's predecessor, the Federal Power Commission, with the responsibility to set rates for wellhead natural gas sales, authority the Commission did not think it possessed.[54] Before *Phillips*, the Commission interpreted the Natural Gas Act as limiting its ratemaking jurisdiction to wholesale natural gas sales by interstate pipelines and exempting wellhead sales from its ratemaking jurisdiction, on the basis that such sales constituted the "production or gathering of natural gas," exempt from its jurisdiction.[55] However, in *Phillips* the Court narrowed the application of the "production" exemption, finding that natural gas producers were

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52. *See* Energy Transfer Partners, L.P., 121 F.E.R.C. ¶ 61,282, paras. 80–85 (2007) (respondent asserted that the procedural due process requirements of the Fifth Amendment dictate that enforcement litigation take place in federal district court).

53. *See* NORMAN J. SINGER & J.D. SHAMBIE SINGER, SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION §§ 45.1, 45.8 (7th ed. 2007), *available at* Sutherland s 45:1 (Westlaw) (discussing the process of statutory interpretation and construction).

54. 347 U.S. 672 (1954).

55. *Id.* at 677–78.

"natural gas companies" subject to the ratemaking jurisdiction of the Commission.[56]

By the standard discussed above, the Supreme Court did much more than clarify the law in *Phillips*; the Court changed the law in the sense that it completely overturned the interpretation of the Natural Gas Act that had guided regulation of natural gas production for nearly twenty years. That reinterpretation extended rate regulation well beyond wholesale gas sales to encompass a wide swath of natural gas production. Essentially, the Court's decision in *Phillips* had the same effect as enactment of legislation amending the Natural Gas Act itself.

The *Phillips* decision imposed a tremendous regulatory burden both on the Commission and natural gas producers. At the time of *Phillips*, there were thousands of natural gas producers in the United States. Under the decision, the Commission was charged with setting wellhead rates for each of these producers. The agency struggled valiantly to honor the Supreme Court's reading of the Natural Gas Act, but it ultimately proved to be a Sisyphean task.[57] Altogether, the agency developed three different regulatory approaches, each of which failed. First, the agency attempted to set rates for each producer through individual ratemaking proceedings. This approach quickly proved to be administratively infeasible and was abandoned in 1960. The agency then resorted to setting area-wide rates, dividing the country into five producing regions and setting rates for all producers in a particular region, setting interim ceiling rates based on average contract prices paid during 1959 and 1960. This approach also failed and was abandoned in 1974. Finally, the agency adopted national price ceilings for the sale of natural gas into interstate pipelines. This approach failed as well, contributing to natural gas shortages at the end of the 1970s.

In the end, it took Congress more than thirty years to reverse *Phillips* through enactment of natural gas decontrol legislation. The first step toward removing the regulatory regime mandated by the Supreme Court took place with the enactment of the Natural Gas Policy Act of 1978, which provided for partial decontrol of natural gas prices. The second and final step occurred through enactment of the Natural Gas Wellhead Decontrol Act of 1989. After enactment of these two laws, the *status quo ante* was restored, and wellhead production was no longer rate regulated.

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56. *Id.* at 682–83 & n.10.

57. In Greek mythology, Sisyphus was cursed to roll a large boulder up a hill, only to watch it roll down again, repeating the process throughout eternity. EDITH HAMILTON, MYTHOLOGY 439–40 (Little, Brown and Company 1998) (1942).

2. California ex rel. Lockyer v. FERC

A more recent example of a court decision that changed energy law, in the sense that it overturned FERC's settled interpretation of one of its core statutes, was *California ex rel. Lockyer v. FERC*.[58] In that decision, the Ninth Circuit held that FERC had the authority to order retroactive refunds under § 205 of the Federal Power Act,[59] notwithstanding the plain language of §§ 205(e) and 206(b). It is not clear in *Lockyer* how far back FERC could conceivably order retroactive refunds. The agency could reach back months or perhaps even years.

The *Lockyer* court certainly changed FERC's settled interpretation of §§ 205 and 206 of the Federal Power Act. Under a strict reading of § 205(e), FERC has very limited power to order refunds. If a seller has a rate on file, FERC can only order refunds if a seller has filed a rate change, if the proposed rate went into effect before the completion of a FERC investigation, and if the agency ultimately determines the rate is unlawful. In that circumstance, FERC can order refunds of the difference between the filed rate change and the rate the agency found to be just and reasonable, but only for the period where the filed rate was effective, not for any period before the filed rate change. Before *Lockyer*, FERC did not read § 205(e) to allow it to order retroactive refunds in the absence of a filed rate change.

The *Lockyer* decision also appears inconsistent with the plain language of § 206(b) of the Federal Power Act, which otherwise governs refunds. Under § 206(b), as it existed at the time of *Lockyer*, in the event of a refund proceeding instituted on complaint, "the refund effective date shall not be earlier than the date 60 days after the filing of [a] complaint," and in the case of a proceeding instituted by FERC on its own motion, "the refund effective date shall not be earlier than the date 60 days after the publication by the Commission of notice of its intention to initiate such proceeding . . . ."[60] *Lockyer* involved a refund proceeding initiated on complaint, in which FERC set a refund effective date at the earliest date it believed was allowed by law, sixty days after notice of its initiation of a refund proceeding.

Admittedly, *Lockyer* was a surprising interpretation, at least to FERC. Leading up to *Lockyer*, Congress had been considering amending § 206(b) to change the refund effective date for a number of years, to eliminate the sixty-day notice period and to allow for a refund effective date coincident with the date of a complaint and the date FERC initiated a refund proceeding. Congress ultimately revised § 206(b) to that end in the Energy

58. 383 F.3d 1006 (9th Cir. 2004), *cert. denied*, 549 U.S. 882 (2006).
59. *Id.* at 1015–16.
60. 16 U.S.C. § 824e(b) (2000).

Policy Act of 2005.[61] Arguably, this enactment was unnecessary if FERC had authority under § 205(e) to provide for retroactive refunds, let alone to waive the sixty-day waiting period.

Curiously, the court in *Lockyer* almost ignored the plain language of §§ 205(e) and 206(b) in reaching its conclusion, preferring to rely on "the underlying theory or regulatory structure established by the FPA"[62] and "the fundamental purpose and structure of the FPA,"[63] rather than the plain words of §§ 205(e) or 206(b). Indeed, the court's statutory construction does not even parse the words of §§ 205(e) or 206(b).[64] Unable to find any statutory language to support its interpretation, the court simply asserted that the authority to order retroactive refunds was "inherent" in the Federal Power Act.[65] In other words, retroactive refund authority lives somewhere between the lines of the Act.

Perhaps the heart of *Lockyer* is the imprecision of the court in distinguishing between "refunds" and "disgorgement of profits." In the eyes of FERC, *refund* is a particular term, meaning returning the difference between a just and reasonable rate and an unjust and unreasonable rate. With respect to wholesale power sales, FERC believed it could order refunds only in the course of a § 206 proceeding, initiated by complaint or by FERC on its own motion. FERC also believed it could not order retroactive refunds.

Disgorgement of profits is a different remedy, namely the disgorgement of all proceeds above a cost level. FERC can order disgorgement of profits for violations of tariffs established under the Federal Power Act or Natural Gas Act. Disgorgement can be ordered without regard for whether rates are unjust and unreasonable in order to remedy a tariff violation. FERC has long held that it had a remedy of ordering disgorgement of profits for tariff violations. However, the statutory basis for ordering disgorgement of profits is not § 206(b) or its companion in the Natural Gas Act, § 5(a), but §§ 309 and 16 of the Federal Power Act and Natural Gas Act, respectively.

The confusion in *Lockyer* rests with the court's use of the particular term *refund* when seeming to restate FERC's long-standing authority to order disgorgement of profits for tariff violations. As noted above, refunds and disgorgement of profits can be distinguished. In a refund, FERC can order the return of the difference between a just and reasonable rate and an unjust and unreasonable rate. It can lower the rate charged by a seller while still

61. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1285, 119 Stat. 594, 980 (2005) (codified as amended at 16 U.S.C. § 824e(b) (2006)) (revising refund effective date).

62. *Lockyer*, 383 F.3d at 1016.

63. *Id.* at 1017.

64. *Id.* at 1015–17.

65. *Id.* at 1016.

leaving the seller with the profit earned by charging a just and reasonable rate. Disgorgement of profits, by contrast, involves the return of profits; the seller merely recovers its costs, or costs plus a regulated profit level.

If *Lockyer* is read liberally to mean *disgorgement of profits* in places where it uses *refund*, it can be an accurate description of FERC remedial authority, effecting no change in the *status quo ante*. Otherwise, the decision can be read as significantly changing energy law and expanding FERC's remedial powers.

FERC did not seek rehearing of *Lockyer*. Power sellers sought rehearing in the Ninth Circuit and later filed a petition for a writ of certiorari with the Supreme Court, in part on the grounds that FERC might abuse this new authority to order retroactive refunds. That was a rationale FERC could hardly be expected to agree with. FERC opposed granting certiorari, largely on the grounds that if the court granted FERC greater remedial power than the agency believed it was due under the Federal Power Act, that only improved the ability of the agency to guard the consumer from exploitation.[66]

3. Massachusetts v. EPA

As discussed above, the line between energy and environmental law may become more and more difficult to discern in the future, as the United States moves toward establishing a carbon-reduction regime. For that reason, FERC must be mindful of developments in environmental law relevant to climate change.

The Supreme Court's decision in *Massachusetts v. EPA*[67] changed energy and environmental law, in the sense used in this Article. It overturned EPA's interpretation of the Clean Air Act that had governed for many years and directed EPA to take the first steps in a new regulatory proceeding to consider whether the agency should regulate the greenhouse gas emissions of new motor vehicles under the Clean Air Act.

Previously, EPA had concluded that it lacked authority to regulate carbon dioxide and other greenhouse gases as *air pollutants* under the Clean Air Act. Under § 202(a)(1) of the Clean Air Act,

The [EPA] Administrator shall by regulation prescribe . . . standards

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66. *See* Brief for the Federal Energy Regulatory Commission in Opposition at 25, Coral Power, L.L.C. v. California *ex rel.* Brown, 127 S. Ct. 2972 (2007) (Nos. 06-888, 06-1100), *available at* http://www.usdoj.gov/osg/briefs/2006/0responses/2006-0888.resp.pdf ("Those new statutory provisions and measures instituted by [FERC] since the California energy crisis in 2000–2001 also reinforce the conclusion that the remedial issue raised in the principal petition . . . does not warrant review by this Court, especially at this interlocutory stage of the proceedings.").

67. 549 U.S. 497 (2007).

> applicable to the emission of any air pollutant from any class or classes of new motor vehicles or new motor vehicle engines, which in his judgment cause, or contribute to, air pollution which may reasonably be anticipated to endanger public health or welfare.[68]

EPA had declined to regulate greenhouse gases under § 202(a)(1), concluding that it lacked authority under the Clean Air Act to issue mandatory regulations relating to greenhouse gas emissions.[69] EPA's conclusion was based largely on a complicated statutory interpretation of § 202(a)(1) of the Clean Air Act.[70] The Agency's conclusion was strengthened by questions about the strength of the scientific evidence relating to causation and the efficacy of new motor vehicle standards, as well as policy reasons concerning the President's ability to negotiate treaties.[71]

The Supreme Court, in a 5–4 decision, rejected this interpretation of § 202(a)(1) of the Clean Air Act, holding that EPA had authority to regulate carbon emissions and the emissions of other greenhouse gases, and that the Agency was obliged to conduct a proceeding to set new motor vehicle standards. According to the Supreme Court, if EPA makes a finding of endangerment, the Clean Air Act requires the Agency to regulate emissions from new motor vehicles, and EPA can only refrain from doing so if it determines that greenhouse gases do not contribute to climate change or offers some reasonable explanation of why the Agency cannot or will not exercise its discretion to make such a determination.[72] Under *Massachusetts*, the only question is whether sufficient information exists to make an endangerment finding.[73]

In the wake of *Massachusetts*, EPA initiated a rulemaking to determine whether it should regulate carbon emissions from new motor vehicles.[74] It remains to be seen whether EPA will issue final rules to regulate carbon emissions from new motor vehicles. The mere prospect may serve to

68. 42 U.S.C. § 7521(a)(1) (2000). In the Clean Air Act, *welfare* is defined to include "effects on . . . weather . . . and climate." *Id.* § 7602(h).

69. *Massachusetts*, 549 U.S. at 511.

70. *See id.* at 511–12 (claiming that Congress "declined to adopt a proposed amendment establishing binding emissions limitations").

71. *See id.* at 513 (implying that EPA relied heavily on a report suggesting that the causal link between tailpipe emissions and global warming could not be established).

72. *See id.* at 533 ("If EPA makes a finding of endangerment, the Clean Air Act requires the agency to regulate emissions of the deleterious pollutant from new motor vehicles.").

73. *Id.* at 534. In April 2009, EPA issued a proposed endangerment finding. Proposed Endangerment and Cause or Contribute Findings for Greenhouse Gases Under Section 202(a) of the Clean Air Act, 74 Fed. Reg. 18,886 (proposed Apr. 24, 2009) (to be codified at 40 C.F.R. ch. 1).

74. Regulating Greenhouse Gas Emissions Under the Clean Air Act, 73 Fed. Reg. 44,354 (proposed July 30, 2008).

increase the likelihood of Congress enacting climate-change legislation, in part because the Clean Air Act is viewed as a very poor vehicle for reducing carbon emissions.[75]

The Supreme Court changed environmental law in the sense that it overturned the settled and long-standing interpretation of the law by a regulatory agency, in this case EPA. *Massachusetts* had the same effect as an enactment of a new law that revised the Clean Air Act and required EPA to regulate carbon dioxide and other greenhouse gas emissions as air pollutants under the Act.

C. Agency Reinterpretation of Existing Law

Perhaps the most interesting manner of changing energy law, at least from the vantage of the head of a regulatory body, is through agency reinterpretation of existing law. Sometimes the most dramatic changes in energy law can be accomplished through reinterpreting existing law. As discussed earlier, interpretation of a statute can be more of an art than a science, resulting in different possible interpretations that involve more or less legal risk. It is not unusual for a statutory provision to have more than one possible interpretation. How an agency chooses among these interpretations, and interprets—and reinterprets—a statute involves a balance between a fair reading of the statute, an assessment of the legal risk involved in different interpretations, and policy considerations.

A rational balancing would accept an interpretation that entails a higher degree of legal risk, if necessary to advance important policy objectives. A regulatory body will not always elect the most aggressive interpretation—the interpretation that is most likely to be challenged in the courts and involve the greatest legal risk. But an agency may be willing to accept a degree of legal risk, depending on the importance of policy objectives. Statutes can incorporate a tremendous amount of unexercised authority available to regulatory bodies. As the need for changes in energy law rises, as discussed in Part I of this Article, it may become necessary to resort to this corpus of unexercised authority. Indeed, the legal risk involved in reinterpreting existing law is not a constant, and can be more fairly characterized as waxing and waning over time. A legal interpretation that involved extreme legal risk at one point may later entail only modest risk.

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75. Former House Energy and Commerce Committee Chairman John Dingell predicted that regulating carbon emissions under the Clean Air Act would lead to a "glorious mess." *Strengths and Weaknesses of Regulating Greenhouse Gas Emissions Using Existing Clean Air Act Authorities: Hearing Before the Subcomm. on Energy and Air Quality of the H. Comm. on Energy and Commerce*, 110th Cong. (2008), http://archives.energycommerce.house.gov/cmte_mtgs/110-eaq-hrg.041008.CleanAirAct.shtml (follow "Connect to the Archived Video Webcast of this Hearing" hyperlink).

Some may perceive that the choice by a regulatory body to reinterpret its legal authority more expansively is nothing more than a grasp for power. That is an uncharitable view and one I must disagree with. An alternative explanation lies with an appreciation of a regulator's sense of duty. Every agency is tasked with certain missions. FERC's missions are reasonably well established by its organic acts and have been reiterated by the courts. For example, the courts have declared that FERC's primary task is to "protect consumers against exploitation."[76] Sometimes a regulator is given a duty but not granted the necessary express authority to fulfill that responsibility. Sometimes the need for a change in energy law grows over time, for the reasons described in Part I, but the statute remains static. The statutory tools at the disposal of an agency that were once adequate may become insufficient over time. In those circumstances, it should be expected that a regulatory body may reexamine its legal authority and consider electing a more expansive interpretation. That reinterpretation may better enable an agency to discharge its historic duties. Of course, FERC remains an agency of limited powers, since reinterpretation must be rooted in a fair reading of a statute. FERC accepts those limits, even when there is a compelling public interest at stake.

A federal regulatory agency is quasi-judicial, not judicial. It has some similarities to a court as it is a body of limited powers, it must have legal authority to act, and it must have some factual or strong theoretical foundation for its actions. But a regulatory agency is different from a court in the sense that it is entrusted with certain duties by its organic acts. The central task of the Commission, to "guard the consumer from exploitation," is not a passive duty; it is an active responsibility. While a court can wait for a dispute to be brought before it, FERC must constantly search for ways to better discharge its duty. Sometimes that search will lead to reinterpretation of its legal authority.

The ability of federal regulatory agencies to reinterpret their statutes and adopt a more expansive reading is not a constant. To some extent, it will vary depending on the vintage of their organic acts. As a general matter, agencies endowed with authority through statutes enacted during the New Deal probably have a better ability to reinterpret their statutes more expansively, for reasons discussed above. FERC is fortunate to be one such agency.

Sometimes there is a perception that regulators introduce change into

76. FPC v. Hope Natural Gas Co., 320 U.S. 591, 610 (1944); *see also* NAACP v. FPC, 520 F.2d 432, 438 (D.C. Cir. 1975), *aff'd*, NAACP v. FPC, 425 U.S. 662 (1976) ("Congress's central concern with exploitation is of course reflected in the statute's emphasis on just and reasonable prices . . . .").

areas where there is repose. Certainly, that is a perception within the regulated community. In my view, this is a misperception. In most cases, regulators are forced to react to change that occurs within regulated industries as a result of dynamic market change and other factors discussed in Part I. Regulators may, of course, seek to channel policy change in a certain direction, but the need to change energy law is driven largely by external factors, not by a whim of the regulator.

Reinterpretation of existing statutes by regulatory bodies need not offend lawmakers in Congress. Indeed, the extent to which a more aggressive interpretation of an existing statute is welcomed by Congress is remarkable. Congress has frequently ratified FERC reinterpretations of its existing legal authority, even urging the agency to go further.[77]

1. Natural Gas Pipeline Unbundling

The first step toward rolling back *Phillips* and decontrol of natural gas prices was enactment of the Natural Gas Policy Act of 1978. This law only partially decontrolled natural gas prices, however. Under the partially regulated system, many natural gas pipelines entered into long-term contractual obligations, known as “take-or-pay” contracts, to purchase minimum quantities of natural gas from producers at prices that proved to be well above market levels.[78] To some extent, this problem was collateral damage from the success of gas decontrol.

The surge in pipeline take-or-pay obligations forced the Commission to react to events and develop new approaches to pipeline regulation.[79] The

77. The wheeling provisions of the Energy Policy Act of 1992 ratified FERC’s policy of promoting transmission open access through its merger and market-based rate conditioning authority in the late 1980s. *See* Kelliher, *supra* note 32, at 589–97. At least three provisions of the Energy Policy Act of 2005 ratified FERC interpretations of its preexisting authority under the Federal Power Act and Natural Gas Act. Section 311(c) of the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594, 685–86 (2005), ratified FERC’s interpretation of its authority to site LNG import terminals under § 3 of the Natural Gas Act. Initial Decision of the Presiding Examiner on a Pipeline Certificate Application, 47 F.P.C. 567, 572 (1970); Distrigas Corp. v. FPC, 495 F.2d 1057, 1064 (D.C. Cir. 1974). Section 1241 of the Energy Policy Act of 2005 ratified the FERC policy of granting rate incentives to members of regional transmission organizations. Section 1242 of the Energy Policy Act of 2005 ratified FERC’s discretion to approve certain participant funding schemes. The Energy Policy Act of 2005 urged FERC to go even further than it had on its earlier reinterpretation of its existing legal authority. For example, § 211A of the Energy Policy Act of 2005 followed the Supreme Court’s affirmation of Order No. 888, the open transmission access rule. Since the rule was affirmed by the Supreme Court in a unanimous decision, there was no need for Congress to ratify the rule per se. Instead, Congress enacted § 211A, which granted FERC authority to go further than Order No. 888, by authorizing the agency to require open access by unregulated transmitting utilities not subject to Order No. 888.

78. United Distribution Cos. v. FERC, 88 F.3d 1105, 1123 (D.C. Cir. 1996).

79. *See* Order No. 436, 50 Fed. Reg. 42,408, 42,411 (Oct. 18, 1985) (codified in

initial attempts by the agency were struck down by the courts because FERC "ha[d] not adequately attended to the agency's prime constituency," captive shippers vulnerable to the exercise of market power by pipelines.[80] In Order No. 436, FERC began "the transition toward removing pipelines from the gas-sales business and confining them to a more limited role as gas transporters."[81] Previously, pipelines accounted for most wholesale sales of natural gas. This process of removing pipelines from the gas-sales business is known as "unbundling." For the first time, FERC imposed the duties of common carriers upon interstate pipelines.[82] The courts largely upheld the rule but faulted FERC for declining to resolve the problem of pipeline take-or-pay obligations, remanding on that basis.[83]

The Commission found that the open-access requirements in Order No. 436 were a partial success, and that pipelines' remaining bundled gas sales were unduly discriminatory or preferential, violating §§ 4 and 5 of the Natural Gas Act. FERC's solution was mandatory unbundling of pipelines' gas sales and transportation services, as established in Order No. 636.[84] This final unbundling rule was also affirmed by the courts.[85]

The open-access policies of the Commission with respect to the natural gas pipeline network were rooted in §§ 4 and 5 of the Natural Gas Act. These provisions, like their counterparts in the Federal Power Act, charge FERC with assuring that all natural gas rates and practices subject to the jurisdiction of the Commission shall be just and reasonable, and grants the agency the power to determine the just and reasonable rate or practice and fix the same by order. Section 7(e) of the Natural Gas Act authorizes FERC to condition certificates for services and facilities in such a manner as the public convenience and necessity may require. Such certificate and conditioning authority are the means by which FERC effectuates the purpose of the Natural Gas Act to assure just and reasonable rates.

As was the case with electric transmission open-access policy, the Commission interpreted legal authority it had possessed for nearly fifty

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scattered sections of 18 C.F.R.) ("The Commission's overriding goal in this docket is to adapt our regulations to these fundamental legal and technical changes so that we may continue to fulfill our statutory mandates under the NGA and the NGPA.").

80. Md. People's Counsel v. FERC, 761 F.2d 780, 781 (D.C. Cir. 1985); *see also* Md. People's Counsel v. FERC, 761 F.2d 768, 776 (D.C. Cir. 1985).

81. *United Distribution Cos.*, 88 F.3d at 1123.

82. Associated Gas Distribs. v. FERC, 824 F.2d 981, 997 (D.C. Cir. 1987).

83. *United Distribution Cos.*, 88 F.3d at 1124.

84. *See id.* at 1126 ("[T]he principal innovation of Order No. 636[] was mandatory unbundling of pipelines' sales and transportation services."); *see also* Order No. 636, 57 Fed. Reg. 13,267, 13,269 (Apr. 16, 1992) (codified at 18 C.F.R. pt. 284) (discussing the necessity of functional unbundling when transitioning to a competitive market).

85. *United Distribution Cos*., 88 F.3d at 1127–30; *see also* New York v. FERC, 535 U.S. 1, 28 (2002) (finding that FERC made a "statutorily permissible policy choice").

years to impose common carrier duties upon interstate pipelines and provide open access to the pipeline network. Its decision to do so was certainly related to an overall policy direction in favor of decontrol and increased competition in wholesale natural gas markets. The Natural Gas Policy Act of 1978 did not significantly enhance FERC authority to require unbundling and open access. But, just like the changes to § 211 of the Federal Power Act discussed later, it sent a policy signal to the agency in favor of open access that emboldened FERC to rely on other, much older statutory authority to move in the same policy direction.

But the Commission was not merely reacting to events; FERC was channeling policy in a certain direction, namely in favor of promoting competition in wholesale natural gas markets.[86] The development of competition policy with respect to natural gas markets also demonstrated a certain synergism between Congress and the Commission. FERC's natural gas unbundling policy was both a consequence and a companion to natural gas decontrol.[87] The legislative history of the Natural Gas Wellhead Decontrol Act of 1989 suggests Congress understood the relationship between decontrol and unbundling, and that unbundling was "essential" to the decision to enact total decontrol.[88] Enactment of full decontrol in turn encouraged FERC to impose mandatory unbundling on interstate pipelines.

2. Transmission Open Access

In 1996, FERC issued Order No. 888, a landmark final rule requiring public utilities to offer open access to their transmission systems.[89] This rule aimed to reduce the potential for these utilities to engage in undue discrimination and preference in transmission service in order to protect the consumer from exploitation. It also sought to promote more effective competition in wholesale power markets.

The legal foundations for this rule were §§ 205 and 206 of the Federal

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86. *See* Order No. 636, 57 Fed. Reg. at 13,268 ("[Order No. 636] will therefore reflect and finally complete the evolution to competition in the natural gas industry. . . . [T]his promotion of competition among gas suppliers will benefit all gas consumers . . . ."); Order No. 436, 50 Fed. Reg. at 42,411 ("[Order No. 436] adjusts, within the scope of the authority delegated by the Congress, those aspects of our current regulations that now appear to hinder the development of competition in those areas where competition will better protect the public interest than will traditional public utility regulatory rules.").

87. *See* Order No. 636, 57 Fed. Reg. at 13,269 (discussing the consistency of the goals of Order No. 636 and the Wellhead Decontrol Act); Order No. 436, 50 Fed. Reg. at 42,411 ("[Order No. 436] also secures to consumers the benefits of competition in natural gas markets consistent with both the NGA and the NGPA.").

88. H.R. REP. NO. 101-29, at 6 (1989), *reprinted in* 1989 U.S.C.C.A.N. 51, 56.

89. Order No. 888, 61 Fed. Reg. 21,540, 21,541–43 (May 10, 1996) (codified at 18 C.F.R. pts. 35 and 385 (2008)).

Power Act, which authorize FERC to act to prevent undue discrimination and preference in transmission of electric energy in interstate commerce.[90] Essentially, FERC argued that it was inherently unduly discriminatory for a vertically integrated utility to fail to provide open access to its transmission system.

To accomplish this end, it was necessary for FERC to reinterpret §§ 205 and 206 to require open access by all public utilities by rule. Interestingly, these sections had remained largely unchanged since 1935,[91] and it was not until sixty years later that FERC discovered it had the legal authority to require open access, an action that the agency could presumably have taken any time between 1935 and 1996. However, that view would ignore the developments that occurred in the electricity industry, particularly the advent of wholesale competition.

Accepting arguendo that FERC had authority in 1935 to require transmission open access, it is by no means obvious that this policy would have been in the public interest. The independent power sector did not exist at the time, and there was little competition in wholesale power markets. The policy benefit of requiring transmission open access would have been elusive and the legal risk likely much greater than was the case sixty years later.

One reason that FERC was emboldened to take this action was that it had reason to believe Congress was comfortable with a policy direction favoring transmission open access. Just a few years earlier, Congress had enacted the Energy Policy Act of 1992, which enhanced FERC's authority to order wheeling as a means of assuring transmission open access.[92]

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90. Section 205 broadly precludes public utilities, in making any transmission or sale subject to FERC's jurisdiction, from "mak[ing] or grant[ing] any undue preference or advantage to any person or subject[ing] any person to any undue prejudice or disadvantage." 16 U.S.C. § 824d(b) (2006). Section 206 provides,

> Whenever the Commission, after a hearing held upon its own motion or upon complaint, shall find that any rate, charge, or classification, demanded, observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

Id. § 824e(a).

91. The sections were largely unchanged with the exception of the change to the refund effective date in § 206 effected through enactment of the Regulatory Fairness Act in 1988. *Id.* § 824e(b).

92. *See id.* § 824j (requiring that an entity or person generating power may request from FERC an order requiring transmission of the generated power over a utility's transmission lines); *see also* Kelliher, *supra* note 32, at 589–91 ("The bill's sponsors shared FERC's view that transmission access may be a barrier to enhanced competition in wholesale power markets and removed many of the restrictions on FERC's wheeling

FERC diligently exercised this new authority but found that individual wheeling orders, which could be issued only upon application and not on the Commission's own motion, were an unsatisfactory means of providing open access.[93] Even though the legislative solution adopted by Congress proved inadequate, FERC could reasonably conclude that the legal risk, or at least the political risk, of relying on its §§ 205 and 206 authority to require open access was lower than it would have been previously.

FERC was also encouraged by its experience with natural gas pipeline unbundling, specifically satisfaction with the policy itself and its success in the courts. The reaction of both Congress and the courts to FERC natural gas pipeline unbundling policy indicated that adoption of similar policies with respect to the transmission grid might enjoy comparable success. The natural gas unbundling experience demonstrates how the legal risk of reinterpretation is not a constant, and that risk may rise and fall over time. In this case, the legal risk of reinterpretation of §§ 205 and 206 of the Federal Power Act to require transmission open access declined in the course of judicial review of natural gas unbundling policy.

Faced with the inadequate remedy of § 211 orders issued under new authority, FERC examined its preexisting legal authority to determine if there was another way to achieve transmission open access. The agency settled on reinterpretation of its long-standing authority under §§ 205 and 206. FERC's exercise of its §§ 205 and 206 authority to require transmission open access was not based on a factual record of abuse but on the potential for undue discrimination and preference.[94] Theory can be a sufficient basis for FERC regulatory action.[95]

The FERC open-access order was challenged in court and upheld by both the U.S. Court of Appeals for the District of Columbia Circuit and the Supreme Court.[96] The Supreme Court was unanimous in holding that the

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authority . . . .").

93. Order No. 888, 61 Fed. Reg. at 21,541.

94. *Id.*

95. Associated Gas Distribs. v. FERC, 824 F.2d 981, 1008–09 (D.C. Cir. 1987) ("Agencies do not need to conduct experiments in order to rely on the prediction that an unsupported stone will fall; nor need they do so for predictions that competition will normally lead to lower prices."). Even in the decision vacating the FERC Standards of Conduct final rule, the court invited the Commission to attempt to justify the rule on theoretical grounds alone. *See* Nat'l Fuel Gas Supply Corp. v. FERC, 468 F.3d 831, 844 (D.C. Cir. 2006) ("In the absence of factual evidence . . . FERC may try to support the Standards by setting out its best case for relying *solely* on a theoretical threat of abuse."). However, FERC decided against making the attempt.

96. Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom.* New York v. FERC, 535 U.S. 1 (2002). FERC's authority to impose open-access requirements was upheld by the D.C. Circuit and not raised before the Supreme Court. The Supreme Court decision focused on FERC's authority over unbundled retail transmission. *New York*, 535 U.S. at 4–5.

Commission could have gone further and required retail unbundling. Interestingly, the only division on the Court was related not to whether FERC went too far, but whether the agency failed to go far enough. Three members of the Court wrote separately to state their view that FERC not only had authority to require transmission open access over transmission facilities unbundled from retail sales, but that FERC must go further and assert jurisdiction over all transmission facilities, including those associated with bundled retail sales.[97]

The court decisions upholding Order No. 888 strongly suggest that FERC has not necessarily reached the limits of its authority under §§ 205 and 206 of the Federal Power Act. Essentially, these decisions held that the Commission could impose transmission open-access rules on all public utilities that owned transmission facilities in order to promote competition and reduce the potential for undue discrimination and preference, based on limited factual findings and relying heavily on theory.[98] The courts reaffirmed that FERC is at its zenith of authority when it acts to prevent undue discrimination and preference. Usually when an agency acts at its zenith of authority, it receives a zenith of deference from the courts on judicial review. There is no reason to conclude that FERC cannot rely on §§ 205 and 206 to impose additional requirements on public utilities if such requirements are designed to promote competition and reduce the potential for undue discrimination and preference, again relying largely on theory.

The policy objective sought by FERC in its transmission open-access rules was very important, namely promoting effective competition in wholesale power markets. The agency recognized that transmission open access was a necessary element of effective competition. Open access was the next major step in FERC's wholesale competition policy, a step that FERC concluded was essential. Reinterpretation of existing law was necessary to achieve that end. FERC's reinterpretation changed energy law because it fundamentally altered the long-standing interpretation of §§ 205

97. *New York*, 535 U.S. at 25, 29.

98. *See Transmission Access Policy Study Group*, 225 F.3d at 667, 683 ("[T]he open access requirement of Order 888 is premised not on individualized findings of discrimination by specific transmission providers, but on FERC's identification of a fundamental systemic problem in the industry."). One of the challenges to Order No. 888 was based on the Commission's reliance on economic theory, namely the incentive for transmission-owning utilities to use their ownership of transmission facilities to exercise vertical market power and discriminate against competing wholesale power sellers. The court dismissed this line of attack, distinguishing *Electricity Consumers Resource Council v. FERC*, 747 F.2d 1511 (D.C. Cir. 1984), where the court reversed a FERC order because it "was persuaded that the Commission had distorted the economic theory it claimed to apply." *Transmission Access Policy Group*, 225 F.3d at 688. The rule seems to be that to the extent broad FERC regulatory requirements are based on economic theory, they must rest on sound economic theory.

and 206 of the Federal Power Act. Yet, both the District of Columbia Circuit and the Supreme Court affirmed FERC's reinterpretation. Congress later amended the Federal Power Act without attempting to reverse the FERC transmission open-access rules. Based on these actions, one can conclude that Congress ratified FERC's interpretation of §§ 205 and 206. In fact, Congress went further and granted FERC additional authority to require open access by nonjurisdictional transmitting utilities.[99]

The development of transmission open-access policy reflected a certain synergism between Congress and the Commission. Congress took the first step with enactment of the wheeling provisions of the Public Utility Regulatory Policies Act of 1978. Then, beginning in the 1980s, FERC took the next step by conditioning mergers and market-based rate cases on open-access requirements.[100] Congress largely ratified the Commission's open-access policy with the wheeling amendments in the Energy Policy Act of 1992. The biggest step toward open access was taken with adoption of Order No. 888 four years later. Congress took no action to disturb Order No. 888 after it was affirmed by the Supreme Court.

3. Electric Market-Based Rates

As discussed earlier, federal electricity law has recognized competition since the 1930s. However, the level of wholesale competition was very low until technological change destroyed the natural monopoly in generation and spurred the development of a new class of competitors, independent power producers. But federal policymakers consciously encouraged these developments.

Electricity competition policy was born in the United States in 1978 with enactment of the Public Utility Regulatory Policies Act.[101] The birth was somewhat of an accident, since Congress did not obviously intend to promote competition in the Act. However, the birth occurred nonetheless as the Public Utility Regulatory Policies Act promoted competition in wholesale power markets by establishing a mandatory purchase requirement.[102] The requirement obliged utilities to purchase generation from qualifying facilities that met certain requirements.[103] Because utilities

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99. *See supra* note 75.

100. *See* Kelliher, *supra* note 32, at 553–70 (noting that an increased level of merger applications provided FERC an opportunity to condition the mergers on open-access requirements).

101. Public Utility Regulatory Policies Act of 1978, 16 U.S.C. §§ 1601–2645 (2006).

102. *See id.* § 824a-3 (2006) (requiring FERC to establish rules encouraging cogeneration and mandating that utilities offer to "purchase electric energy from such facilities").

103. *See* Federal Power Act, 16 U.S.C. § 796(17)–(18) (2006) (defining relevant terms).

were barred from owning qualifying facilities, this new class of generation was reserved for nonutilities.[104]

Beginning in the early 1980s, FERC "began to rely increasingly on market forces to lower wholesale power prices" and assure just and reasonable rates.[105] "To this end, the Commission began to authorize public utilities to charge market-based rates for wholesale power sales, rather than cost-based rates. This marked a fundamental change in FERC policy. The objective of this new policy was clearly to lower wholesale power prices."[106]

Authorization of market-based rates for wholesale power sales was a pillar of electric competition policy.[107] This was a departure from traditional cost-based ratemaking, which was focused on preventing the exercise of market power by controlling profits rather than by fostering efficiency.[108] FERC policy was intended to create competitive pressures that would improve efficiency, reduce costs, and lower wholesale power prices.[109]

It is important to recognize that market-based pricing of wholesale power sales is not deregulation for the simple reason that wholesale sales have continued to remain regulated since FERC took the first steps toward development of its market-based rate policies. The nature of that regulation has changed significantly, to be sure, but wholesale power sales were never deregulated. FERC has steadily strengthened its regulation of wholesale power sales as it continues to authorize and review the validity of the grant of market-based rates.[110]

The foundation for market-based rate pricing is interpreting § 205 of the Federal Power Act to find that a market-based rate is "just and reasonable," as required by § 205, if the seller lacks market power or has adequately mitigated its market power. The central duty of the Commission is to "guard the consumer from exploitation," which is achieved by preventing

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104. *See* 16 U.S.C § 796(17)(C)(ii), (18)(B)(ii) (2000) (limiting "qualifying small power production facility" and "qualifying cogeneration facility" to facilities that are "owned by a person not primarily engaged in the generation or sale of electric power" other than from qualifying facilities).

105. Kelliher, *supra* note 9, at 8.

106. *Id*.

107. *Id.* at 8–9.

108. *Id.*; *see* California *ex rel*. Lockyer v. FERC, 383 F.3d 1006, 1012 (9th Cir. 2004) ("[A]pproximately a decade ago, companies began to file market-based tariffs that did not specify the precise rate to be charged. As a result, FERC then departed from its historical policy of basing rates upon the cost of providing service plus a fair return on invested capital, and began approving market-based tariffs.").

109. Kelliher, *supra* note 9, at 9.

110. *See* Kelliher, *supra* note 9, at 13–14 (noting that FERC required additional filing requirements in 2002 for utilities engaged in wholesale cost and market rate sales).

market power exercise. That duty is equally fulfilled when market power exercise is prevented through robust competition as it is through classic rate regulation.

Essentially, FERC reinterpreted the 1935 Act after a half century to allow it to authorize market-based rates in addition to cost-of-service rates. The Commission was careful in its application of this new interpretation, approving market-based rates for individual sellers on an interim basis in a number of pricing experiments beginning in the 1980s.[111] These experiments led to a general policy that was applied through case-by-case adjudications.[112] It was many years after the inception of the market-based rate program that the Commission issued final regulations.[113]

The courts have upheld the Commission's reinterpretation, holding that the authorization of market-based rates is consistent with the agency's legal duty to assure just and reasonable rates.[114] *Lockyer* upheld the FERC market-based rate program, distinguishing it from market-based programs developed by the Federal Communications Commission and Interstate Commerce Commission that were previously overturned because those agencies were deemed to have relied solely on market forces to assure just and reasonable rates.[115] By contrast, the *Lockyer* court found FERC did not

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111. Entergy Servs., Inc., 58 F.E.R.C. ¶ 61,234, at 61,753 (1992) (approving market-based rates for wholesale power sales in order to provide greater efficiencies than traditional cost-based rate regulation); Pub. Serv. Co. of Ind., 51 F.E.R.C. ¶ 61,367, at 62,225 (1990) ("[I]mproved supply options should allow the purchasing utilities to reduce their costs, which will benefit their ratepayers when these cost reductions are passed through in their bills."), *modified sub nom.* PSI Energy, Inc., 52 F.E.R.C. ¶ 61,260, *clarified*, 53 F.E.R.C. ¶ 61,131, *petition dismissed sub nom.* N. Ind. Pub. Serv. Co. v. FERC, 954 F.2d 736 (D.C. Cir. 1992); Pac. Gas & Elec. Co., 38 F.E.R.C. ¶ 61,242, at 61,790 (1987) (allowing experimental competitive rates for wholesale power sales because "competition . . . encourages utilities to make efficient decisions with a minimum of regulatory intervention. Ultimately, consumers should benefit from lower prices as competition improves efficiency"), *modified*, 47 F.E.R.C. ¶ 61,121 (1989), *modified*, 50 F.E.R.C. ¶ 61,339 (1990), *modified sub nom.* W. Sys. Power Pool, 55 F.E.R.C. ¶ 61,099, at 61,319 (1991) (rejecting flexible pricing for bulk power sales because applicant had failed to eliminate anticompetitive effects by mitigating market power in generation and transmission), *granting stay*, 55 F.E.R.C. ¶ 61,154 (1991), *reh'g granted in part*, 55 F.E.R.C. ¶ 61,495 (1991), *modified*, 59 F.E.R.C. ¶ 61,249 (1992); Pub. Serv. Co. of N.M., 25 F.E.R.C. ¶ 61,469, at 62,059–60 (1983) (approving experiment to promote efficiency in wholesale power markets through market-based pricing of sales).

112. Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities, 72 Fed. Reg. 39,904 (July 20, 2007) (to be codified at 18 C.F.R. pt. 35); 73 Fed. Reg. 25,832 (May 7, 2008) (order on rehearing).

113. *Id.*

114. *See* California *ex rel.* Lockyer v. FERC, 383 F.3d 1006, 1013 (9th Cir. 2004) (determining that market-based tariffs do not, per se, violate the Federal Power Act); *see also* La. Energy & Power Auth. v. FERC, 141 F.3d 364, 365 (D.C. Cir. 1998) (rejecting that FERC acted arbitrarily and capriciously by approving market-based rates without a hearing); *see also* Kelliher, *supra* note 9, at 12.

115. *Lockyer*, 383 F.3d at 1013. The court also found FERC did not adequately enforce

rely solely on an *ex ante* finding that an applicant for market-based rates lacks market power, but that it also relied on continuing reporting requirements to assure that rates were just and reasonable and not subject to market manipulation.[116] The Supreme Court has not ruled on the legality of the FERC market-based rate program, denying two petitions for certiorari.[117]

Since *Lockyer*, Congress enacted the Energy Policy Act of 2005 without seeking to reverse FERC's interpretation of its authority to approve market-based rates. Not only were no provisions enacted to that end, there were no amendments offered or even introduced to curtail market-based rates. That is significant, since the Energy Policy Act of 2005 was enacted in the wake of the California and western power crisis of 2000–2001, and it would have been a simple matter to draft legislation to reverse FERC's interpretation. It would have been a matter of adding a simple sentence to § 205, or perhaps only a few words. It can be concluded that Congress ratified FERC's interpretation of the Federal Power Act to authorize market-based rates.

4. Hydrokinetics

A more recent example of where FERC has reinterpreted existing law in a manner that changed energy law is in the area of licensing hydrokinetics projects by reinterpreting the Federal Water Power Act of 1920 to establish a pilot license for new hydrokinetic projects.[118] Hydrokinetics is the use of waves, tides, and currents from oceans and free-flowing rivers to generate electricity. The potential for these technologies is tremendous.[119]

In the wake of a technical conference held by FERC in December 2006 on barriers to the development of hydrokinetics technology, the agency concluded the greatest need was exhibition of these technologies through demonstration or pilot projects. There is virtually no operating history for

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the ex post reporting requirement. *Id*. at 1014.

116. *Id*.

117. *Id.* at 1006, *cert. denied*, 127 S. Ct. 2972 (2007); Colo. Office of Consumer Counsel v. FERC, 490 F.3d 954 (D.C. Cir. 2007), *cert. denied*, 128 S. Ct. 1872 (2008). In *Morgan Stanley*, the Supreme Court specifically noted it had not ruled on the legality of the FERC market-based rate program. Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1, 128 S. Ct. 2733, 2741 (2008) ("Both the Ninth Circuit and D.C. Circuit have generally approved FERC's scheme of market-based tariffs. We have not hitherto approved, and express no opinion today, on the lawfulness of the market-based-tariff system, which is not one of the issues before us.") (citations omitted).

118. The Federal Water Power Act of 1920 became Part I of the Federal Power Act upon enactment of the Public Utility Act of 1935, Pub. L. 74-333, 49 Stat. 803, 838, 839 (codified as amended at 16 U.S.C. §§ 791, 791a (2006)).

119. *See generally* FERC, HYDROELECTRIC INFRASTRUCTURE TECHNICAL CONFERENCE, (2006), http://elibrary.ferc.gov/idmws/nvcommon/NVViewer.asp?Doc=11217148:0.

the various hydrokinetics technologies, so demonstration projects are necessary to prove these technologies to the point where they can obtain financial support.

To authorize demonstration projects, a licensing process suitable for pilot projects to test these technologies is needed. The licensing process used by FERC for conventional hydropower projects since 1920 is not suitable for demonstration projects. A conventional hydropower license has a fifty-year term and requires the submission of a license application containing significant environmental data. This process is not suitable for hydrokinetics demonstration projects since these projects have no operating history and cannot submit measurable environmental data in a license application. Also, a fifty-year term is far too long for a pilot project.

For these reasons, as Chairman, I directed FERC staff to consider whether the agency could establish a new licensing process suitable for demonstration projects. FERC staff responded with a very creative pilot license proposal drawn from a reinterpretation of the 1920 Act. Under this pilot license, an applicant would be required to submit minimal environmental data upfront. But a pilot license would require monitoring to identify any harm to fish or the environment and would authorize FERC to order suspension of operation or removal of such a project. The term of the pilot license would run five years, much shorter than the fifty-year term for conventional projects under existing law. The new hydrokinetics pilot license has not been tested in the courts yet, but there has been broad enthusiasm for the new approach developed by the Commission.

The key to development of the pilot license was the observation that § 6 of the Federal Power Act sets a maximum limit of fifty years for an original license, but no minimum limit.[120] The result has been a surge of applications for pilot licenses.[121] What is interesting is that a licensing process designed nearly ninety years ago for conventional hydropower projects has been adapted to meet the needs of hydrokinetics technologies that were not contemplated at that time. That is a tribute to how well the Federal Water Power Act of 1920 was drafted, as well as to the creativity of the FERC staff when presented with a challenge.

5. *Gas Gathering*

Not all agency reinterpretations of existing law are successful, however, and some are even reversed by the courts. One of the areas where FERC has been most persistent and creative in interpreting its legal authority is in

120. Federal Power Act § 6, 16 U.S.C. § 799 (2006).

121. As of January 5, 2009, FERC had issued 138 preliminary permits for hydrokinetic licenses under the pilot program, with 68 applications for preliminary permits pending.

the area of jurisdiction over offshore natural gas gathering facilities. This is also an area where FERC has suffered a long series of defeats in court.[122]

Under the Natural Gas Act, FERC does not have jurisdiction over gathering facilities.[123] *Gathering* has been defined as "the collecting of gas from various wells and bringing it by separate and several individual lines to a central point where it is delivered into a single line."[124] Under the Natural Gas Act, gathering facilities are left to the jurisdiction of the states.[125]

FERC uses a "primary function" test to determine whether a facility is devoted to jurisdictional interstate transportation or nonjurisdictional gathering of natural gas.[126] Under that test, FERC relies on various physical characteristics of the facilities to determine their jurisdictional status. The line between gathering and transportation facilities is reasonably easy to draw onshore. But in the decades since enactment of the Natural Gas Act in 1938, natural gas production has increasingly moved offshore, both to state and federal waters. The movement of gathering offshore into federal waters creates a regulatory gap, where neither federal nor state regulators have authority over gathering.

This regulatory gap has arisen in part due to natural gas pipeline unbundling. Before Order No. 436, "interstate natural gas pipelines generally did not perform transportation-only or gathering-only services."[127] Instead, they "used all their facilities, including any gathering facilities they owned, to provide a bundled transportation and sale for resale service, for which they charged a single bundled rate."[128] As part of Order No. 436, FERC required that rates for open-access transportation service separately identify cost components attributable to transportation, storage, and gathering.[129] Upon implementation of Order No. 436, pipelines "generally continued to bundle gathering service within their stand-alone open-access transportation service."[130] The Commission

122. *See, e.g.*, EP Operating Co. v. FERC, 876 F.2d 46, 48 (5th Cir. 1989); Sea Robin Pipeline Co. v. FERC, 127 F.3d 365, 368 (5th Cir. 1997).

123. Natural Gas Act § 1(b), 15 U.S.C. § 717(b) (2006).

124. Barnes Transp. Co., 18 F.P.C. 369, 372 (1957); *see also* ExxonMobil Gas Mktg. Co. v. FERC, 297 F.3d 1071, 1076 (D.C. Cir. 2002).

125. Natural Gas Act § 1(c), 15 U.S.C. § 717(c) (2006).

126. FERC first articulated the primary function test in *Farmland Indus., Inc.*, 23 F.E.R.C. ¶ 61,083 (1983). The Commission later modified the test in *Amerada Hess Corp.*, 52 F.E.R.C. ¶ 61,268 (1990).

127. Criteria for Reassertion of Jurisdiction over the Gathering Services of Natural Gas Company Affiliates, 118 F.E.R.C. ¶ 61,114, para. 4 (2007) [hereinafter Gathering Clarification Order].

128. *Id.*

129. 18 C.F.R. § 284.10(c)(1) (2006).

130. Gathering Clarification Order, 118 F.E.R.C. at para. 8.

repeatedly urged pipelines to fully unbundle gathering from transportation service,[131] and ultimately most pipelines did so.[132] In the wake of Order No. 636, pipelines began to "spin down" their gathering facilities to corporate affiliates or to "spin off" the facilities to unrelated third parties.[133]

It is in the nature of economic regulatory bodies to deplore unregulated monopolies. They are viewed as an evil, and something that cannot be tolerated. That instinct, and it truly is an instinct, has likely been the impetus for some of the persistence by FERC in seeking a means to regulate offshore gathering. Over the past fourteen years, FERC has advanced a variety of legal theories to justify some assertion of rate regulation over offshore natural gas gathering facilities. The courts have rejected each of these legal theories.[134]

The first attempt was in *Arkla Gathering Services Co.*, where FERC attempted to regulate gathering performed by affiliates of interstate natural gas pipelines.[135] The Commission held that it could regulate gathering by affiliates of natural gas companies, even if those affiliates were not jurisdictional "natural gas companies" according to its "in connection with" jurisdiction under Natural Gas Act §§ 4 and 5, if exerting control is "necessary to accomplish the Commission's policies for the transportation of natural gas in interstate commerce."[136] FERC held that if a gathering affiliate acted in concert with a jurisdictional pipeline in a manner that frustrated effective regulation of the pipeline, the agency could look through or disregard corporate form and treat the pipeline and affiliate as a single entity, and regulate the gathering facilities as if they were owned by the interstate pipeline.[137] In *Conoco Inc.*, the court reversed the Commission's requirement that a pipeline file a default gathering contract continuing existing rates in a spin down on the grounds that the agency had

131. FERC stated its preference for full unbundling of gathering service from transportation in its 1989 Rate Design Policy Statement, Interstate Natural Gas Pipeline Rate Design, 47 F.E.R.C. ¶ 61,295, at 62,059 (1989), restating its strong preference for fully unbundling gathering service in Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 57 Fed. Reg. 36,128 (Aug. 12, 1992).

132. Gathering Clarification Order, 118 F.E.R.C. at para. 8.

133. *Id.* paras. 17–20.

134. Williams Cos. v. FERC, 345 F.3d 910 (D.C. Cir. 2003); Sea Robin Pipeline Co. v. FERC, 127 F.3d 365 (5th Cir. 1997); Nw. Pipeline Corp. v. FERC, 905 F.2d 1403 (10th Cir. 1990); EP Operating Co. v. FERC, 876 F.2d 46 (5th Cir. 1989).

135. Arkla Gathering Servs. Co., 67 F.E.R.C. ¶ 61,257, *order on reh'g*, 69 F.E.R.C. ¶ 61,280 (1994), *reh'g denied*, 70 F.E.R.C. ¶ 61,079 (1995), *reconsideration denied*, 71 F.E.R.C. ¶ 61,297 (1995), *aff'd in part and rev'd in part*, Conoco Inc. v. FERC, 90 F.3d 536 (D.C. Cir. 1996).

136. *Arkla Gathering Servs. Co.*, 67 F.E.R.C. at 61,871.

137. *Id.*

not identified any authority for that condition.[138] But the court did not rule on FERC's reservation of the right to reassert jurisdiction, preferring to wait until an exercise of authority.[139]

Partially rebuffed, FERC turned to § 5(e) of the Outer Continental Shelf Lands Act as the basis to assert jurisdiction over offshore gathering facilities. The agency issued rules requiring companies providing natural gas transportation services, including gathering, on the Outer Continental Shelf to file information concerning pricing and service structures, including information gathering.[140] This attempt was also frustrated, as the courts vacated the FERC rules.[141]

The Commission next turned back to the Natural Gas Act, seeking to apply the reservation of authority in *Arkla* to a particular case. Acting on a complaint from Shell against Transco and its gathering affiliate, the Commission found that the pipeline and affiliate had acted in concert to frustrate FERC regulation by requiring Shell to pay exorbitant gathering rates and to agree to anticompetitive conditions.[142] The Commission imposed a just and reasonable gathering rate.[143]

On judicial review, *Williams Gas Processing-Gulf Coast Co. v. FERC* vacated and remanded the Commission's orders.[144] At the heart of the court's ruling was its conclusion that the agency misapplied the *Arkla* test. In particular, the court suggested that closing a regulatory gap with respect to offshore gathering was not a legitimate purpose, holding that the rationale for regulation under *Arkla* was preventing frustration of regulation of the *pipeline*, not the gatherer.[145] Thus, the *Williams* court placed strict limits on the scope of the *Arkla* test.[146]

In the wake of *Williams*, the Commission issued a notice of inquiry to evaluate possible changes to the *Arkla* test and invited suggestions based on other legal theories to justify regulation of offshore gathering.[147] In response, FERC clarified the *Arkla* test but concluded that a gathering

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138. *Conoco Inc.*, 90 F.3d at 553.
139. *Id.*
140. Regulations Under the Outer Continental Shelf Lands Act Governing the Movement of Natural Gas on Facilities on the Outer Continental Shelf, Order No. 639, 65 Fed. Reg. 20,354 (Apr. 17, 2000); 65 Fed. Reg. 47,294 (Aug. 2, 2000) (order on rehearing); 93 F.E.R.C. ¶ 61,274 (2000) (order denying clarification).
141. Williams Cos. v. FERC, 345 F.3d 910, 916 (D.C. Cir. 2003).
142. Transcon. Gas Pipe Line Corp., 96 F.E.R.C. ¶ 61,115 (2001).
143. Transcon. Gas Pipe Line Corp., 103 F.E.R.C ¶ 61,177, para. 41 (2003).
144. Williams Gas Processing-Gulf Coast Co. v. FERC, 373 F.3d 1335, 1345 (D.C. Cir. 2004).
145. *Id.* at 1343.
146. *Id.* at 1342–43.
147. Criteria for Reassertion of Jurisdiction over the Gathering Services of Natural Gas Company Affiliates, 70 Fed. Reg. 55,819 (issued Sept. 23, 2005) (notice of inquiry).

affiliate charging a monopoly rent for gathering is an insufficient basis to reassert jurisdiction.[148]

In the end, the Commission ran out of legal theories, accepted the limits on its Natural Gas Act jurisdiction over gathering, and reluctantly acquiesced in the reality that offshore gathering is an unregulated monopoly.[149] The Natural Gas Act provides for unregulated monopolies in offshore gathering, and FERC recognizes legislation is necessary for it to obtain jurisdiction over offshore gathering.[150]

CONCLUSION

Federal regulatory agencies are agencies with limited powers, the powers specified in the statutes charged to their administration. I recognize those limits, and my record of decisions as Chairman and Commissioner of FERC demonstrates that I respect those limits. But frequently those statutes lend themselves to more than one interpretation. As discussed earlier, the question of which interpretation to choose depends to a large extent on a balancing of the need for the agency to take a particular action, the discretion afforded by existing law, and the level of legal risk.

With respect to assessing the need to act, a governing factor is the nature of the duties entrusted to an agency. The courts have held that the primary task of the Commission is to guard the consumer from exploitation. In my view, that is not a passive duty. All things being equal, in my experience, an agency is more likely than not to choose a conservative interpretation of its legal authority. However, when presented with new challenges, springing from the dynamic nature of energy markets, technological developments, the convergence of energy markets with other markets, the tension between energy and environmental law, and other factors, an agency may elect a more expansive interpretation.

The pace of change in energy law has increased in recent years, and signal change has come equally from enactment of new legislation, court decisions, and agency interpretations. I see no reason to expect that the

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148. Gathering Clarification Order, 118 F.E.R.C. at para. 35.

149. *See* Press Release, FERC, Commission Clarifies Policy on Jurisdiction over Natural Gas Gathering Facilities (Feb. 15, 2007), http://www.ferc.gov/news/news-releases/2007/2007-1/02-15-07-G-1.asp. FERC Chairman Joseph T. Kelliher has observed that

> [t]he Commission has tried a number of times to assert jurisdiction over offshore gathering facilities to protect against undue preference and the exercise of monopoly power, but has been repeatedly rebuffed by the courts. We must accept the judgment of the courts. Under current law, offshore gathering is an unregulated monopoly. That will remain the case unless and until the law changes.

Id.

150. *Id.*

pace of change will slow, since the factors that have led to changes in energy law in recent years have not dissipated. If anything, the pressure for continued change is rising.

Although energy law can be expected to continue to change, the manner in which that change is accomplished is uncertain. It is possible that Congress will enact significant energy or environmental legislation that effects significant change. I hope the Obama Administration and Congress will have the wisdom to pursue an approach that achieves a balance between sound energy and environmental policy. It is also possible that Congress will attempt to enact legislation but fail in the process. My hope is that enactment of climate-change legislation will not prove to be a Sisyphean task. If so, the path that change in energy law takes to achieve carbon reductions may be agency reinterpretation of existing law, principally reinterpretation of the Clean Air Act by EPA. That may require FERC and other agencies in turn to reinterpret other laws to fulfill their respective legal duties.

But there are limits on the extent of change that can be accomplished through the reinterpretation of existing law. Certain changes in energy and environmental law can only be achieved through enactment of new legislation.

In my view, FERC has not reached the full limits of its statutory authority, and there remains nascent authority in the Federal Power Act and Natural Gas Act. Whether there is a need for the agency to reinterpret its statutory authority more expansively in the future depends on the circumstances, on both the need to act and the willingness of Congress to enact sound energy legislation.

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KEYNOTE ADDRESS

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It is a pleasure to be here at the *Administrative Law Review*'s 2008 Energy Law Symposium and join alumnus and Federal Energy Regulatory Commission (FERC) Chairman Joe Kelliher at the podium. I appreciate the University's invitation to participate in this discussion on the important topic of regulation of the energy markets. From recent market events, it is clear that energy will be at the forefront of our national discussions for many years to come.

When I first introduce myself to people and explain what I do for a living, their normal response is often the following: "May you live in interesting times." The more I heard this statement, the more I wanted to understand its origin. It turns out that this saying is derived from ancient China and rather than being a glass-half-full sort of comment, I found out it was meant as a curse more than an off-handed blessing. Certainly if energy prices are volatile on a given day, it feels like a curse.

This curse of volatile energy prices is one that is felt by all Americans. These issues are a matter of intense focus at the Commodity Futures Trading Commission (CFTC) due to the key role that futures markets play in the price discovery process for commodities, and this Commission is closely scrutinizing the current regulatory structure given the seismic changes that have occurred in these markets.

These days the entire financial system is at the center of the nation's attention, and an intense debate rages about the current state of the financial markets and the root causes of recent instability. We at the CFTC have

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been closely monitoring the events unfolding each day—both in the markets and on Capitol Hill—and we have worked hard to ensure that, through these turbulent times, the futures markets are functioning to provide transparent pricing and centralized clearing to reduce counterparty risk in the system. The Lehman Brothers bankruptcy a few weeks ago tested our regulatory safeguards aimed at protecting customer funds and the integrity of the futures markets. The staff of our Division of Clearing and Intermediary Oversight was on-site in New York during this critical time, working tirelessly to ensure futures customers were protected. I am proud of the work of our agency during this time, knowing that when tested—in a time of crisis—both our laws and staff met the challenge. The next Administration and Congress will likely tackle wholesale regulatory reform next year, and recent market events certainly underscore the importance of updating the overall regulatory structure for Wall Street. The CFTC stands ready to be a part of that dialogue and to highlight the need to protect customers in its markets and to uphold the integrity and reliability of the markets' price discovery function.

Against this turbulent backdrop, we continue to pursue the regulatory principles I charted for the agency when I assumed the position of Acting Chairman last summer. Since that time we have tackled what seems like a lifetime's worth of challenging regulatory issues. The initiatives I have pursued, including enhanced market transparency and controls coupled with aggressive enforcement, are even more important during these volatile market conditions.

Over the past year, the Commission has undertaken several steps directed at enhancing the oversight of the energy markets. These initiatives fall into four broad categories: (1) increasing transparency and market controls, (2) pursuing aggressive enforcement, (3) improving regulatory coordination, and (4) seeking more cops on the beat. I'd like to walk through these four steps one by one.

Step One: Increasing Transparency and Market Controls

One of the core missions of the CFTC is protecting the sanctity of the central price discovery process on futures exchanges. If prices are not reflecting the fundamental factors of supply and demand, the futures markets are not functioning properly, and all Americans suffer. If there is a lack of confidence in the validity of the price of a commodity, commercial participants will be less likely to manage risk in the futures markets. Furthermore, those involved with the commercial merchandising of a physical commodity, such as a utility or power generator, will be hesitant to forward contracts with customers if there is doubt about the basis of a

price discovered on the futures markets. This is why the CFTC's core mission of protecting the central price discovery process is so important.

The proper protection of price discovery begins with transparency. Market regulators must receive the necessary information to conduct surveillance of market activity and evaluate policy changes as circumstances evolve. The backbone of the CFTC's market surveillance program is the large trader reporting system. All large traders must file daily with the CFTC their futures and options positions in the markets. This information enables the CFTC's surveillance economists to oversee all traders of size to ensure that no one is attempting to manipulate the futures markets.

In addition to transparency, the CFTC imposes position controls on certain markets to ensure that one trader does not control too large of a position to corner or squeeze the markets. This combination of transparency and market controls has historically worked well in protecting the sanctity of prices discovered on the futures markets. Since our creation thirty-three years ago, this mission was relatively straightforward: to enforce and police. The centralized futures market was its own distinct market—price discovery occurred at brick-and-mortar exchanges under the watchful eye of one federal regulator.

But with the advent of electronic trading and globalization, we have witnessed the development of satellite markets that complement and compete with the centralized and regulated futures markets. First was the growth of the over-the-counter (OTC) swaps market that formed, allowing Wall Street institutions to customize and tailor risk-management products for commercial users of those commodities beyond standardized futures markets. Swap dealers offer these individualized OTC products to their customers, then combine and offset this risk before bringing the residual price risk to the futures markets.

As these off-exchange swaps markets developed, customers sought more efficient ways to trade these instruments, and as a result, electronic trading platforms—called exempt commercial markets (ECMs)—began to form. The most prominent ECM is the Intercontinental Exchange in Atlanta (ICE).

While these satellite markets brought innovation and competition, they also complicated the regulatory focus and mission of this agency due to the potential influence these entities could have on the central price discovery process that occurs in the futures markets. Just as the moon has the ability to affect the earth's tides, these satellite markets with direct links to the central futures market have the ability to influence the price formation of commodities.

Over the last year, the CFTC has systematically been reviewing these

developments to determine whether these satellite markets have had an impact on the centralized price discovery process and to make regulatory adjustments as needed. My tenure as Acting Chairman of the CFTC began with an examination of the trading of natural gas contracts on ECMs. Last fall the Commission held a public hearing relating to natural gas trading on ECMs. This resulted in CFTC legislative recommendations for Congress, which were ultimately made law as part of the recently enacted Farm Bill.[1] Those new authorities include the requirement that the CFTC receive large trader information from the markets and that the exchange imposes position limits and accountability levels for certain contracts.

Linkages between contracts are not purely a domestic occurrence but also happen across international borders. The CFTC announced earlier this summer certain modifications to its Foreign Board of Trade recognition process, including enhanced information sharing and position and accountability limits that are comparable to the regulated U.S. contracts that serve as the foreign contract price reference. These improvements were necessary due to the possibility that these linked foreign markets could influence prices on the centralized futures market *in the United States*. It was not done in an effort to oversee *foreign* exchanges that are regulated by their home regulators. This combination of enhanced information data and additional market controls will help the CFTC in its surveillance of its regulated domestic exchanges while preserving the benefits of its Foreign Board of Trade recognition program.

Lastly, the CFTC has taken action to improve the transparency of swap dealers and index traders in the energy markets. There is public concern about the amount of long-term commodity index investments flowing into the futures markets and the potential impact it may have on commodity prices. This summer the CFTC used its special call authority to gather more detailed data dating back to December 31, 2007, from swap dealers on the amount of index trading occurring in the over-the-counter markets and to examine whether index traders are properly classified for regulatory and reporting purposes. This was an unprecedented action, given that the CFTC regulates on-exchange futures contracts and does not have specific jurisdiction of over-the-counter swaps.

The CFTC staff report[2] found that on June 30, 2008, the total net amount of commodity index trading—both OTC and on-exchange activity—stood

1. Food Conservation and Energy Act of 2008, Pub. L. No. 110-234, 122 Stat. 923 (2008) (to be codified in scattered sections of 7 U.S.C.).

2. COMMODITY FUTURES TRADING COMM'N, STAFF REPORT ON COMMODITY SWAP DEALERS AND INDEX TRADERS WITH COMMISSION RECOMMENDATIONS (2008), *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf.

at $200 billion. Of this amount, $161 billion was tied to commodities traded on U.S. markets regulated by the CFTC. Although a sizeable amount of this $161 billion figure may not reach the futures markets due to internal netting by swap dealers, to put the number in context, it represents 17% of the roughly one trillion dollars of notional value for these same commodities traded on-exchange.

For New York Mercantile Exchange (NYMEX) crude oil, the net notional amount of commodity index investment rose from about $39 billion in December to $51 billion in June—an increase of more than 30%. However, this rise appears to have resulted from the increase in the price of oil, which rose from approximately $96 per barrel to $140 per barrel over that period. Measured in standardized futures contract equivalents, these figures equate to an 11% decline in aggregate positions of commodity index participants during this six-month period.

Staff also looked to determine whether the clients of swaps dealers were putting on positions that would have exceeded exchange position limits or accountability levels when combined with the clients' on-exchange positions. Looking at our most recent snapshot of June 30, of the 550 clients identified in the more than thirty markets analyzed, the survey data shows thirty-five instances across thirteen markets where noncommercial traders appeared to have an aggregate on-exchange and OTC position above a speculative limit or an exchange accountability level.

While these combined positions do not violate current regulations and the excess amounts were generally small, information regarding those who significantly exceeded limits or levels would be useful in the CFTC's surveillance of the futures markets.

In light of the preliminary data and findings, the Commission made several recommendations, including the enhancement of transparency for both public-reporting purposes for futures contracts and OTC swaps contracts, the creation of a CFTC office of data collection, and the replacement of the bona fide hedge exemption for swap dealers with a new limited risk-management exemption.

While the report's findings are useful and instructive, the data collection and analysis need to continue if the agency is to get a clearer picture of this vast marketplace. However, these preliminary recommendations represent enhanced transparency, increased reporting and information, and improved controls and practices used to oversee the markets while keeping our futures markets competitive, open, and on U.S. soil.

Step Two: Continuing Aggressive Enforcement

During these turbulent market conditions for energy products, the

environment is ripe for those wanting to illegally manipulate the markets, and as a result, the Commission has stepped up its already aggressive enforcement presence. In June, the Commission took the extraordinary step of disclosing that, in December 2007, its Division of Enforcement launched a nationwide crude oil investigation into practices surrounding the purchase, transportation, storage, and trading of crude oil and related derivatives contracts.

In July, the CFTC announced the first case stemming from its national crude oil investigation.[3] The CFTC charged the proprietary trading firm Optiver and several related defendants with manipulation and attempted manipulation on multiple occasions of energy futures contracts traded on the NYMEX, including crude oil, heating oil, and gasoline. As alleged in the complaint, on several days in March 2007, Optiver's traders amassed large positions in several energy contracts and then conducted trading in a way so as to "bully" and "hammer" the markets to benefit their positions.

These charges go to the heart of the CFTC's core mission of detecting and rooting out illegal and intentional manipulation of the markets. As with most of our manipulation cases, this alleged activity was meant to artificially move prices for short, discrete periods of time—in this case, temporarily moving prices up or down for several minutes over certain days in March 2007. But even such short-term distortions of prices will not be tolerated by the Commission, and the Commission will fully utilize its enforcement powers to track down anyone who is illegally trying to game the markets.

The Commission's Division of Enforcement has also been watching the markets closely over the last several weeks. On September 22, 2008, we announced that our Enforcement Division would be looking into that day's trading in crude oil when prices spiked over $16 per barrel in the last day of trading for the October contract. Our Enforcement Division prides itself on its "real time" enforcement of the Commodity Exchange Act,[4] and quick responsiveness is imperative to maintaining confidence in the markets, especially during these tumultuous times.

Step Three: Improving Oversight Coordination

Given the CFTC's limited size and the enormity of the global marketplace, the CFTC must also engage others in government as we seek to meet our important mission. The regulatory structure over the energy

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3. Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties Under the Commodity Exchange Act, U.S. Commodity Futures Trading Comm'n v. Optiver U.S., L.L.C., No. 08 Civ. 6560 (S.D.N.Y. July 24, 2008).

4. Commodity Exchange Act, 7 U.S.C. §§ 1–27f (2006).

space is one that assigns multiple tasks to multiple regulators. At the CFTC, we have worked closely with our regulatory partners at the Securities and Exchange Commission (SEC), Federal Energy Regulatory Commission (FERC), Federal Trade Commission (FTC), and with our cooperative partners in criminal prosecutions at the Department of Justice. Recent legislative developments have made clear Congress's intent that multiple regulators should work together to ensure there are no gaps in the oversight of important markets like the energy markets. We have long had productive relationships working with our sister regulatory agencies, and I intend to continue down that path to provide market oversight that is comprehensive and beneficial. Where the regulatory boundaries of the various agencies meet or overlap it is not surprising that everyone involved is aggressively pursuing action to the fullest extent of their jurisdiction. I am hopeful that in those places where sincere differences of opinion exist as to the boundaries of that jurisdiction, the courts will be able to resolve those issues quickly. Both Chairman Kelliher and I have respectfully acknowledged that the agencies have a difference of legal opinion on the issue of the CFTC's exclusive jurisdiction that will likely be resolved by the courts. But, rest assured, the CFTC and FERC stand shoulder to shoulder in the goal of ensuring that the energy markets remain free from manipulation.

The CFTC has pursued other cooperative government initiatives in the energy markets. In June, the CFTC announced the formation of an Interagency Task Force to evaluate developments in the commodity markets, which includes economic staff from the CFTC, Federal Reserve, Treasury, Energy, and Agriculture Departments as well as other agencies. It is intended to bring together the best financial minds in government to aid public and regulatory understanding of the forces that are affecting the functioning of these markets. The Task Force issued an interim report[5] on the crude oil markets in July and aims to issue its final report in the fall.

On the international front, yesterday the International Organization of Securities Commissions—the global standard-setting body for financial market regulators—announced that the CFTC and the United Kingdom Financial Services Authority would lead a Task Force on Commodity Markets to share thoughts on enhancing regulation for these markets with our international regulatory counterparts and coordinate supervisory approaches. I look forward to co-leading this cooperative effort.

An emerging and developing area of the energy space that will certainly

5. INTERAGENCY TASK FORCE ON COMMODITY MKTS., INTERIM REPORT ON CRUDE OIL (2008), *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf.

require cooperative regulatory action is in carbon emissions. Just as we work with cash regulators in the energy, financial, and agricultural sectors, we expect that with a further development of carbon trading, the CFTC will partner with the cash market regulator—such as the EPA—to ensure the futures markets in carbon are reliable markets for price discovery. The CFTC's expertise in futures and the fact that it already regulates both the Chicago Climate Exchange and the Green Exchange makes it uniquely situated to regulate the complexities of futures trading even where another regulator, such as the EPA, contributes its own expertise in regulating the underlying commodity. I expect that as the carbon-emissions markets develop and attract more users, the CFTC will play an important role in shaping the carbon futures markets and making sure the protections provided by the Commodity Exchange Act extend to these new developing exchanges.

Step Four: Seeking More Cops on the Beat

All of these new initiatives are resource and staff intensive, but I believe they are critical to help us properly oversee our markets. In addition to these latest proposals, it is also important to remember that we are full-time regulators overseeing these markets each and every day. To say we are busy is a gross understatement, especially given that our staffing levels are near record-low numbers. Since the CFTC opened its doors thirty-three years ago, the volume on futures exchanges has grown 8,000% while the CFTC's staffing numbers have fallen 12%.

This agency is only 450 individuals strong—roughly one-third the size of FERC and one-eighth the size of the SEC—but we oversee $5 trillion worth of notional financial flows in our markets daily. It is imperative that the CFTC receive the additional resources commensurate with the public responsibilities expected of it.

In closing, there are challenging days ahead for regulators and these markets, including finding near-term ways to stabilize and shore up the financial and energy markets. But I remain optimistic about the ingenuity of the American spirit to overcome these challenges during these "interesting" economic times. The American people have always overcome obstacles in our path, and I am confident that we will greet these challenges with hard work and entrepreneurial determination.

RECENT DEVELOPMENT

MAIN DISH WITH A SIDE OF VOLUNTARY COMMITMENTS: DISH NETWORK–DIRECTV REVISITED

BY SEAN M. CARROLL*

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INTRODUCTION

A lot can happen in a decade. It seems like just yesterday, but over eight years have passed since the attempted merger between EchoStar Communications Corporation, then owner of Dish Network, and Hughes Electronics Corporation, then owner of DIRECTV.[1] Although the Federal Communications Commission (FCC) denied their merger attempt in 2002,[2] the many changes that have occurred in the multichannel video programming distribution (MVPD) market[3] and our country's economy since then[4]—not to mention the FCC's recent approval of the relatively similar XM–Sirius Satellite Radio merger[5]—suggest the need to reconsider the merger. In light of these changes and the increasing importance of video media in our society, Dish Network and DIRECTV would be justified in moving forward with preliminary talks and reapplying to merge.[6] Not only will the merger benefit both companies, but if the applicants make certain voluntary commitments[7]—much like XM and Sirius did in their merger application[8]—then the merger will likely be in the public interest and thus gain the FCC's approval this time around.

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1. *See* EchoStar Communications Corp., General Motors Corp. & Hughes Electronics Corp., Consolidated Application for Authority to Transfer Control, FCC CS Docket No. 01-348 (Dec. 3, 2001) [hereinafter EchoStar–DIRECTV Application], *available at* http:www.fcc.gov/transaction/echostar-directv/echostarappli.pdf.

2. *See* EchoStar Commc'ns Corp., 17 F.C.C.R. 20,559, 20,562 (2002) (hearing designation order) [hereinafter EchoStar–DIRECTV Order] (claiming that the merger was not in the public interest).

3. *See* Video: Swanni's 2008 Predictions: DIRECTV & EchoStar Will Merge (2007), http://www.tvpredictions.com/swanniseven121707.htm [hereinafter Swanni's 2008 Predictions] (noting that "competition has expanded since 2002").

4. *See EchoStar Announces Price Freeze*, L.A. TIMES, Jan. 8, 2008, at C2 (citing the poor economy as a reason for increased competition in the MVPD market).

5. *See* XM Satellite Radio Holdings Inc., 23 F.C.C.R. 12,348, 12,352–53 (2008) [hereinafter XM–Sirius Order] (finding that the applicants' voluntary commitments and other conditions warranted approval of the merger).

6. *See* Mike Masnick, *Dish and DirecTV Figure If XM and Sirius Can Merge . . .* , TECHDIRT, Aug. 6, 2008, http://techdirt.com/articles/20080806/1743471914.shtml (stating that there are "rumors" that the companies attempt another merger); Andy Pasztor & Vishesh Kumar, *Dish Network Again Casts Its Deal Gaze at DirecTV*, WALL ST. J., Aug. 5, 2008, at B1 (stating that Dish Network CEO Charles Ergen may be "positioning Dish for a major strategic shift that may involve reviving attempts to combine Dish and DirecTV"). *But see* Linda Moss, *Dish Loss Fuels Rumors: But DirecTV's CEO Dismisses Idea of a Satellite-TV Merger*, MULTICHANNEL NEWS, Aug. 9, 2008, http://www.multichannel.com/article/CA6585953.html (reporting that DIRECTV's CEO Chase Carey publicly dismissed the idea of a merger).

7. Making voluntary commitments is a common practice in applications for license transfer. Lawrence M. Frankel, *The Flawed Institutional Design of U.S. Merger Review: Stacking the Deck Against Enforcement*, 2008 UTAH L. REV. 159, 201 (stating that these voluntary commitments are generally the result of a negotiation process between the merging parties and the Federal Communications Commission (FCC)).

8. *See* XM–Sirius Order, *supra* note 5, at 12,433–36 (outlining the various commitments that XM–Sirius made in order to make the merger in the public interest).

I. BACKGROUND

A. The Original EchoStar–DIRECTV Decision

Dish Network and DIRECTV are currently the two largest digital broadcast satellite (DBS) providers in the MVPD market.[9] In 2001, the owners of the two satellite providers applied to the Justice Department and the FCC for approval of their merger application.[10] The companies felt that the union would allow the merged DBS provider (New DIRECTV) to compete more effectively with cable systems in the MVPD market.[11] This was in part because the merger would have allowed the providers to eliminate their inefficient use of the DBS spectrum by consolidating the numerous duplicative channels that they distributed.[12] Finally, the applicants claimed that the merger, due to economic savings, would allow New DIRECTV to provide broadband Internet access to all parts of the country for the first time.[13]

However, the FCC denied the application on the basis that the public-interest harms outweighed the benefits.[14] The Commission ruled, among other things, that the merger would be against the public interest by reducing the number of competitors in the relevant product market, thus undermining the FCC's goals of increased and fair competition in the DBS market.[15] Further, the FCC feared the merger would result in harms caused by the concentration of ownership in a single license of the key DBS spectrum,[16] thereby increasing the likelihood of collusion between video service providers.[17]

9. *See* Stephen Super, *Congress Gives Satellite Viewers Local Station Option*, 6 B.U. J. SCI. & TECH. L. 14 (2000) (noting that Echostar and DIRECTV were the two largest satellite carriers at the time).

10. *See generally* EchoStar–DIRECTV Application, *supra* note 1.

11. *See* EchoStar–DIRECTV Order, *supra* note 2, at 20,573 (2002) (citing the companies' claim that they would be able to offer new and expanded programming choices to consumers postmerger).

12. *Id.*

13. *Id.* at 20,573–74; *see also* Benton Foundation, New OECD Numbers: Broadband Around the World, http://benton.org/node/25492 (last visited Aug. 21, 2009) (noting the United States' poor broadband deployment).

14. *See* EchoStar–DIRECTV Order, *supra* note 2, at 20,562–63 (finding that the applicants have not met their burden of demonstrating the public interest that would be served by the merger).

15. *Id.* at 20,562.

16. *See id.* (claiming that such concentration would not result in more-effective competition).

17. *See id.* at 20,625 (citing "basic economic principles and the characteristics of the market" as factors that point to increased likelihood of collusion).

B. The XM–Sirius Decision

At the time, the FCC's reasons for rejecting the merger application seemed convincing. A lot has changed, however, in the past seven years, not least of which is the Commission's recent approval of the XM–Sirius merger. The FCC approved the XM–Sirius merger in part because of the merged company's voluntary commitments, which mitigated the impact of any harmful, anticompetitive effects.[18] Among other things, those commitments included an offering of á la carte programming, a commitment to set aside channels for noncommercial, educational, and informational programming, and a three-year price cap.[19] At the time of the merger, XM and Sirius were the two largest providers of satellite digital audio radio service in the United States. Despite the differences between the successful XM–Sirius merger and the EchoStar–Dish Network merger proposed in 2001,[20] there are also many similarities between them that warrant reconsideration of the merger.[21]

C. The Changing Landscape of the MVPD Market

In addition to the FCC's laissez-faire approach in the XM–Sirius decision, competition in the MVPD market has increased dramatically in the past few years and is currently at an all-time high. This is mainly the result of factors such as increased cable penetration and new entrants to the market.[22]

II. THE FCC'S MERGER STANDARD OF REVIEW[23]

When faced with a merger application,[24] the FCC must determine

18. *See* XM–Sirius Order, *supra* note 5, at 12,352 (making clear that absent the voluntary commitments, the merger would "increase the likelihood of harms to competition and diversity").

19. *See id.* at 12,433–36 (listing and expounding upon the voluntary commitments).

20. *See* Ryan Saghir, *XM/Sirius Merger Is Not Like EchoStar/DirecTV and Here's Why*, ORBITCAST, Feb. 26, 2007, http://www.orbitcast.com/archives/xmsirius-merger-3.html (explaining that, at the time of the EchoStar–DIRECTV proposed merger, the MVPD market was markedly different than it is today and much less competitive than the radio market).

21. *See* Joel D. Corriero, Comment, *Satellite Radio Monopoly*, 33 DEL. J. CORP. L. 423, 446 n.173 (2008) (noting such similarities include combining two satellite licenses into one, claiming as a benefit the ability to eliminate duplicated channels, and increasing competition against the rest of the relevant market); Pasztor & Kumar, *supra* note 6 (arguing that the DBS providers, much like XM and Sirius, face competition from a variety of media).

22. *See infra* Part IV for a discussion on these factors.

23. In telecommunications mergers, the U.S. Department of Justice conducts its own, separate investigation into the antitrust considerations of the proposed merger. That investigation is beyond the scope of this Recent Development.

24. Specifically, in the case of a Dish Network–DIRECTV merger, the parties would be applying to the FCC for consent to transfer control of various Commission authorizations

whether the proposed transfer of licenses will serve the "public interest, convenience, and necessity."[25] The applicants bear the burden of proving, by a preponderance of the evidence, that the proposed merger will serve the public interest.[26] In making this determination, the FCC considers whether the merger is in compliance with the Communications Act of 1934 and the FCC's rules.[27] In general, the FCC's public-interest evaluations consider the following factors: competition in relevant markets, the acceleration of private-sector deployment of advanced services, the diversity of information sources and services to the public, and the general management of the public-interest spectrum.[28] In the end, the FCC makes its decision based on a balancing test that weighs "any potential public interest harms of the proposed transaction against any potential public interest benefits" in terms of the above-mentioned factors.[29] Specifically, "As the harms to the public interest become greater and more certain, the degree and certainty of the public interest benefits must also increase commensurately in order for us to find that the transaction on balance serves the public interest."[30]

III. A DISH NETWORK–DIRECTV MERGER IS IN THE PUBLIC INTEREST

A. Competition and the Relevant Product Market

Although it is true that in 2001, the relevant market for DBS service consisted of only DBS service providers, the relevant market has expanded over the last few years. The FCC uses the Justice Department's guidelines for determining the relevant product market, which define the market as "the smallest group of competing products for which a hypothetical monopoly provider of the products would profitably impose at least a small

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and licenses, including DBS and fixed-satellite space-station authorizations. *See* EchoStar–DIRECTV Order, *supra* note 2, at 20,561 (outlining the considerations passed upon in the case of the EchoStar–DIRECTV Order).

25. 47 U.S.C. § 310(d) (2006).

26. XM–Sirius Order, *supra* note 5, at 12,364.

27. *Id.* at 12,363–64.

28. *Id.* at 12,364–65.

29. *Id.* at 12,364.

30. Ameritech Corp., 14 F.C.C.R. 14,712, 14,825 (1999) (memorandum opinion and order). It should also be noted that the Commission takes the public's comments into account when making a public-interest determination, and there is never a shortage of lobbying in such proceedings. This is important because while Rupert Murdoch, one of the industry's most influential lobbyists, was opposed to the original EchoStar–DIRECTV merger, he now owns a controlling interest in DIRECTV and would clearly be in favor of a merger this time around. *See* Phillip Swann, *DirecTV–EchoStar Merger: 5 Reasons Why It Will Happen*, TVPREDICTIONS.COM, Aug. 4, 2006, http://www.tvpredictions.com/mergeryes080406.htm (predicting that having Murdoch on their side this time around could alone make the difference).

but significant and non-transitory increase in price . . . ."[31] This means that if one product is a close-enough substitute for the other, the FCC considers them to be in the same market.[32] Based on this definition, at the very least, the relevant product market for DBS services today should include cable television service, video service provided by telephone companies (telcos) such as Verizon and AT&T, and television on the Internet.[33] This is a significant expansion from the relevant product market for DBS services in 2001, but as one expert television analyst put it, "things are different now."[34] In addition, the Justice Department itself ruled in 1997 that DBS providers compete in a "broad market" comprising both cable and DBS providers.[35] Due to what has become such a broad relevant product market, competition is now at an all-time high for DBS service providers.[36]

1. Cable

In the original EchoStar–DIRECTV Order, then-Commissioner Kevin Martin criticized the majority's view that DBS's relevant market did not include cable, stating that "such an approach is not reflective of the actual competitive landscape . . . ."[37] Today, there is no question that the current Chairman would feel the same way, as increased cable buildout[38] and cable providers' ability to bundle video, telephone, and high-speed Internet services have increased cable's stronghold on the MVPD market and encroached onto DBS providers' territory.[39] Charles Ergen, CEO of Dish Network, stated that cable's "triple play" offerings of video, telephone, and

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31. XM–Sirius Order, *supra* note 5, at 12,367 (internal quotation marks omitted).

32. *See* Bert Foer, *Panel Discussion I: Development of Bank Merger Law*, 13 FORDHAM J. CORP. & FIN. L. 511, 525 (2008) (using an example from the Federal Trade Commission to illustrate the application of this standard).

33. The relevant market could also be expanded to include video media such as video iPods, YouTube, Slingbox, and video via mobile phones.

34. Swanni's 2008 Predictions, *supra* note 3.

35. *See* Thomas P. Walsh, III, *Defining the Relevant Market: Impacts of the Abolition of the Presumption of Market Power in Patent Tying Cases*, 84 DENV. U. L. REV. 267, 288 (2006) (quoting Andy Pasztor & Yochi J. Dreasen, *EchoStar's Past Argument May Foil Its Bid for Hughes*, WALL ST. J., Nov. 12, 2001, at B8) (explaining the conflicting definitions of markets for satellite-broadcasting suppliers).

36. *See EchoStar Announces Price Freeze*, *supra* note 4 (citing growing concerns over a recession as a reason for EchoStar's price freeze). In addition, many competitors of DBS providers recently made plans to increase prices for their services, making it even more important that DBS providers be able to effectively compete. *See id.* (stating that Comcast, Cablevision, and Verizon all have made plans to increase prices).

37. EchoStar–DIRECTV Order, *supra* note 2, at 20,689.

38. *See* Swann, *supra* note 30 ("[C]able TV service is now available in more markets [than it was in 2002].").

39. *See* Julia Angwin & Andy Pasztor, *Weaker Reception: Satellite TV Growth Is Losing Altitude as Cable Takes Off*, WALL ST. J., Aug. 5, 2006, at A1 ("A decade-long growth spurt for U.S. satellite-television broadcasters is sputtering amid a resurgent cable industry and changes in what consumers want from their TV providers.").

Internet are "stealing good customers" away from his company.[40] In fact, even before the triple play became a factor in customers' decisions on MVPD providers, economist Robert Willig conducted a study finding that "former DIRECTV subscribers who cited cost as the reason for canceling [DIRECTV service] were three times as likely to become cable subscribers as to become EchoStar subscribers."[41] The combination of cable's pervasiveness and the conversion of customers from DBS services serves as proof that DBS providers are in competition with cable providers. The products are substitutes for each other and should be classified in the same product market.

A related issue with regard to defining the relevant market is the competition between Dish Network and DIRECTV. In 2000, EchoStar, then Dish Network's parent company, filed an antitrust suit against DIRECTV claiming as part of the suit that they were each other's biggest competitors and that their relevant product market should be limited to just DBS services.[42] However, both Dish Network and DIRECTV are now owned by different companies than they were when the suit was initially filed. Furthermore, from as early as 2001, Peter Standish, a lawyer for Hughes and Echostar, has stated that the market is very different now than it was when the suit was first filed.[43] More importantly, although it is true up to a certain point that Dish Network and DIRECTV compete against each other, the reality is that DBS providers are primarily competing together against cable providers and other video service providers such as telcos.[44]

2. *Telcos*

On top of increased competition from cable, DBS providers are also feeling competition from telcos, specifically Verizon's FiOS and AT&T's U-verse, which are new entrants in the MVPD market. Importantly, both Verizon and AT&T have entered as legitimate video providers since the

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40. *Id.*

41. *See* Joseph Larson et al., *The Role of Economics and Economists in Antitrust Law*, 2004 COLUM. BUS. L. REV. 380, 456 (using the study to show that satellite-TV demand is driven by cable services and not alternative satellite pricing).

42. *See* EchoStar–DIRECTV Order, *supra* note 2, at 20,609, 20,623 (discussing EchoStar's arguments in their Amended Complaint in the antitrust action).

43. *See* Andy Pasztor & Yochi J. Dreazen, *EchoStar's Past Arguments May Foil Its Bid for Hughes: Reverberating Antitrust Charges May Block Satellite-Broadcasting Ambitions*, WALL ST. J., Nov. 12, 2001, at B8 (asserting that arguments made by EchoStar in its antitrust suit may come back to hurt it in its new merger application).

44. *Cf.* Corriero, *supra* note 21, at 433–34 (analyzing the Justice Department's decision in the XM–Sirius merger and determining that, although those companies once competed against each other to attract new customers, there was never "significant competition between them for customers who had already subscribed to one or the other service").

FCC's original EchoStar–DIRECTV decision and its determination on DBS providers' product market.[45] These services now provide two more competitors to the DBS providers in the market areas where Verizon and AT&T have deployed their fiber. As early as 2006, analysts said that because of these new entrants and their increasing market presence, a DBS merger could pass FCC scrutiny.[46] Although the telcos' video services are by no means ubiquitous, their deployment continues to expand,[47] and "both time and expectation" are taken into consideration when determining market definition.[48]

3. *Internet*

Another new entrant in the MVPD market is the Internet. Although we do not yet have universal Internet service, we are getting closer to universal access and it seems as though President Barack Obama will do everything he can to make that goal a reality.[49] Even if universal access is not achieved within the next few years, broadband is pervasive enough now to be considered in the same product market as DBS. "Wifi is everywhere now . . . even in the most remote areas," says one MVPD market expert.[50] A variety of public places such as libraries, McDonald's, and Starbucks all provide Americans access to the Internet. Furthermore, computers are significantly more affordable now than they were a decade ago, giving more and more Americans access to the Internet. Not only is the Internet more pervasive today, but people are using the Internet for purposes that

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45. *See* Swann, *supra* note 30 (stating that the launch of TV services from Verizon and AT&T have increased competition in the MVPD market since the original EchoStar–DIRECTV merger application).

46. *See* Linda Moss, *Wall Street Sizes Up a Satellite Merger*, MULTICHANNEL NEWS, July 24, 2006, http://www.multichannel.com/article/CA6355545.html (citing a lawmaker and analysts who believe the media landscape has changed enough to validate a merger).

47. *See* Benton Foundation, Proposal for the Creation of a Rural Fiber Fund, http://www.benton.org/node/20091 (last visited Aug. 21, 2009) (proposing the government approve funding needed to wire all of rural America with full fiber networks).

48. *See* Walsh, *supra* note 35, at 287 (using the satellite-television industry as an example).

49. *See* Lynnette Luna, *How Does Obama's Broadband New Deal Come to Fruition?*, FIERCEBROADBAND WIRELESS, Dec. 11, 2008, http://www.fiercebroadbandwireless.com/story/how-does-obamas-new-new-deal-come-fruition/2008-12-11 (examining Obama's proclamation that Internet access in America must be universal).

50. *See* Video: Interview by Sumi Das with Sam Diaz, Senior Editor, ZDNet, http://news.zdnet.com/2422-13568_22-213440.html (last visited Dec. 16, 2008) [hereinafter Das Interview] (describing the current satellite-television landscape and why the XM–Sirius merger was possible). Even Congressman Rick Boucher (D-Va.) who represents part of rural America would be on board for a potential Dish Network–DIRECTV merger. *See* Moss, *supra* note 46 (stating that Rep. Boucher has been active on satellite issues since the 1980s and that he favored the DBS providers' last attempt to merge).

directly compete with DBS. Today, more Americans than ever get their television fix via the Internet; the percentage of Americans that go online for news on a typical day increased by fifty percent from 2000 to 2004.[51] According to a 2007 study, nearly eighty million Americans watch their favorite television shows on the Internet.[52] That is forty-three percent of the online population, a figure that has almost doubled in the last year.[53] One college student even goes as far as saying, "the [I]nternet is becoming much more of a television community than actual television is."[54] The pervasiveness of the Internet combined with Americans' increasing use of broadband to watch television make it clear that the Internet competes with DBS providers and is part of the relevant MVPD market.

Thus, although opponents of a Dish Network–DIRECTV merger will point to the presumption that a merger that reduces the number of competitors in a product market to one or two is against the public interest,[55] that presumption simply does not apply here because there are significantly more competitors in the relevant product market now than ever before.

B. Advanced Services

As noted already, one of the reasons why the relevant product market for DBS services is larger today is because of the ability of cable providers and telcos to provide a triple play offering of video, telephone, and broadband Internet to consumers.[56] However, for economic reasons,[57] DBS providers are currently not able to provide certain advanced services,[58] specifically

51. *See* PEW RESEARCH CENTER FOR THE PEOPLE & THE PRESS, MEDIA CONSUMPTION AND BELIEVABILITY STUDY 5 (2004), *available at* http://people-press.org/reports/pdf/215.pdf (reporting that twenty-four percent of Americans had gone online for news on the day before the survey).

52. *See* Press Release, Solutions Research Group, Primetime Is Anytime: Americans Are Turning to Broadband for Their Favorite TV Shows (Feb. 4, 2008), http://www.srgnet.com/pdf/Prime%20Time%20is%20%20Anytime%20-%20February%204%202008.pdf (listing results from a survey of over one thousand Americans in November 2007).

53. *Id.*

54. Ali Rothschild, *Narrowcasting Changes How Americans Watch TV, Did Internet Kill the TV Star?*, DAILY CARDINAL, Oct. 15, 2008, http://www.dailycardinal.com/article/20867 (noting the same student also remarked that he "had more instances of friends gathered around a laptop than around a television set").

55. *See* EchoStar–DIRECTV Order, *supra* note 2, at 20,603 (stating the long-standing public policy view that diversity of service serves the common good).

56. *See supra* notes 39–40 and accompanying text.

57. *See* Calvin S. Goldman et al., *The Role of Efficiencies in Telecommunications Merger Review*, 56 FED. COMM. L.J. 87, 122 (2003) (stating that economic factors play an "integral role" in antitrust analysis).

58. Other advanced services include more high-definition TV channels, interactive digital video recorders, and broadband-enabled set-tops. *See* Swann, *supra* note 30 (arguing

broadband, to consumers.[59] This does not appear likely to change anytime soon, as both companies are seeing a slowdown in the number of new subscribers,[60] and earlier this year, Dish Network actually posted the first quarterly subscriber loss in the history of U.S. satellite television.[61] If the DBS providers could not afford to provide broadband before, they surely will not be able to do so now in the present context of subscription losses, increased competition, and our nation's struggling economy.

A merger between the two DBS providers would provide a solution to this competitive imbalance. Analysts estimate that a Dish Network–DIRECTV merger would save as much as $3 billion a year[62] for New DIRECTV through "economies of scale," "eliminated redundancies," and increased "leverage in programming deals."[63] This extra revenue would give New DIRECTV enough revenue to roll out a potent wireless-broadband offering to consumers and keep pace with major cable and telco operators.[64]

C. Diversity of Programming

Another advantage of this increased postmerger revenue would be New DIRECTV's ability to set aside capacity in order to address and fulfill the FCC's goal of increased program diversity. The elimination of the many currently duplicated channels between Dish Network and DIRECTV[65] will free up capacity that can be leased to diverse programmers. In the XM–Sirius Order, the FCC evaluated the merger's impact on diversity and found that a simple commitment by the parties to lease capacity to qualified programmers[66] would account for and satisfy diversity concerns.[67] There is

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that the merged companies could pool their resources to better provide advanced services); *see also* Goldman et al., *supra* note 57, at 90 (stating that new technologies stimulate merger and acquisition activity).

59. *See* Pasztor & Kumar, *supra* note 6 (positing that neither DBS provider has such ability due to the lack of financial resources that a merger could muster).

60. *See* Angwin & Pasztor, *supra* note 39 (reporting that in 2006 both companies' gains decreased to half of what they had been in previous years).

61. *See* Moss, *supra* note 6 (asserting that Dish Network lost 25,000 subscribers in the second quarter of 2008).

62. *See* Angwin & Pasztor, *supra* note 39 (noting that these savings would be more than enough to cover broadband expansion); *see also* Pasztor & Kumar, *supra* note 6 (estimating potential savings of $2 billion per year).

63. *See* Moss, *supra* note 46 (reporting that analysts believe the savings realized from a merger would allow the merged companies to pursue "an aggressive wireless-broadband strategy").

64. *See* Swann, *supra* note 30 (concluding that with the money saved, the companies could make the large investment necessary to compete in the MVPD market).

65. *See infra* Part IV.D.

66. "A 'Qualified Entity' includes any entity that is majority-owned by persons who are African American, not of Hispanic origin; Asian or Pacific Islanders; American Indians or Alaskan Natives; or Hispanics." XM–Sirius Order, *supra* note 5, at 12,409 n.437.

no reason why a similar commitment from New DIRECTV would not similarly fulfill the FCC's goal of diverse programming.

D. Efficient Use of Spectrum

Going hand in hand with the increased capacity for new channels resulting from a merger is the amount of spectrum that the FCC could save if the two DBS operators stopped providing so many of the same channels. Although not determinative, the FCC considers efficiencies of this nature,[68] or more specifically, the efficient use of spectrum, to be one of its main policy goals.[69] With the current state of the DBS market, this goal is simply not being achieved. Prior to the XM–Sirius merger, the FCC had noted, in favor of the applicants, that XM and Sirius offered 87 duplicative channels.[70] Dish Network and DIRECTV currently offer over 500 duplicative channels.[71] A merger would allow New DIRECTV to eliminate these duplications and use the resulting saved spectrum and revenue to provide advanced services, diverse and noncommercial educational and informational programming, and lower prices.[72]

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67. *See id.* at 12,380–81 ("[T]his voluntary commitment mitigates the potential harm from a decrease in diversity.").

68. *See* Goldman et al., *supra* note 57, at 110 (noting that the FCC historically prefers to condemn some transactions that would result in "high concentration levels even in the face of likely significant efficiencies"). Though recognizing the FCC's concerns, some commentators have cautioned against premature judgment:

> Although we agree there are transactions that should be viewed as "unthinkable," even though they may create some efficiencies, it is in the closer calls that care must be taken not to prematurely judge a transaction as "good" or "bad" due to the disparity between the burdens imposed on the government and on the transaction parties. In those transactions killed by such insurmountable presumptions, there will never be an opportunity for society to potentially benefit from the associated efficiency gains.

Id.

69. *See* EchoStar–DIRECTV Order, *supra* note 2, at 20,586 (stating that the nature of the application requires consideration of "long standing federal spectrum policies," including spectrum efficiency and competition).

70. XM–Sirius Order, *supra* note 5, at 12,381.

71. EchoStar–DIRECTV Order, *supra* note 2, at 20,586.

72. *See* Goldman et al., *supra* note 57, at 93, 96 (arguing that mergers in the telecommunications sector can allow companies to "offer a less expensive, more efficient, and broader range of services to consumers through joint production").

IV. VOLUNTARY COMMITMENTS[73]

Due to the similarities between this merger and the XM–Sirius merger, Dish Network and DIRECTV would likely need to adopt a series of voluntary commitments in order for the FCC to approve the merger. These commitments would mitigate some of the uncertainties that are commonly associated with mergers.[74] One, as noted, *supra*, will be a commitment to lease a certain amount of capacity to qualified programmers in order to maintain program diversity.[75] Another, in terms of pricing, should be a commitment to cap monthly charges in rural areas to the lowest fees paid by subscribers anywhere across the country.[76] Although rural America's lack-of-access argument will not stand up much longer,[77] a voluntary price cap for a few years would go a long way in quelling current fears of inflated prices, much like the price cap that XM and Sirius committed to in their merger.[78]

CONCLUSION

Simply put, "To impose a rigid merger specificity test to transactions has the potential of hampering a firm from obtaining, as expeditiously as possible, efficiencies that may be critical to the firm's ability to compete . . . and that may promote competition in the industry."[79] Although some may argue that many of the benefits of the merger could theoretically be accomplished through other means, such as interconnection or a joint venture, such actions come with high transaction costs that the struggling industry will not want or even be able to afford.[80]

Notwithstanding the benefits of a merger, it is possible that, absent a merger, the MVPD market may still lose a competitor. Analysts have claimed for years that without a merger there would be an extremely tough

73. Applications where the FCC informally identifies significant competitive concerns will generally be approved after the applicants "voluntarily amend their application to include conditions or commitments sufficient to ameliorate the FCC's concerns." Donald J. Russell & Sherri Lynn Wolson, *Dual Antitrust Review of Telecommunications Mergers by the Department of Justice and Federal Communications Commission*, 11 GEO. MASON L. REV. 143, 149 (2002).

74. *See id.* at 151 (implying that the defining characteristics of a merger review are the inherent uncertainties associated with the merger).

75. *See supra* Part IV.C.

76. *See* Pasztor & Kumar, *supra* note 6 (believing that such a price cap would be enough to alleviate fears of reduced competition).

77. *See* Das Interview, *supra* note 50 (stating such an argument); *see also supra* Part IV.A.

78. *See* XM–Sirius Order, *supra* note 5, at 12,435 (agreeing that XM–Sirius will cap all retail prices for three years after consummation of the merger).

79. Goldman et al., *supra* note 57, at 123.

80. *See id.* at 123–24 (discussing reasons why firms elect not to pursue efficiencies internally, such as cost and contracting difficulties).

road ahead for DBS providers.[81] In fact, six years ago, an analyst proclaimed that due to increased competition in the market, DBS providers most likely will not "be able to sustain the increasing capital costs required to keep up with cable"[82] and may "be *forced* to merge."[83] The bottom line is that today, "video is coming from all kinds of sources."[84] Thus, a merger between Dish Network and DIRECTV, with certain voluntary commitments, would not be against the public interest and would benefit the industry and Americans alike.

81. *See* Angwin & Pasztor, *supra* note 39 (reporting that while both major DBS providers are still profitable, they are spending more than ever to gain new customers); *see also* Swann, *supra* note 30 (affirming that Dish Network's "back is up against the wall").

82. Pasztor & Dreazen, *supra* note 43.

83. Walsh, *supra* note 35, at 288 (emphasis added).

84. *See* Swanni's 2008 Predictions, *supra* note 3 (observing the expansion of sources of audiovisual media).

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