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## BOOM AND BUST FOR WHOM?: THE ECONOMIC PHILOSOPHY BEHIND THE 2008 FINANCIAL CRISIS

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INTRODUCTION.....	141
I. THE RULE OF LAW.....	142
A. The Market-Government Dichotomy.....	142
B. The Dichotomy's Constitutional Incarnation.....	145
II. REGULATORY AGENCIES INFILTRATED.....	147
A. The "Free Market" Fallacy.....	147
B. Special Interests and Ideology.....	149
1. <i>The Growth of The Fourth Branch</i> .....	149

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2. <i>Warnings from Public Choice Theory</i> .....	151
3. <i>Regulatory Agencies Captured</i> .....	154
4. <i>The Efficient Capital Markets Hypothesis</i> .....	157
5. <i>True Believers at the Economy's Helm</i> .....	158
III. INEFFICIENT CAPITAL MARKETS AT WORK .....	160
A. Previous Policies .....	161
1. <i>OTC Derivative Deregulation</i> .....	161
2. <i>Signs of Trouble: Enron</i> .....	163
3. <i>Mark-to-Market Accounting</i> .....	164
B. The 2008 Financial Crisis .....	165
1. <i>Loose Monetary Policy</i> .....	165
2. <i>Credit Devaluation</i> .....	167
3. <i>The Risk/Reward Disparity</i> .....	168
4. <i>Accounting for Liquidity</i> .....	170
5. <i>Market Irrationality</i> .....	171
C. The Government Response .....	172
1. <i>Moral Hazard</i> .....	173
2. <i>1987 All Over Again</i> .....	175
D. Lessons Learned .....	176
IV. REFORMING REGULATION.....	178
A. Should Government Regulate At All?.....	179
B. Recommendations for Future Strategies.....	180
1. <i>Contain Externalities</i> .....	180
2. <i>Enable Individual Risk Particularization</i> .....	181
3. <i>Identify Values</i> .....	182
4. <i>Overcome Self-Interest</i> .....	183
5. <i>Employ Third-Party Mediation</i> .....	185
CONCLUSION .....	186

## INTRODUCTION

ALTHOUGH overvalued mortgage-backed securities have been widely blamed for the 2008 financial crisis, write-offs from these instruments merely represent the toppling of the first domino. The extent of the resulting economic damage demonstrates the inherent vulnerability of America's financial system. Since the 1980s, financial gurus responsible for the nation's economic health have failed to acknowledge a fact that history has shown to be true: financial markets not subject to restrictive regulation produce national economic crises. As public choice theory warns, special interest groups have captured federal agencies responsible for formulating the nation's financial policies.<sup>1</sup> These groups have sought to deregulate financial markets, based on a popular but faulty conception of the government-market relationship and an overestimation of the market's tendency to further the greater good.<sup>2</sup> While freeing financial markets provides profits to producers of financial instruments, taxpayers incur the costs of such policies when the inevitable crisis hits.

In the context of the recent financial crisis, this Note posits that tension between government and market interests provides the key to securing individual freedom. Part II examines the theoretical underpinnings of the United States' political system and discusses the market-government balance commonly mistaken for a one-sided struggle against government tyranny. Part III discusses special interest groups' infiltration of regulatory agencies, as public choice theory warned would occur. In this case, the infiltration yielded policies that were ideologically opposite to those traditional public choice theorists feared, while equally harmful. Part IV details how resulting government policies encouraged market volatility, which benefited financial instrument producers at consumers' expense. Part V suggests reforms to restore the market-government equilibrium.

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1. For an overview of public choice theory as applied throughout this Note, see generally James A. Dorn, *Public Choice and the Constitution: A Madisonian Perspective*, in 6 *POLITICAL ECONOMY AND PUBLIC POLICY: PUBLIC CHOICE AND CONSTITUTIONAL ECONOMICS* 57, (James D. Gwartney & Richard E. Wagner eds., 1988). In contrast to many public choice theorists, this Note does not posit that all regulation is inappropriate. On the contrary, the author argues that financial market deregulation is an example of the sort of special interest regulation traditional public choice theorists disdain.
  2. *Id.*

## I. THE RULE OF LAW

### A. The Market-Government Dichotomy

Political philosophy illuminates the true relationship between the government and the market. In his writings, Thomas Hobbes theorized that individuals, in an effort to avoid the pre-governmental anarchy that rendered their lives so “solitary, poor, nasty, brutish, and short,”<sup>3</sup> would cede autonomy to an absolute authority, the government, in exchange for security and protection from one another.<sup>4</sup> Hobbes noted, however, that this surrender of autonomy for the sake of security might enable the government to aggrandize itself, accumulating property<sup>5</sup> and rights formerly held and exercised by the citizenry.<sup>6</sup> It seems clear that if unchecked, this trend could produce despotism. Hobbes’ writings beg the question: How can citizens control the governmental monster they create to provide security?

Writing over a hundred years later, Adam Smith answered this question, suggesting that the free market might prevent totalitarianism. In his *Wealth of Nations*,<sup>7</sup> Smith extolled the free market’s ability to provide a forum in which individuals express their preferences democratically, producing an efficient distribution of goods.<sup>8</sup> According to Smith, the market’s “invisible hand” guides the economy to a stable equilibrium, establishes individual property rights in law, and thereby prevents the government from taking citizens’

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3. THOMAS HOBBS, *LEVIATHAN* 89 (Richard Tuck ed., Cambridge Univ. Press 1996) (1651).
  4. See, e.g. THOMAS HOBBS, *DE CIVI* 13 (Sterling P. Lamprecht ed., Appleton-Century-Crofts 1949) (1651) (“[T]he state of men without civil society, which state we may properly call the state of nature, is nothing else but a mere war of all against all; and in that war all men have equal right unto all things.”). See also GRAHAME THOMPSON, *THE POLITICAL ECONOMY OF THE NEW RIGHT* 12 (1990).
  5. “Property” refers to “everything that properly belongs to a person . . . including his life and liberty[.]” RICHARD PIPES, *PROPERTY AND FREEDOM* xv (1999). As used throughout this Note, property is generally meant to include money owned privately by individuals or held communally by the government.
  6. HOBBS, *supra* note 3.
  7. ADAM SMITH, *THE WEALTH OF NATIONS* (1776).
  8. This concept echoes ideas expressed much earlier by Stoic philosopher Cicero, who wrote that “by giving and receiving, by mutual exchange of commodities and conveniences, we succeed in meeting all our wants.” WILLIAM D. GRAMPP, 1 *ECONOMIC LIBERALISM: THE BEGINNINGS* 44 (1965) (quoting MARCUS TULLIUS CICERO, *DE OFFICIIS* i, 4 (C.W. Keyes trans., 1928) (44 B.C.)). However, “neither [Cicero] nor the economic liberals of a later age believed in an unrestrained freedom to acquire and use wealth.” *Id.* at 42.

rightful property.<sup>9</sup> The free market thus acts as a “counterweight to the authoritarian tendencies of the political system.”<sup>10</sup>

The market-government dichotomy proffered by Smith remains powerful to this day. “Free” societies are largely free of despotism as a result of the restrictions placed on government by commerce’s emphasis on private property and contract rights, which this Note refers to as “the market.”<sup>11</sup> However, the market operates under the same tendency to aggrandize itself as does the government. So while the market restrains government, government must restrain the market as well. Government must provide rules for market actors to follow. In so doing, government fulfills the citizenry’s desire to prevent coercive transactions, which drove individuals to form a government in the first place.<sup>12</sup> By preventing coercion, government rules stabilize expectations and secure individual property rights.<sup>13</sup>

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9. See SMITH, *supra* note 7. See also PIPES, *supra* note 5, at 111 (“By the sixteenth century, it was axiomatic in Western Europe that the king ruled but that his subjects owned, and that royal authority stopped where private property began.”); THOMPSON, *supra* note 4 (characterizing Smith’s writing as a response to Hobbes’ dilemma).

10. THOMPSON, *supra* note 4, at 13.

11. See *generally id.* at 11–15 (discussing the market-government equilibrium).

12. See Nicholas Mercuro, *The State & the Integration of Ecology, Law and Economics* [hereinafter Mercuro, *State & Integration*], in *ECOLOGY, LAW AND ECONOMICS: THE SIMPLE ANALYTICS OF NATURAL RESOURCE AND ENVIRONMENTAL ECONOMICS* 71, 74 (Nicholas Mercuro ed., 2d ed. 1997) (“Once [individuals in a state of anarchy] recognize the potential prospects for improvement in the character of their economic life brought on by establishing a social contract or constitution, they will enter into some form of social contract or formally adopt a constitution.”); see also MIKE FEINTUCK, ‘THE PUBLIC INTEREST’ IN REGULATION 15 (2004),

That the assignment of property claims should increase only the income of the individual who utilizes them is not enough. The members of a society have an interest in granting property rights to an individual member of society only when they enjoy an increase in their own welfare from the recognition of the guarantees given to one of their members.

(quoting GORDON C. BJORK, *PRIVATE ENTERPRISE AND THE PUBLIC INTEREST: THE DEVELOPMENT OF AMERICAN CAPITALISM* 65 (1969)).

13. See Mercuro, *State & Integration*, *supra* note 12, at 74 (“Thomas Hobbes and John Locke . . . developed a parallel conception of government and law wherein the principle function of the government was seen to be, among other things, to protect the purported ‘well-settled’ sovereign natural rights held by individuals.”); see also PIPES, *supra* note 5, at 232 (“[I]t has been rightly said that ‘democracy is strengthened if certain types of economic freedom are curtailed.’” (quoting DAN USHER, *THE ECONOMIC PREREQUISITES TO DEMOCRACY* 90 (1981))).

Thus, the tension between the market and the government provides individuals with both economic freedom and security.<sup>14</sup> Citizens in a democracy provide input to both sides of the dichotomy—to the government through votes and to the market through purchasing decisions. In economic terms, “behavior in the political arena is, in its essence, no different from behavior in the market, the individual acting in both contexts rationally to maximize his or her utility.”<sup>15</sup> In a perfectly-functioning system, citizen inputs would reach equilibrium, as both the market and the government would reflect the citizenry’s choices, creating an efficient balance. Government would regulate as much as necessary to prohibit coercion, while market-based resource allocation reflects individuals’<sup>16</sup> preferences and protects their property from arbitrary government takings.

Vital to this government-market tug-of-war is the requirement that both sides keep pulling. If one side were to cease its struggle, the market and the government might collude to eliminate consumers’ property rights and destroy freedom. If government were to dominate the market, the resulting communist state would assume control of private property. Likewise, if the market were to dominate the government, an extreme form of corporatism, such as fascism, might result, in which the government would permit private ownership of large economic units and shelter them from competition, thus limiting consumers’ expression of choice through purchasing decisions.<sup>17</sup> Under either system, the government would assume control of private property in violation of individual freedom.<sup>18</sup>

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14. PETER SELF, ROLLING BACK THE MARKET: ECONOMIC DOGMA & POLITICAL CHOICE 170–71 (2000). See also CASS R. SUNSTEIN, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE 12 (1990) (explaining how market forces of freedom and autonomy balance government forces of welfare and equity).

15. FEINTUCK, *supra* note 12, at 8 (quoting ANTHONY I. OGUS, REGULATION: LEGAL FORM AND ECONOMIC THEORY 59 (1994)).

16. The United States clings to the legal fiction that a corporation is an individual. Like an individual, a corporation submits to governmental regulation in exchange for security.

17. GRAMPP, *supra* note 8, at 42 (“Men of wealth frequently have learned, to their cost, that a state which promises to safeguard their property still may deprive them of the freedom to use it in their own interest (the lesson in [the 20th] century being provided by Hitler to those businessmen who welcomed him as a savior from communism).”).

18. SELF, *supra* note 14, at 171 (stating that this dichotomy “can last only so long as the market does not grow too dominant or democracy become too awkward or rebellious”).

## B. The Dichotomy's Constitutional Incarnation

The United States Constitution reflects the founding fathers' recognition of this market-government dichotomy. In the years following the Declaration of Independence, many considerations informed the deliberations on the structure of post-revolutionary American government. Foremost in the minds of the Constitution's primary drafter, James Madison, was the desire to limit central government power, in order to avoid embracing a homegrown despot akin to the one so recently overthrown. The evident need, however, to overcome the coordination and factionalism problems of decentralized government under the Articles of Confederation counterbalanced this aspiration.<sup>19</sup>

The Constitution that eventually emerged reflected Madison's revision of republican thought.<sup>20</sup> "Madison abandoned the classical republican belief in direct self-rule by the citizenry without rejecting the fundamental republican faith in deliberative democracy."<sup>21</sup> Federalism distributed power between the individual states and the federal government to prevent a tyranny of the majority, while checks and balances within the federal government guarded against the factionalism and demagoguery Madison feared.<sup>22</sup> In such a representative democracy, citizens provide input to both sides of the market-government equation. Individuals express their government preferences through voting, and their market preferences through their purchasing decisions. Ideally, these inputs reflect the citizenry's conception of the appropriate balance between individual and state power, and thereby protect individuals from oppression by a despot, or by each other.<sup>23</sup>

Defining the appropriate scope of governmental interference in the market requires defining which individual rights deserve protection. Madison's view, eventually codified in the Constitution and the Bill of Rights, was that the government should protect negative rights, in defining what the government may not do, rather than affirmative ones, which would define the government's affirmative obligations to regulate the market on behalf of

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19. SUNSTEIN, *supra* note 14, at 14.

20. *Id.* at 15.

21. *Id.*

22. *Id.* at 16. *See also* James Madison, Speech at the Virginia Convention (Dec. 2, 1829), reprinted in JAMES MADISON: WRITINGS 824 (Jack N. Rakove ed., 1999) ("The essence of Government is power; and power, lodged as it must be in human hands, will ever be liable to abuse.").

23. GRAMPP, *supra* note 8, at 98 ("The achievement consisted in bringing together two elements in liberal doctrine which never before had been integrated and which are in fact quite difficult even to reconcile.").

consumers.<sup>24</sup> Thus, Madison's Constitution produced a passive national government protective of negative rights, rather than an active welfare state.<sup>25</sup> In so limiting central governmental power, the Constitution also limits the role of the market, by providing the government the authority to regulate that private sphere when necessary.<sup>26</sup> Although the Constitution and Bill of Rights include discrete protections for both negative rights,<sup>27</sup> and affirmative rights,<sup>28</sup> the Constitution primarily reflects the idea that the federal government should regulate minimally and leave the heavy lifting to the separate states.<sup>29</sup>

Recognizing, however, that protecting consumers is a legitimate use of governmental authority does little to determine when such authority is rightly applied.<sup>30</sup> This ambiguity was manifested after the Revolution in clashes between Federalists and Republicans over economic policy.<sup>31</sup> "The economic policy of the Federalists was designed to increase the national power of the United States, whereas the economic policy of the Republicans was meant to improve the capacity of the people for self-government."<sup>32</sup> Although the

24. See Madison, *supra* note 22.

25. Dorn, *supra* note 1, at 57.

26. As Representative Betty McCollum noted, "A free market isn't the same thing as an unregulated market. The private sector and the government play two different but very essential roles in our economy, and there's a healthy tension between the private and the public interest." *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 149 (2008) [hereinafter *Hearing*] (statement of Rep. Betty McCollum, Member, H. Comm. on Oversight and Gov't Reform).

27. Such as the Contracts Clause, U.S. CONST. art. I, § 10, and the Privileges and Immunities Clause, *Id.* art. IV, § 2.

28. Such as the assumption that government action may be required to protect life, liberty, and property *Id.* amend. V. See also SUNSTEIN, *supra* note 14, at 17 ("The protection of life, liberty, and property was a central task of the federal and state governments in the framers' view; and that protection required governmental action."); Dorn, *supra* note 1, at 57 (stating that Madison envisioned the federal government exercising those powers "necessary to safeguard persons and property").

29. SUNSTEIN, *supra* note 14, at 17–18; Richard A. Epstein, *Taxation, Regulation, and Confiscation*, 20 OSGOODE HALL L.J. 433, reprinted in 29 - 6 POLITICAL ECONOMY AND PUBLIC POLICY, 181, 181 (James D. Gwartney et al. eds., 1988).

30. GRAMPP, *supra* note 8, at 110 (noting ambiguity about what had been decided on the Constitution's "regulation of commerce"); RICHARD A. HARRIS & SIDNEY M. MILKIS, *THE POLITICS OF REGULATORY CHANGE: A TALE OF TWO AGENCIES* 29 (1989) ("[I]nstitutional tension [between federalism and regulatory agency power] . . . only mirrors the constitutional ambiguity on the legitimate scope of government and separation of powers in American politics." (citation omitted)).

31. GRAMPP, *supra* note 8, at 116 ("To the Republicans, government power was the enemy of individual liberty.").

32. *Id.* at 114.

parties disagreed on the proper scope of central government authority, both recognized the need for the government to regulate the market; they just disagreed on where to draw the line.

## II. REGULATORY AGENCIES INFILTRATED

Despite its preeminence in the Founders' minds, the two-way nature of the market-government relationship received little attention as time passed. In the nineteenth century, regulation's judicial origin produced a public ethos favoring unconstrained private enterprise.<sup>33</sup> In the twentieth century, the economic tumult of the Depression prompted a public outcry for active government oversight.<sup>34</sup> The bureaucracy founded by the New Deal and expanded in subsequent years provided a vehicle through which special interests could further their agendas.<sup>35</sup> The following section will explore how producers of financial services, proclaiming the market's inherent value-neutral efficiency, successfully recruited government agencies tasked with regulating the nation's financial markets as willing accomplices to their profit-seeking. Arguably, it was this subversion of regulatory agencies that increased market volatility while decreasing consumer protections, rendering the American economy vulnerable to financial ruin.

### A. The "Free Market" Fallacy

A distinct distrust of federal regulation developed in the nineteenth century. Because the fledgling United States lacked the federal bureaucracy necessary to regulate the market, that task fell mainly to the states. Lacking the bureaucracy—and perhaps the political will<sup>36</sup>—to implement significant ex-ante restrictions, state governments declined to regulate the market meaningfully via statute. As a result, common law state courts took up much of the slack in protecting consumer interests against producers.<sup>37</sup>

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33. See *infra* Part II.A.

34. Robert Rabin, *Federal Regulation in Historical Perspective*, in PETER H. SCHUCK, FOUNDATIONS OF ADMINISTRATIVE LAW 8, 39 (2d ed. 2004).

35. MASHAW ET AL., ADMINISTRATIVE LAW: THE AMERICAN PUBLIC LAW SYSTEM 5 (5th ed. 2003).

36. SUNSTEIN, *supra* note 14, at 17.

37. This is not to suggest that courts were hostile to regulation prior to the New Deal. On the contrary, Barry Cushman has demonstrated convincingly that nineteenth and early twentieth century courts did vindicate individual rights. Barry Cushman, *Rethinking the New Deal Court*, 80 VA. L. REV. 201 (1994). However, as discussed *infra*, the fragmented, ex-post nature of this regulation concealed its existence from public view, producing the

Consequently, most nineteenth century consumer-protection law was judge-made rather than statutory.<sup>38</sup>

Regulation's invisibility produced a decidedly pro-producer ethos in America.<sup>39</sup> When a judicial decision protected a consumer right against a producer, this ex-post outcome was seen as pre-political and value-neutral, rather than as an example of deliberate governmental regulation of a market actor.<sup>40</sup> The fact that business regulation was conducted after the fact and hidden in a case's facts shaped Americans' conception of the proper government-market balance. "Seeing the common law status quo as pre-legal and neutral, judges (and many others) did not recognize its principles as part of a regulatory system at all, but regarded them instead as the state of nature."<sup>41</sup> As a result of the nation's history of invisible regulation, even today "[t]he market is perceived as dispensing benign virtue and discipline, while the political allocation of resources is perceived as dispensing ill discipline and ultimately oppression."<sup>42</sup>

This ex-post judicial regulation also limited the type of market regulation that the federal government could enact before the New Deal. Because judges could only reverse the market-order based on precedent, governmental regulation of the market was handicapped considerably.<sup>43</sup> Moreover, the few federal agencies founded in the nineteenth century, such as the Army Corps of Engineers (1824), the Patent and Trademark Office (1836), and the Comptroller of the Currency (1863), were established to further economy activity rather than control it.<sup>44</sup>

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conventional view that Roosevelt's "switch in time" represented a sea change in judicial review of federal regulation, when in fact the New Deal just increased regulation's visibility.

38. SUNSTEIN, *supra* note 14, at 17.

39. See THOMPSON, *supra* note 4, at 27–28.

40. SUNSTEIN, *supra* note 14, at 19.

41. *Id.*

42. THOMPSON, *supra* note 4, at 13. See also SCHUCK, *supra* note 34, at 8 (noting that in America, unlike other countries, a strong pro-market bias forces regulators to "bear a burden of justification").

43. SUNSTEIN, *supra* note 14, at 19–20.

44. *Id.* at 17.

## B. Special Interests and Ideology

Then the Great Depression came. Economists have proffered a variety of theories regarding the causes of the economic crisis of the 1930s.<sup>45</sup> In fact, most well-known twentieth century economic theories advocated policies intended to prevent another Depression. For example, in his *The General Theory of Employment, Interest and Money*, John Maynard Keynes argued that forward-looking industry, facing a downturn in consumer demand, did not expand future production despite the presence of inexpensive capital, causing a downward spiral in the economy.<sup>46</sup> Monetarists such as Milton Friedman claimed that the Federal Reserve's failure to increase the supply of money after the stock market crash of 1929 turned what would have been a recession into a deep depression.<sup>47</sup> Neoclassical economists such as Irving Fisher and Ben Bernanke argued that the pre-Depression oversupply of money fueled banks with capital reserves to leverage excessively and engage in risky investments, rendering them especially susceptible to any economic downturn.<sup>48</sup> Other economists such as Henry Simons and Hyman Minsky claimed that an inherently unstable credit system permitted changes in consumer confidence to alter the money supply.<sup>49</sup> Friedrich Hayek's neo-Austrian school suggested that any government monetary policy can cause financial crisis, and that the government therefore should not engage in monetary policy at all.<sup>50</sup>

### 1. *The Growth of the Fourth Branch*

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45. Scholarship suggests that the widely assumed market manipulation of the 1920s did not actually occur. See Paul G. Mahoney, *The Stock Pools and the Securities Exchange Act*, 51 J. FIN. ECON. 343 (1999).
46. JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* (1936).
47. MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES 1867–1960* 407–09 (1963).
48. See generally IRVING FISHER, *BOOMS AND DEPRESSIONS* (1932); Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257 (1983), reprinted in 2 *NEW KEYNESIAN ECONOMICS: COORDINATION FAILURES AND REAL RIGIDITIES* 293, 296 (N. Gregory Mankiw & David Rome eds., 1991).
49. CHARLES P. KINDLEBERGER, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES* 61 (3d ed. 1996).
50. FRIEDRICH A. HAYEK, *MONETARY THEORY AND THE TRADE CYCLE* (N. Kaldor & H. M. Croome trans., 1933).

Whatever its causes, the Roosevelt Administration interpreted the Depression as “militat[ing] in favor of a bigger and more centralized regulatory apparatus.”<sup>51</sup> While “[p]re-New Deal regulatory initiatives rested on the common law assumption that minor government policing could ensure a smoothly functioning market[,] . . . the Depression put to rest this constrained view of national power,”<sup>52</sup> or so the reasoning went. A series of responses by the federal government, the New Deal, interpreted the common-law-regulated market order as neither pre-political nor sacred, but rather the result of deliberate policy choices<sup>53</sup> which had failed to effectively limit the market’s tendency to excess.<sup>54</sup> Roosevelt himself urged the nation to “lay hold of the fact that the laws of economics are not made by nature. They are made by human beings.”<sup>55</sup> Resultantly, the New Deal increased government regulation of the private sector substantially. From 1932 to 1938, the government created or expanded sixteen federal agencies, including the Tennessee Valley Authority (1933), Securities and Exchange Commission (1934), and Food and Drug Administration (1938).<sup>56</sup>

While largely credited with bridging the gap between the Depression and the enormous increase in federal spending during World War II, New Deal reforms produced two additional relevant effects. First, the New Deal eliminated the appearance of value-neutrality from common law principles, thereby raising questions about what values the government should protect. While not explicitly validating Roosevelt’s call for a “Second Bill of Rights,”<sup>57</sup> federal agencies were criticized for furthering affirmative rights, such as the right to clean air and product safety, through redistribution, at the expense of negative rights securing private property.<sup>58</sup>

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51. HARRIS, *supra* note 30, at 29. Some scholars suggested ulterior motives for the government’s New Deal regulation of financial markets. *See, e.g.*, Mahoney, *supra* note 45, at 347 (arguing that blaming financial markets for the Depression both deflected blame from the federal government and capitalized on longstanding populist and Progressive political interests in controlling Wall Street).

52. Rabin, *supra* note 34, at 41.

53. SUNSTEIN, *supra* note 14, at 20. Note that this view is not universally accepted. Hobbes’ contemporary, John Locke, argued that some individual rights, including the right to own, are prepolitical, and therefore must be respected by any just government.

54. Rabin, *supra* note 34, at 41 (citing the New Deal conception of “government activity as a permanent bulwark against deep-rooted structural shortcomings in the market economy”).

55. SUNSTEIN, *supra* note 14, at 20 n.16.

56. *Id.* at 25.

57. *See generally* CASS R. SUNSTEIN, THE SECOND BILL OF RIGHTS: FDR’S UNFINISHED REVOLUTION AND WHY WE NEED IT MORE THAN EVER (2004) (citing Franklin Delano Roosevelt, State of the Union Address (Jan. 11, 1944)).

58. *See, e.g.*, PIPES, *supra* note 5, at 240–45; Epstein, *supra* note 29, at 182–83.

Second, the New Deal rejected federalism emphatically. In *Federalist No. 46*, Madison noted that if “the people should in future become more partial to the federal than to the state governments, ... in that case, the people ought not surely to be precluded from giving most of their confidence where they may discover it to be most due[.]”<sup>59</sup> The federal government interpreted the Depression as just such a mandate. Roosevelt and his successors established a panoply of federal agencies to regulate numerous sectors of formerly private enterprise, including financial markets, and Congress delegated these agencies broad rulemaking authority.<sup>60</sup> Creating a bureaucracy capable of addressing national issues rejected Madison’s vision that state power would check federal power.<sup>61</sup>

## 2. Warnings from Public Choice Theory

The danger of simultaneously expanding the federal government authority and largely removing a check on government’s use of this power led those with property to fear an arbitrary, redistributive government. Increased federal government power thus produced producer-consumer economic factionalism, just as Madison feared.

Public choice theory’s central insight is that like market actors, elected representatives act rationally to maximize their utility.<sup>62</sup> In many cases, their utility is first and foremost concerned with getting elected (or re-elected). This goal would be best served by satisfying constituents, but for the inefficiencies plaguing the political process. For better or worse, winning an election depends on much more than a candidate’s positions on issues. A candidate must sell himself to voters. Candidates therefore need expertise, staff, and advertising—all of which require money.<sup>63</sup> A rational individual’s

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59. THE FEDERALIST NO. 46 (James Madison), *reprinted in* JAMES MADISON: WRITINGS, *supra* note 22, at 266, 267.

60. *See* MASHAW ET AL., *supra* note 35, at 5 (discussing the establishment of such agencies). *See also id.* at 9 (calling the Administrative Procedure Act “a catch-up statute trying to provide law to cover legitimate agency practices. . . .”) (citation omitted).

61. SUNSTEIN, *supra* note 14, at 22.

62. James M. Buchanan, *Toward Analysis of Closed Behavioral Systems*, in *THEORY OF PUBLIC CHOICE* 12 (James M. Buchanan & Robert D. Tollison eds., 1972) (“Political decisions are not handed down from on high by omniscient beings who cannot err. Individuals behave in market interactions, in political-government interactions, in cooperative non-governmental interactions, and in other arrangements.”).

63. James D. Gwartney & Richard E. Wagner, *Public Choice and the Conduct of Representative Government*, in 6 *POLITICAL ECONOMY AND PUBLIC POLICY*, *supra* note 29, at 3, 9 (“Just as neglect of economic profit is the route to market oblivion, neglect of potential votes is the route to political oblivion.”); *see also* Richard L. Stroup, *The Unpredictable Politics behind*

campaign support is proportional to the utility the individual expects to gain if the candidate wins. This shapes candidates' positions powerfully, encouraging them to support policies most likely to garner votes and financial donations, which are not always those that best serve constituents' interests.

This tendency suggests that elected representatives' positions will not mirror their constituencies'. Instead, minority groups enjoy several advantages which permit them to exercise greater influence than their low numbers otherwise would permit. Minority groups threatened with harm by majoritarian government action are especially motivated to organize, and better able to avoid the problem of "free-riders."<sup>64</sup> "Precisely because the many are no competition for the few, there are numerous occasions for those able to mobilize to achieve regulatory successes that harm the unorganized substantially."<sup>65</sup> Politicians recognize a low political cost from supporting such special interests. There is always a benefit to someone in reversing a market-made decision.<sup>66</sup> Representatives can almost always justify their positions as furthering the "greater good."<sup>67</sup> Resultantly, "[a]n astute politician who wants to succeed politically is strongly motivated to support narrow but intense over broad but diffuse interests."<sup>68</sup> This renders representative democracy especially susceptible to capture by special interest groups seeking regulation beneficial to their members, often at the majority's expense.<sup>69</sup>

Such rent-seeking depends on legislators influencing the agency officials tasked with regulating industry.<sup>70</sup> Legislators do so in a number of ways. Since agencies' authority derives from Congress, legislators can influence agency decisions by adjusting agency budgets, changing the scope of an agency's rulemaking authority, or even vetoing an agency decision.<sup>71</sup> Furthermore, as head of the executive branch, even the president may be

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*Regulation: The Institutional Basis*, in REGULATION AND THE REAGAN ERA: POLITICS, BUREAUCRACY AND THE PUBLIC INTEREST 242, 243–244 (Roger E. Meiners & Bruce Yandle eds., 1989) ("[E]xpensive advertising campaigns can provide [candidates] an important competitive edge.").

64. Gwartney, *supra* note 63, at 20–21. "Free-riders" are individuals who reap the benefits of a collective action without paying for that action directly, such as non-union workers who reap the benefits of union-negotiated wage agreements.

65. STEVEN P. CROLEY, REGULATION AND PUBLIC INTERESTS: THE POSSIBILITY OF GOOD REGULATORY GOVERNMENT 19 (2008).

66. Stephen Breyer, *Regulation and Its Reform*, in SCHUCK, *supra* note 34, at 14, 16.

67. CROLEY, *supra* note 65, at 39.

68. Gwartney, *supra* note 63, at 19.

69. FEINTUCK, *supra* note 12, at 21.

70. CROLEY, *supra* note 65, at 16.

71. *Id.* at 17.

susceptible to minority influence, since he must also placate special interest groups in exchange for campaign funding and political support from voters and legislators.<sup>72</sup> Moreover, special interest groups may influence agency officials directly under the “revolving door” theory, which posits that agency officials often tread lightly in order to preserve opportunities for future employment in the industries they regulate.<sup>73</sup>

Other inefficiencies plague the political process as well. While individuals in the market bear the direct costs of their purchasing decisions, government policy affects all citizens regardless of individual preference, and elections occur less frequently than shopping trips.<sup>74</sup> Additionally, candidates for political office represent “bundles” of positions on different issues. A voter must choose the bundle of positions he or she most approves of, which likely does not correspond perfectly to his or her preference on all issues.<sup>75</sup> Voter indifference takes its toll as well; although the minority gains tremendously from special interest legislation and regulation, the loss to each majority voter is quite small.<sup>76</sup> In light of the fact that one vote has an infinitesimal chance of swaying the outcome of an election, these incentives discourage individuals from expending the sizeable effort necessary to identify candidates’ positions and previous political actions before an election.<sup>77</sup>

Certain policy areas are especially likely to provoke such rational voter ignorance and apathy. Generally, “[t]he more complex the policy under question, the more difficult it is for the average voter to figure out how he or she is affected.”<sup>78</sup> As a result, a regulatory agency largely controls the amount of popular attention a policy issue receives, by selectively using administrative procedure to solicit participation from implicated interests and the White House.<sup>79</sup> Additionally, the media plays an important role in identifying and shaping public sentiment. Psychological studies indicate that individuals respond more strongly to visible, imminent threats, of which there are examples readily available, than to less visible, long-term threats.<sup>80</sup> As for-profit enterprises, media entities understandably respond to these incentives

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72. See generally Gwartney, *supra* note 63, at 8-9 (discussing politician behavior).

73. CROLEY, *supra* note 65, at 49.

74. *Id.* at 20-21.

75. Gwartney, *supra* note 63, at 19.

76. *Id.*

77. *Id.* at 11; see also Stroup, *supra* note 63.

78. Gwartney, *supra* note 63, at 20.

79. CROLEY, *supra* note 65, at 301-302.

80. CASS R. SUNSTEIN, *THE COST-BENEFIT STATE: THE FUTURE OF REGULATORY PROTECTION* 26 (2002).

by devoting little coverage to topics not salient to their audiences, further perpetuating public ignorance.

These political inefficiencies make financial regulation a perfect candidate for special interest regulation. Financial regulation is complex and focused on addressing long-term, diffuse threats.<sup>81</sup> As public choice theory makes clear, most voters are at a severe disadvantage in formulating and expressing political opinions regarding financial regulation. The fact that many Americans do not invest in the stock market<sup>82</sup> and are generally not financially literate or savvy,<sup>83</sup> but are still affected by the market's movement, compounds this problem. Moreover, until the recent financial crisis, in which many Americans began feeling the effects of the market's decline, the media had little incentive to discuss the risk of systemic financial ruin.<sup>84</sup>

### 3. Regulatory Agencies Captured

As public choice theory warned, special interest groups successfully infiltrated the government agencies responsible for managing the nation's financial system. Contrary to public choice theory's assumption that such capture inevitably produces increased regulation,<sup>85</sup> the producer-driven interests here instituted a policy of regulatory minimalism. So while the Depression may have "militated in favor of a bigger and more centralized regulatory apparatus[,]"<sup>86</sup> "[t]he far-reaching effect of this new regulatory regime on the political system precipitated a strong reaction, which led to a contending set of ideas supportive of building—or rebuilding—a market-oriented regulatory policy."<sup>87</sup> The success of this reaction represents a classic case of "regulatory capture, in which an agency that is set up to regulate an

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81. Jacob Weisberg, *The End of Libertarianism*, SLATE, Oct. 18, 2008, <http://www.slate.com/id/2202489/>.

82. See Inv. Co. Inst., *Almost Half of U.S. Households Own Mutual Funds*, Nov. 14, 2007, [http://www.ici.org/shareholders/us/07\\_news\\_hholds.html#TopOfPage](http://www.ici.org/shareholders/us/07_news_hholds.html#TopOfPage).

83. See William R. Emmons, *Consumer-Finance Myths and Other Obstacles to Financial Literacy*, 24 ST. LOUIS U. PUB. L. REV. 335, 336–37 (2005) (discussing America's widespread financial illiteracy).

84. See Anthony Faiola et al., *What Went Wrong*, WASH. POST, Oct. 15, 2008, at A1 (noting the minimal press coverage given financial policy meetings).

85. See *supra* part II.B.2.

86. HARRIS, *supra* note 30, at 29.

87. *Id.* at viii.

industry for social benefits ends up regulating the industry for the benefit of the industry.”<sup>88</sup>

Beginning in the 1960s, advocates of such policies, known as the Law and Economics movement, claimed that special interest groups were using regulation to redistribute wealth to the poor, leading to the development of an inefficient welfare state.<sup>89</sup> Noting regulation’s susceptibility to special interests and political process inefficiencies, these critics touted the market’s superiority in satisfying individuals’ wants. As Milton Friedman wrote in his 1962 book *Capitalism and Freedom*,

The characteristic feature of action through political channels is that it tends to require or enforce substantial conformity. The great advantage of the market, on the other hand, is that it permits wide diversity. It is, in political terms, a system of proportional representation. Each man can vote, as it were, for the color of tie he wants and get it; he does not have to see what color the majority wants, and then, if he is in the minority, submit.<sup>90</sup>

The Law and Economics movement thus argued that the government would best serve citizens’ interests by minimizing its regulatory role. Rather than active oversight, the movement insisted that government should establish an effective legal framework to enforce private contracts, provide collective resources (such as roads and water), and otherwise leave the market alone.<sup>91</sup>

The movement, however, went one step further. Blaming the bleak economic situation in the late 1970s on excessive regulation,<sup>92</sup> the movement urged a policy of government *facilitation*, rather than restriction, of the

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88. JOEL WALDFOGEL, *THE TYRANNY OF THE MARKET: WHY YOU CAN’T ALWAYS GET WHAT YOU WANT* 169 (2007). *See also* Gwartney, *supra* note 63, at 14–15 (noting that federal agencies tend to take on the interests of the industries they are tasked with regulating).

89. SELF, *supra* note 14, at 171. *See also* THOMPSON, *supra* note 4, at 29–30 (discussing policies promoted by Friedrich Hayek); Gwartney, *supra* note 63, at 18 (stating that majoritarianism permits majorities to impose costs on minorities).

90. MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 15 (1962).

91. *See* SELF, *supra* note 14, at 159; Nicholas Mercuro, *Environmental Economic Remedies, in* *ECOLOGY, LAW AND ECONOMICS*, *supra* note 12, at 161, 186 (“Like the market, political institutions are to be structured around the common unifying principle of gains-from-trade with a prescriptive focus on cost-minimizing rights . . . .” (citing DAVID REISMAN, *THE POLITICAL ECONOMY OF JAMES BUCHANAN* 176 (1990))).

92. SUNSTEIN, *supra* note 14, at 30; THOMPSON, *supra* note 4, at 11.

economy, principally through expansive monetary policy. Instead of protecting consumers from the risks posed by an unfettered market, regulatory agencies were to foster a climate in which the market would thrive, drastically altering the mission of the Federal Reserve, Securities and Exchange Commission (SEC), and Treasury Department.<sup>93</sup>

The Law and Economics movement achieved great political success in the United States.<sup>94</sup> Pro-market groups persuaded President Carter to reduce price and entry regulation in the late 1970s,<sup>95</sup> and “[w]hen Reagan assumed office in 1981, ‘regulatory reform’ was one of four pillars of a policy to rescue the U.S. from its economic abyss.”<sup>96</sup> The Federal Reserve’s monetary policy initiatives and the increase of federal deficit spending under Reagan, widely credited with rescuing the economy from late 1970s stagflation, provides a perfect example of policies designed to push the economy along, rather than hold it back. Under the Clinton administration, Reagan’s desire for regulatory reform was realized, when then Federal Reserve Chairman Alan Greenspan and Treasury Secretary Robert Rubin successfully “championed the abolition of the ‘Glass-Steagall’ Banking Act of 1933,<sup>97</sup> which was meant to prevent a recurrence of the rampant speculation that preceded the Depression.”<sup>98</sup> With Glass-Steagall out of the way, banks were free to engage in investment banking activities, increasing their ability to make riskier investments and reap greater profits.

By thus empowering producers of financial services, such government policies tilted the market-government balance in the market’s favor. Market actors obviously preferred cooperating with the government to fighting it.<sup>99</sup>

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93. In 1998, representatives from these agencies successfully threatened and deterred a fourth regulatory agency, the Commodity Futures Trading Commission (CFTC), from regulating financial derivatives, against the wishes of CFTC head Brooksley E. Born. Faiola et al., *supra* note 84.

94. Western nations’ subconscious self-definition in opposition to the central planning of their Cold War enemy, the USSR, likely contributed to this success. *See* SUNSTEIN, *supra* note 14, at 11 (“A general attack on collectivism promises to be a central distinguishing feature of the last quarter of the twentieth century.”).

95. Rabin, *supra* note 34, at 49–50.

96. Robert W. Crandall, *Foreword to REGULATION AND THE REAGAN ERA*, *supra* note 63, at ix, x. *See also* John Cassidy, *The Minsky Moment*, NEW YORKER, Feb. 4, 2008, available at [http://www.newyorker.com/talk/comment/2008/02/04/080204taco\\_talk\\_cassidy](http://www.newyorker.com/talk/comment/2008/02/04/080204taco_talk_cassidy) (“Since the nineteen-eighties, Congress and the executive branch have been conspiring to weaken federal supervision of Wall Street.”).

97. Banking Act of 1933, Pub. L. No. 73-66, ch. 89, 48 Stat. 162 (codified at 12 U.S.C. § 377), *repealed by* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999).

98. Cassidy, *supra* note 96.

99. THOMPSON, *supra* note 4, at 3.

Moreover, Supreme Court decisions that gave greater deference to regulatory agencies left market actors little choice but to cooperate.<sup>100</sup> The market's desire to control the government tasked with regulating it should have come as no surprise. As subsequent events demonstrated, "unrestricted power, the absence of accountability, whether in the hands of public or private actors, carries an equal threat to any meaningful construct of democracy."<sup>101</sup>

#### 4. *The Efficient Capital Markets Hypothesis*

Law and Economics' embrace of the efficient capital markets hypothesis ("ECMH") explains both the goal of pro-market regulatory policies and the government's responses to instances of market failure. Support for regulatory minimalism is premised on the theory that the free market allocates resources more efficiently than does central planning by the government.<sup>102</sup> The ECMH posits that when all actors have access to public information, the market accounts for changes in a financial instrument's worth through changes in the price individuals will pay for it.<sup>103</sup> A corollary of this theory is the assumption that an instrument's price will also reflect its volatility and risk, since investors have access to companies' financial information and bear the costs of failed investments.<sup>104</sup>

The ECMH thus mandates limited government intervention in the market. Following Adam Smith's suggestion that individual self-interest operates in the public interest,<sup>105</sup> assuming the existence of efficient prepolitical markets leads to the conclusion that market regulation can only be

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100. *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978), and *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), established a deferential standard of judicial review for agency decisions: whether the agency interpretation of the statute is rational, regardless of whether it is right.

101. FEINTUCK, *supra* note 12, at 19.

102. *Hearing*, *supra* note 26, at 147 (statement of Alan Greenspan, former Chairman, Bd. of Governors of the Fed. Reserve Sys.) ("[F]ree markets grow far faster, create greater wealth, than, say, centrally planned economies."); *see also* THOMPSON, *supra* note 4, at 16.

103. The ECMH comes in three forms. "The so-called strong form posits that all information, both public and private, is incorporated into security prices. The semistrong form theorizes that only all public information is incorporated into security prices. The weak form posits that only one type of public information—historical security prices—is incorporated into current prices." Bradford Cornell & James C. Rutten, *Market Efficiency, Crashes, and Securities Litigation*, 81 TUL. L. REV. 443, 444 n.3 (2006). Policymakers most often consider the semistrong form, *id.*; this Note follows suit.

104. *See generally* JONATHAN BERK & PETER DEMARZO, CORPORATE FINANCE 266-271, 694-712 (2007) (discussing stock and stock option valuation).

105. *See* GWARTNEY, *supra* note 63, at 8 (discussing Smith's philosophy).

explained by the influence of inefficient special interest rent-seeking.<sup>106</sup> Rather than relying on government regulation, ECMH adherents trust in the price mechanism to convey information regarding risk.<sup>107</sup> Indeed, some argue that Madison himself so trusted the market, advocating bank deregulation on the ground that holding shareholders liable for bank failures would encourage responsible decision-making by bank directors.<sup>108</sup> Under these assumptions, the government should not seek to constrain the market's operation, but rather to further its unfettered operation with accommodating monetary policy and deregulation.

Faith in the ECMH is also visible in its believers' reactions to instances in which reality fails to conform to the hypothesis. Assuming that markets are "failure free,"<sup>109</sup> ECMH adherents attribute any crisis either to imperfect information available to investors or to inappropriate government interloping.<sup>110</sup> Blaming the Depression on improper government policy restricting the money supply after the stock market crash of 1929, monetarists such as Milton Friedman argue that the federal government should steadily increase the supply of money by adjusting Federal Reserve interest rates to the market's needs.<sup>111</sup> Under this model, acceptable responses to economic problems take the form of reducing government regulation of financial markets or increasing transparency, rather than restricting traders' activities.

##### 5. True Believers at the Economy's Helm

The officials tasked with regulating the nation's financial system adhere to an economic philosophy overly reliant on the market's presumed efficiency.<sup>112</sup>

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106. See CROLEY, *supra* note 65, at 22; CHRISTOS PITELIS, MARKET AND NON-MARKET HIERARCHIES: THEORY OF INSTITUTIONAL FAILURE 150 (1991); SELF, *supra* note 14, at 100–101; THOMPSON, *supra* note 4, at 3.

107. FEINTUCK, *supra* note 12, at 8; PITELIS, *supra* note 106, at 97 ("Coase . . . suggests that [externalities] will tend to be internalized by individuals concerned. All the state needs to do, therefore, is to establish clear property rights.").

108. Dorn, *supra* note 1, at 91. Madison also supported the founding of the Second Bank of the United States to stabilize the dollar after the war of 1812. Independence Hall Ass'n, Second Bank of the United States/Portrait Gallery, [http://www.ushistory.org/tour/tour\\_2bank.htm](http://www.ushistory.org/tour/tour_2bank.htm) (last visited Mar. 29, 2009).

109. PITELIS, *supra* note 106, at 149.

110. See KINDLEBERGER, *supra* note 49, at 16 ("[I]here can be no bubbles because market prices reflect fundamentals, and that sharp falls in prices frequently reflect 'policy switching' by government or central banks.")

111. PITELIS, *supra* note 106, at 150.

112. See WALDFOGEL, *supra* note 88, at 169 ("These views are held by those at the highest levels of the U.S. government."). Indeed, even President George W. Bush has stated,

When called before Congress to justify their failure to prevent the current financial crisis, former Federal Reserve Chairman Alan Greenspan, SEC Chairman Christopher Cox, and Treasury Secretary John Snow made statements demonstrating their common belief that market failure is caused by imperfect information rather than inherently unstable markets.<sup>113</sup>

Alan Greenspan has repeatedly touted his view that the government should help the market and otherwise stay out of the way. Greenspan testified at a congressional hearing in 1994 on regulation of financial derivatives. He stated that “[t]here’s nothing involved in Federal regulation which makes it superior to market [self-]regulation.”<sup>114</sup> Greenspan in 1997 said, “There appears to be no need for government regulation of off-exchange derivative transactions.”<sup>115</sup> As recently as April 2008, Greenspan wrote in the *Financial Times* that “[b]ank loan officers . . . know far more about the risks and workings of their counterparties than do bank regulators.”<sup>116</sup> And before Congress in October 2008, Greenspan argued that the financial crisis would correct the market’s underestimation of the risk complex financial instruments pose, thereby rendering any additional regulation superfluous and unjustifiably harmful to the economy.<sup>117</sup>

SEC Chairman Cox made comparable statements. Cox argued in his testimony that government regulation should encourage individuals to invest in the market, stating that “[i]t would be very, very difficult to get people in America to part with their money, to have investors be confident that they could put money into the system with[out] rules.”<sup>118</sup> This reflects the common misconception that the only legitimate purpose legal rules serve is permitting market actors’ to economize on contracting costs.<sup>119</sup> Cox went on to say,

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“Milton Friedman has shown us that when government attempts to substitute its own judgments for the judgments of free people, the results are usually disastrous.” *Id.* at 170.

113. See *Hearing*, *supra* note 26.

114. *Hearing*, *supra* note 26, at 32 (statement of Alan Greenspan, former Chairman, Bd. of Governors of the Fed. Reserve Sys.).

115. *Id.*

116. Alan Greenspan, Commentary, *The Fed is Blameless on the Property Bubble*, FIN. TIMES, Apr. 6, 2008, available at [http://us.ft.com/ftgateway/superpage.ft?news\\_id=fto040620081712547444&page=1](http://us.ft.com/ftgateway/superpage.ft?news_id=fto040620081712547444&page=1).

117. *Hearing*, *supra* note 26, at 147 (statement of Alan Greenspan, former Chairman, Bd. of Governors of the Fed. Reserve Sys.).

118. *Id.* at 144–45 (statement of Christopher Cox, Chairman, Sec. & Exch. Comm’n).

119. See John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 3 (1999) (“Much of the modern ‘law and economics’ literature on corporate governance has assumed that financial market regulation was

I think it's vitally important that we never fail to appreciate how powerful a means of wisdom markets can be in allocating scarce resources in a nation of 300 million people and a world of 6 billion people. Markets are going to give us the wisdom of crowds . . . .<sup>120</sup>

Treasury Secretary Snow demonstrated a similar worldview in his testimony. He noted the importance of finding the right balance between government and market forces, but stated that whenever market regulation was proposed, he decided whether to support that regulation by asking himself, “[W]ill this make the market work better or will it get in the way of the way markets work?”<sup>121</sup> Snow went on to suggest that regulation often does more harm than good, by reducing market actors’ incentives to conduct due diligence and independently evaluate risk.<sup>122</sup>

### III. INEFFICIENT CAPITAL MARKETS AT WORK

While the ECMH makes sense in theory, government economic policies based off the model have repeatedly failed to prevent financial crises. These failures are due to the fact that like the political process, the market also suffers from inefficiencies, for which the ECMH makes no allowance.<sup>123</sup> Far from remedying political process inefficiencies, pro-market policies actually increase the frequency and severity of market failure.<sup>124</sup> Moreover, not only do these policies fail to stabilize the economy and maximize wealth, but they enable producers to take consumers’ property—the very opposite of

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unnecessary and that the role of corporate law was simply to offer a model form contract to investors to enable them to economize on contracting costs.”)

120. *Hearing, supra* note 26, at 145 (statement of Christopher Cox, Chairman, Sec. & Exch. Comm’n). *See also* Kara Scannell & Sudeep Reddy, *Greenspan Admits Errors to Hostile House Panel*, WALL ST. J., Oct. 24, 2008, available at <http://online.wsj.com/article/SB122476545437862295.html> (calling Cox a “longtime free-market Republican”).

121. *Hearing, supra* note 26, at 50 (statement of John Snow, Sec’y of Treas.).

122. *Id.*

123. Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961), in FOUNDATIONS OF THE ECONOMIC APPROACH TO LAW 44, 53 (Avery Weiner Katz ed., 1998) (“[E]ntrepreneurs in [more volatile] industries make greater profits, subject to the danger that, when risk strikes, one of them may be so severely damaged that he will never recover his losses, or that he may be wiped out altogether. In such cases undesirable secondary social and economic losses would, of course, follow.”).

124. *See SELF, supra* note 14, at 160–61 (noting that applying more market principles will only exacerbate instances of market failure).

regulation's purported objective. Indeed, history disproves the ECMH and demonstrates how policies based on this flawed theory have caused the financial crisis now crippling the nation.

## A. Previous Policies

### 1. OTC Derivative Deregulation

The deregulation of the over-the-counter (“OTC”) derivatives market provides an example of disastrous government policy based on the ECMH assumption that the market adequately prices risk into the price of financial instruments.

Trading financial derivatives over the counter allows investors to circumvent margin requirements on stock purchases. Although the Federal Reserve imposed a margin requirement of fifty percent on stock purchases (requiring investors to have \$50 on account in order to buy \$100 of stock) in an effort to limit leveraged speculation,<sup>125</sup> derivatives were subject only to a fifteen percent requirement (requiring investors to have only \$15 in an account in order to buy \$100 of stock futures).<sup>126</sup> Arbitrage between the New York Stock Exchange and the Chicago Mercantile Exchange thus permitted high-risk, high-reward stock speculation.<sup>127</sup>

The systemic danger this loophole posed to economic stability was noted early on by officials. The Government Accountability Office (GAO) in 1994 published an exhaustive study entitled “Financial Derivatives: Actions Needed to Protect the Financial System,” which warned that

[d]erivatives activities are rapidly expanding and increasingly affected by the globalization of commerce and financial markets . . . . [T]he sudden failure or abrupt withdrawal from trading of any of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole . . . .

125. 12 C.F.R. §§ 220.12(a), 221.7(a) (2008). The Federal Reserve promulgated these restrictions pursuant to the 1934 Securities Exchange Act, which states that a purpose of margin requirements is “to prevent systemic risk . . . .” 15 U.S.C. § 78g(c)(2)(B)(ii) (2006).

126. See 17 CFR 41.45(b)(1) & 17 CFR 242.403(b)(1) (setting margin requirements for security futures at 20 percent) *but see* Securities Exchange Act of 1934 Release No. 54919 (December 12, 2006) (SR-CBOE-2006-14), 71 FR 75781, 75782 (December 18, 2006) (reducing this requirement to 15% if options are held in a securities account, and even lower for certain traders).

127. KINDLEBERGER, *supra* note 49, at 57.

[T]he federal government would be likely to intervene to keep the financial system functioning in cases of severe financial stress . . . . [I]n some cases intervention has and could result in industry loans or a financial bailout paid for by taxpayers.<sup>128</sup>

The report next stated that the “GAO found that no comprehensive industry or federal regulatory requirements existed to ensure that U.S. OTC derivatives dealers followed good risk-management practices.”<sup>129</sup>

Financial regulators, trusting the ECMH and not believing destabilizing speculation to be possible in an efficient market,<sup>130</sup> saw no need to restrict trading. At a meeting of the President’s Working Group on Financial Markets in April of 1998, a proposal to increase financial derivatives regulation was defeated by then-Federal Reserve Chairman Alan Greenspan, then Treasury Secretary Robert E. Rubin, and then-Securities and Exchange Commission Chairman Arthur Levitt Jr., “all Wall Street legends, [and] all opponents to varying degrees of tighter regulation of the financial system that had earned them wealth and power.”<sup>131</sup>

In fact, Greenspan supported further deregulating OTC derivative trading. During the summer of 1998, Congress heard testimony on the Financial Derivatives Supervisory Improvement Act.<sup>132</sup> CFTC Chairperson Brooksley Born testified against the bill on the grounds that it would limit CFTC authority to regulate existing and future OTC derivatives, and “legalize certain OTC futures contracts that have been forbidden by law since 1982.”<sup>133</sup> Then-Federal Reserve Chairman Alan Greenspan also testified before Congress in favor of deregulation.<sup>134</sup> Greenspan saw “no reason to question the underlying stability of the OTC markets, or the overall effectiveness of private market discipline, or the prudential supervision of the derivatives

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128. U.S. GEN. ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 7 (1994). See also *Hearing, supra* note 26, at 109–110 (statement of Rep. Eleanor Norton, Member, H. Comm. on Oversight and Gov’t Reform) (quoting from this report).

129. U.S. GEN. ACCOUNTING OFFICE, *supra* note 128.

130. See KINDLEBERGER, *supra* note 49, at 21 (“[Milton Friedman] has claimed that there can be no destabilizing speculation.”).

131. Faiola et al., *supra* note 84.

132. H.R. 4062, 105th Cong. (1998).

133. *Financial Derivatives Supervisory Improvement Act and Financial Contract Netting Improvement Act: Hearing on H.R. 4062 and H.R. 4239 Before the H. Comm. on Banking & Fin. Services*, 105th Cong. 156, 159 (1998) (statement of Brooksley Born, Chairperson, Commodities Futures Trading Comm’n) (referencing the Shad-Johnson accord banning single-stock futures).

134. *Id.* at 150 (statement of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.).

activities of banks and other regulated participants.”<sup>135</sup> Instead he advocated the “development of a less burdensome regulatory regime for financial derivatives traded on futures exchanges.”<sup>136</sup> Although this bill never reached a vote, Greenspan’s arguments found a receptive audience two years later. Both houses of Congress passed (without debate or hearing) the Commodities Futures Modernization Act of 2000 (CFMA)<sup>137</sup> as part of an omnibus spending bill in 2000. The CFMA not only permitted the trading of instruments previously banned by the CFTC and SEC, but also removed the CFTC’s authority to regulate OTC derivatives issued by financial institutions by requiring Treasury Department approval for any such regulation.<sup>138</sup> The CFMA’s opponents feared that limiting government oversight of instruments with such widespread effects would permit worldwide economic instability.<sup>139</sup> Attempts to restore regulatory authority, however, were defeated in subsequent years.<sup>140</sup>

## 2. Signs of Trouble: Enron

While the cataclysm suggested by the GOA did not fully materialize until 2008, Enron’s bankruptcy in 2001 demonstrated the shortcomings of OTC derivative deregulation. Enron’s collapse was precipitated by accounting fraud involving OTC energy futures, the deregulation of which formed a central part of Enron’s corporate philosophy.<sup>141</sup> Off-balance sheet

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135. *Id.* at 153.

136. *Id.* at 154.

137. Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763 (2000).

138. See 7 U.S.C. §§ 2(h)(3), 2(g) (2006).

139. See, e.g., Thomas J. Erickson, Comm’r, Commodity Futures Trading Comm’n, Derivatives Deregulation and Financial Markets: Right Medicine at the Right Time?, Remarks to Econ. Strategy Inst. (July 27, 2000) (“Functional regulation is *over* in the area of derivatives should [the CFMA] pass. And this is despite the fact that U.S. equity and derivative markets have thrived over the years, at least in part because of the combination of institutional supervision—which has been successful in ensuring the safety and soundness of financial institutions—on the one hand, and functional, or market, regulation on the other.”) (emphasis in original). These instruments affect the global economy powerfully. See Commodity Exchange Act of 1936 § 3, 7 U.S.C. § 5 (2008) (discussing the global dissemination of futures prices).

140. Peter Behr, *Senate Democrats Attempting to Close ‘Enron Loophole’*, WASH. POST, Oct. 30, 2003, at E7.

141. Jeff Gerth & Richard A. Oppel Jr., *Regulators Struggle With a Marketplace Created by Enron*, N.Y. TIMES, Nov. 10, 2001, at C1 (“For years, the Enron Corporation used its political muscle to build the markets in which it thrived, pushing relentlessly on Capitol Hill and in bureaucratic backwaters to deregulate the nation’s natural gas and electricity businesses[.] . . . creating a ‘regulatory black hole’ [that] fit nicely with . . . the company’s core

transactions involving these derivatives permitted company insiders to perpetrate fraud on stockholders. The revelation of this fraud caused Enron's bankruptcy, the loss of thousands of employees' pensions, and the destruction of "more than \$60 billion in shareholder value—even as [longtime CEO Kenneth] Lay and other top officers sold their own stock for millions of dollars."<sup>142</sup>

This spectacular collapse demonstrated market actors' unwillingness to police themselves,<sup>143</sup> as well as the disastrous consequences such failure of restraint imposes on consumers. While the Enron insiders who produced the flawed derivatives were able to sell out at the top, holders of Enron common stock and energy futures lost an enormous amount of money (much more than company insiders gained), prompting a cacophonous public outcry for a government response.

### 3. Mark-to-Market Accounting

The regulatory response to Enron's collapse, coming in the form of stricter mark-to-market accounting standards,<sup>144</sup> reflects regulators' continuing faith in the efficiency of capital markets. Legislators in 2002 enacted the Sarbanes-Oxley Act,<sup>145</sup> which was intended to restore public confidence in the stock market by mandating mark-to-market corporate accounting and increasing corporate disclosure. The imposition of accounting standards in response to Enron's bankruptcy assumes that the collapse would have been avoided if shareholders had access to accurate information regarding the value of the company's energy futures, per the ECMH. Moreover, this response fit in perfectly with regulators' desire to avoid imposing substantive restrictions on the market.<sup>146</sup>

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management philosophy, which was to be the first mover into a market and to make money in the initial chaos and lack of transparency." See also Alex Berenson & Richard A. Oppel Jr., *Once-Mighty Enron Strains Under Scrutiny*, N.Y. TIMES, Oct. 28, 2001, at 3-1 ("[Enron]'s ties to the Bush administration assured that its views would be heard in Washington.").

142. LOREN FOX, ENRON: THE RISE AND FALL 2 (2003).

143. *Hearing*, *supra* note 26, at 23 (statement of Christopher Cox, Chairman, Sec. & Exch. Comm'n) ("[W]e have learned that voluntary regulation of financial conglomerates does not work.").

144. Mark-to-market accounting standards mandate that every publicly-traded company state the market (not the expected) value of the securities it holds in disclosures required by law.

145. Pub. L. No. 107-204, 116 Stat. 745 (2002).

146. Indeed, a tepid government response such as increasing disclosure requirements often results when legislators oppose industry regulation but the public demands they take

Despite the weakness of the legislative response to Enron, financial market regulators opposed the measure. In a September 18, 2002 letter, Greenspan argued that “public disclosure of pricing data would not improve the overall price discovery process[.]” stating, “I do not believe a public policy case exists to justify this government intervention.”<sup>147</sup> The next year, Snow joined in Greenspan’s opposition, writing that “the ability of private counterparty surveillance to effectively regulate these markets can be undermined by inappropriate extensions of government regulation.”<sup>148</sup> Even after unregulated financial instruments permitted the then largest (WorldCom) and second-largest (Enron) bankruptcies in United States history,<sup>149</sup> regulators remained committed to their view that markets efficiently account for risk, and that governmental regulation of financial markets is therefore unnecessary and inefficient.

## B. The 2008 Financial Crisis

This regulatory history laid the groundwork for the current financial crisis. Government policy initiatives premised on the ECMH—loose monetary policy, the deregulation of OTC derivatives, and the imposition of overly strict mark-to-market accounting standards—are to blame for the current economic crisis. As these policy decisions and the government’s planned bailout demonstrate, regulators continue to rely on an economic model that history reveals to be both empirically inaccurate and normatively unjust.

### 1. Loose Monetary Policy

Monetary policy premised upon incorrect ECMH assumptions played a vital role in precipitating the housing bubble. According to economist Hyman Minsky, events leading up to an economic crisis start with a

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action. See CASS R. SUNSTEIN, WORST-CASE SCENARIOS 39 (2007) (“When the public became concerned about toxic releases from chemical plants . . . the legislative response involved disclosure requirements rather than regulatory controls.”).

147. *Hearing, supra* note 26, at 47 (statement of Rep. Carolyn Maloney, Member, H. Comm. on Oversight and Gov’t Reform).

148. *Id.* at 49 (statement of John Snow, Sec’y of Treas.).

149. Luisa Beltran, *WorldCom files largest bankruptcy ever*, CNN MONEY, July 22, 2002, [http://money.cnn.com/2002/07/19/news/worldcom\\_bankruptcy](http://money.cnn.com/2002/07/19/news/worldcom_bankruptcy); Sam Mamudi, *Lehman folds with record \$613 billion debt*, MARKETWATCH, Sept. 15, 2008, <http://www.marketwatch.com/news/story/story.aspx?guid={2FE5AC05-597A-4E71-A2D5-9B9FCC290520}&siteid=rss>.

“displacement”—some exogenous, outside shock to the macroeconomic system.<sup>150</sup> Perhaps in an effort to halt the stock market decline precipitated by the bursting of the previous bubble in technology stocks,<sup>151</sup> Greenspan cut the overnight interest rate on June 25, 2003 to one percent: the lowest level since 1958.<sup>152</sup> The result was “an unexpected influx of foreign money, particularly Chinese money, into U.S. Treasury bonds. With the cost of borrowing—mortgage rates, in particular—at historic lows, a speculative real-estate boom quickly developed that was much bigger, in terms of over-all valuation, than the previous bubble in technology stocks.”<sup>153</sup> By 2007, “some \$45 trillion of [options and futures] contracts traded on the S&P 500 index alone . . . compared with the total American stockmarket value of just \$10 trillion.”<sup>154</sup>

This phenomenon repudiates the monetarist assumption that government can control the supply of money through changes in interest rates alone. On the contrary, empirical evidence demonstrates that banks also exercise sizeable control over the money supply.<sup>155</sup> The private sector expands the money supply in boom times by issuing new debt, developing new credit instruments, and expanding personal credit.<sup>156</sup> During the housing bubble, the private sector expanded the supply of money in each of these three ways; corporate debt and leverage increased dramatically, mortgage-backed securities and OTC derivatives flourished, and lending standards declined under congressional pressure.<sup>157</sup> As demonstrated in the summer of 2003, federal interest rate adjustments are thus amplified through the financial system, limiting the government’s ability to control the money supply with any precision.

Regulators’ trust in monetary policy permitted risk to be amplified in another way as well; it discouraged restrictions on the OTC derivatives

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150. KINDLEBERGER, *supra* note 49, at 12.

151. See Janelia Tse, *Minsky’s Financial Instability Hypothesis*, *OECOMICUS*, Winter 2001, at 77, 80 (“Each success in prevention of a financial crisis leads to further risk taking and hence a more fragile economy.”).

152. Chris Isidore, *Greenspan: More Cuts Possible*, *CNN MONEY*, July 15, 2003, <http://money.cnn.com/2003/07/15/news/economy/greenspan/index.htm>.

153. Cassidy, *supra* note 96.

154. *Giving Credit Where It is Due*, *ECONOMIST*, Nov. 8, 2008, at 14.

155. KINDLEBERGER, *supra* note 49, at 48 (“As a historical generalization, it can be said that every time the authorities stabilize or control some quantity of money either in absolute volume or growing along a predetermined trend line, in moments of euphoria more will be produced.”).

156. *Id.* at 12.

157. Scannell, *supra* note 120 (noting that former Federal Reserve Governor Edward Gramlich warned Greenspan about potential problems in lending practices in 2000).

officials now blame for the financial crisis' severity. SEC Chairman Cox recognized this failure in his Congressional testimony, stating,

The packaging of risky mortgages into complex structured securities with AAA ratings spread the risks into the securities markets, and what significantly amplified this crisis around the globe was the parallel market in credit default swaps, which is completely unregulated. Credit default swaps multiplied the risk of the failure of bad mortgages by orders of magnitude. And they ensured that when housing prices collapsed, the effects cascaded throughout the financial system.<sup>158</sup>

## 2. Credit Devaluation

The danger appears when the private sector expands the money supply by increasing debt in order to engage in speculation.<sup>159</sup> This speculation may take many forms, including purchases in anticipation of a rise in price, the overestimation of likely returns, or excessive leverage.<sup>160</sup> This sort of speculation ran rampant during the housing bubble. Many individuals took out large mortgages with little or no down payment, expecting to make money reselling properties as they appreciated, while investment companies purchased mortgage-backed securities on margin, overestimating those instruments' likely returns.<sup>161</sup>

The value of debt declines as this new money seeks high-yield investments, such as mortgage-backed securities.<sup>162</sup> Unregulated credit rating agencies made this devaluation possible. Unsurprisingly, competition for banks' business created a race-to-the bottom among these agencies, resulting in risky mortgage-backed securities receiving risk-free ratings.<sup>163</sup> This danger

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158. *Hearing, supra* note 26, at 22 (statement of Christopher Cox, Chairman, Sec. & Exch. Comm'n).

159. See KINDLEBERGER, *supra* note 49, at 12 ("Like Fisher, Minsky attaches great importance to the role of debt structures in causing financial difficulties, and especially debt contracted to leverage the acquisition of speculative assets for subsequent resale.").

160. *Id.* at 13.

161. See *Credit Crisis—The Essentials*, N.Y. TIMES, [http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit\\_crisis/](http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit_crisis/) (last visited Mar. 29, 2009).

162. KINDLEBERGER, *supra* note 49, at 50 ("[I]n periods of euphoria, the quality of debt deteriorates, even though the quantity of money may be growing at some appropriate, limited rate.").

163. See *Mortgage-Backed Securities*, N.Y. TIMES, <http://topics.nytimes.com/topics/>

long had been evident. Under pressure from Citigroup board member and former Treasury Secretary Robert Rubin, Enron debt in 2001 was given a superior rating four days before the company collapsed.<sup>164</sup> On October 8, 2002 a Senate Committee on Government Affairs report urged the SEC to implement rules to regulate credit rating agencies,<sup>165</sup> and in 2005, the SEC issued a proposed rule to do so.<sup>166</sup> The SEC, however, never implemented this rule.

### 3. The Risk/Reward Disparity

The recent financial crisis demonstrates clearly that instruments' market prices do not accurately reflect their risk, contrary to the ECMH's assumption. Across all industries, producers not forced to realize production costs will fail to price those costs into their products. The motivation for this is obvious: Externalizing such costs allows producers to realize greater profits than they otherwise would. Indeed, "[a]n economic externality may be viewed as an economic gain or loss accruing to one or more recipient agents as a result of an economic action initiated by another agent—with the gain or loss not being reflected in market price."<sup>167</sup> Risk is an unavoidable cost inherent in virtually all financial instruments. As public choice theory warned, government policy provided a convenient mechanism for externalizing risk during the housing bubble.

The wholesale purchase of mortgage-backed securities by government sponsored enterprises ("GSE's") Fannie Mae and Freddie Mac provides one

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reference/timestopics/subjects/m/mortgage-backed-securities/index.html (last visited Mar. 29, 2009) ("[T]he ratings agencies that analyze securities ... turned a blind eye to warning signs, like an increase in foreclosures.").

164. *Hearing, supra* note 26, at 96 (statement of Rep. John Yarmuth, Member, H. Comm. on Oversight and Gov't Reform). *See also Citi's Taxpayer Parachute*, WALL ST. J., Nov. 25, 2008, at A14 ("Mr. Rubin asked a Treasury official to lean on credit-rating agencies to maintain a more positive rating than Enron deserved.").

165. STAFF OF S. COMM. ON GOV'T AFFAIRS, 102ND CONG., THE FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 125 (Comm. Print 2002) ("The problem is that the credit rating agencies have no incentive to catch the few wrongdoers, no matter how huge the consequences to the market.").

166. Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. 21306-01 (proposed Apr. 25, 2005) (to be codified at 17 C.F.R. pt. 240). *See also Hearing, supra* note 26, at 96 (statement of Rep. John Yarmuth, Member, H. Comm. on Oversight and Gov't Reform) (referencing the proposed rule).

167. Nicholas Mercurio, *Introduction to Ecology, Law and Economics & the Economy*, in *ECOLOGY, LAW AND ECONOMICS, supra* note 12, at 1, 7 [hereinafter Mercurio, *Introduction*] (citing BERNARD P. HERBER, *MODERN PUBLIC FINANCE* 30 (4th ed. 1979)).

example of producers' tendency to externalize risk. While the private sector reaps a GSE's profits, the public sector bears the risk of default. By selling mortgage-backed bonds to these government agencies, banks and lenders externalized the risk of default, artificially lowering banks' cost of bonds.<sup>168</sup> Simultaneously, the government's insatiable appetite for commercial paper created an artificial demand for these securities, thus raising the price at which banks could sell them.<sup>169</sup> Both factors encouraged the market to provide as much paper as possible at the best ratings possible in order to maximize profits.<sup>170</sup> Additionally, the enormous amount of debt held by Fannie Mae and Freddie Mac gave rise to the perception that these institutions were "too big to fail," which further reduced the perceived risk of default, thus permitting bonds to be overpriced.

The resulting financial crisis not only demonstrated the impropriety of allowing GSE's to purchase mortgages, but also revealed that financial instrument producers fail to account properly for risk. Producers' and consumers' different timelines provides one explanation for market actors' propensity for risk. While financial company employees operate on a short timeline, often looking to demonstrate profit by the end of the quarter or year, investors' timelines are not so delineated and are often long-term. Moreover, investment companies trade heavily using customers' money, taking a percentage of the profits they obtain trading.<sup>171</sup> Failure to turn a significant profit may lose the company a customer and a trader his or her job. Financial firms thus face limited losses and unlimited gains—a powerful incentive to engage in risky transactions.<sup>172</sup>

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168. Calabresi, *supra* note 123, at 51 ("Not charging an enterprise with a cost which arises from it leads to an understatement of the true cost of producing its goods . . ."); Mercurio, *Introduction, supra* note 12, at 16 (pointing out that Pareto efficiency requires the marginal cost of producing a good to equal the marginal benefit of producing the good, and that imperfections in markets permit the inefficient overproduction of goods).

169. See Gretchen Morgenson, *What Will Mac 'n' Mae Cost You and Me?*, N.Y. TIMES, Aug. 23, 2008, at BU1 ("[Fannie Mae and Freddie Mac] guarantee or hold \$5.2 trillion in mortgages. . .").

170. *Hearing, supra* note 26, at 43 (statement of John Snow, Sec'y of Treas.); Calabresi, *supra* note 123, at 51 ("[T]he result is that people purchase more of those goods than they would want if their true cost were reflected in price.").

171. Many investment houses also engage in off-balance sheet trading of company money. See, e.g., Eric Dash, *Citigroup Acknowledges Poor Risk Management*, N.Y. TIMES, Oct. 16, 2007, at C9. Pressure on traders to turn a significant profit may be even stronger in such cases, considering the company's presumed higher tolerance for risk as compared to individual investors.

172. Empirical evidence thus contradicts the conclusion reached by earlier advocates of financial deregulation, who assumed that "entrepreneurs had adequate incentives to minimize agency costs (in part by bonding themselves and otherwise limiting their

#### 4. Accounting for Liquidity

Government reforms that increase transparency fail to prevent financial crises because they fail to address the real problem: inadequate incentives to internalize risk. In fact, such measures actually tend to exacerbate future financial crises. Mark-to-market accounting standards impose simultaneously too much and too little regulation; these disclosure requirements are too weak to prevent the trading activities that cause market downturns, but too rigid to allow companies to survive those downturns.

The accounting standards enacted post-Enron provide a perfect example. In response to Enron's mark-to-model (or "mark-to-make believe") accounting fraud, regulators mandated a strict system of mark-to-market accounting, even for inactively traded financial instruments. This effort aimed to restore public faith in the market by reassuring investors that they were receiving an accurate picture of a company's financial situation.<sup>173</sup> While such a reform is politically attractive and inexpensive to implement, inconveniencing legitimate enterprises minimally, increased disclosure failed to address the systemic issues of risky OTC derivatives, loose monetary policy, unregulated credit rating agencies, and precariously leveraged investment firms.<sup>174</sup>

On the contrary, regulators' reliance on disclosure worsened these problems. Certainly, the investors' need for accurate financial information makes mark-to-market accounting preferable to Enron-style "mark-to-make believe" accounting.<sup>175</sup> Arguably, the combination of regulators' aversion to substantive market regulation and the public outcry for something to be done, however, led regulators to impose unduly rigid disclosure requirements on market actors. Specifically, mark-to-market standards omitted any exception in the event of a credit crisis. The rules specify that when trading in a given

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discretion) in order to maximize [investor value]." Coffee, *supra* note 119, at 3 (critiquing Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)).

173. FAIR VALUE MEASUREMENTS, Statement of Fin. Accounting Standards No. 157 (Fin. Accounting Standards Bd. 2006).

174. See *Hearing*, *supra* note 26, at 78–79 (statement of Christopher Cox, Chairman, Sec. & Exch. Comm'n) (noting that credit default swaps, investment bank holding companies, mortgage brokerages, and municipal securities remain unregulated).

175. Press Release, CFA Inst., Joint Statement of the Center for Audit Quality, the Council of Institutional Investors, and CFA Institute Opposing Suspension of Mark-to-Market Accounting (Oct. 1, 2008), available at [http://www.cfainstitute.org/aboutus/press/release/08releases/20081001\\_01.html](http://www.cfainstitute.org/aboutus/press/release/08releases/20081001_01.html).

security drops below a given level, even if trading decreases as a result of low market liquidity, a firm must nevertheless disclose the “exit price” for that security on its balance sheet and earnings report.<sup>176</sup> When a security’s market is distressed and inactive, its exit price declines to zero, regardless of the anticipated value of the security’s future cash flows.

Such inaccurate accounting has obvious secondary consequences. In this case, write-offs from mortgage-backed securities triggered many lenders’ margin calls, forcing them needlessly to liquidate other securities below their actual market value.<sup>177</sup> This created a rush for liquidity, with investors clamoring to get out of financial instruments and into money. Widespread liquidation flooded the market with securities, decreasing their value and leading to massive write-offs, financial firm bankruptcies, and a rush to sell throughout financial markets.<sup>178</sup> Indeed, “[i]f one house fails, the chain collapses and may bring down good names, those with a reasonable ration of debt to capital, as well as bad.”<sup>179</sup> So although disclosure requirements do play a necessary role in a properly-functioning market, relying on disclosure alone is not only insufficient to adequately address problems caused by a dearth of substantive regulations on financial instruments and leverage,<sup>180</sup> but such reliance also can produce excessively rigid accounting standards that further destabilize markets.<sup>181</sup>

### 5. Market Irrationality

Such panics demonstrate another flaw in the economic philosophy underlying recent government policy. The ECMH assumes that since individuals act rationally to maximize their utility, the market as a whole is

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176. FAIR VALUE MEASUREMENTS, *supra* note 173, at § 7.

177. KINDLEBERGER, *supra* note 49, at 92 (“To the extent that speculators are leveraged with borrowed money, the decline in prices leads to further calls on them for margin or cash and to further liquidation.”).

178. See FRIEDMAN, *supra* note 47, at 419 (“[E]conomic collapse often has the character of a cumulative process. Let it go beyond a certain point, and it will tend for a time to gain strength from its own development as its effects spread and return to intensify the process of collapse.”).

179. KINDLEBERGER, *supra* note 49, at 53.

180. Coffee, *supra* note 119, at 4 (“By themselves, private contracting and the voluntary incentives for disclosure seem incapable of producing the level of continuing disclosure necessary to sustain active securities markets.”).

181. Recent revisions to accounting regulations permit banks more leeway in how assets are valued. See Floyd Norris, *Banks Get New Leeway in Valuing Their Assets*, N.Y. Times, Apr. 2, 2009, at B1. However, increasing banks’ discretion on reporting resurrects the accountability dilemma mark-to-market accounting regulations were intended to remedy.

rational. History indicates otherwise. Booms are precipitated by individuals acting rationally to take advantage of favorable economic conditions, despite the fact that the aggregate of these interests creates an irrational bubble. Likewise, the desire for liquidity is rational individually, but collectively produces an irrational panic. In this way, “the fallacy of composition brings it about from time to time that individual actors all act rationally but in combination produce an irrational result, such as standing to get a better view as spectators of sport, or, more dramatically, running for the exit in a theater fire.”<sup>182</sup> Indeed, “[i]t is not a correct deduction from the Principles of Economics that enlightened self-interest always operates in the public interest.”<sup>183</sup> “Rationality is thus an a priori assumption rather than a description of the world.”<sup>184</sup>

Contrary to arguments advanced by advocates of deregulation, the above examples demonstrate that the market suffers from the same rational individual/irrational group dynamic as the political process. This phenomenon enables organized producer interests to dominate consumer interests in the market just as organized minority political interests often dominate majority interests in politics.<sup>185</sup>

### C. The Government Response

The federal government’s response to the financial crisis also demonstrates the regulatory bias favoring producers’ interests over consumers’ interests, even at the expense of regulators’ laissez-faire ideology. Like the government’s conservatorship of Fannie Mae and Freddie Mac, private financial institutions “too big to fail” are being saved by enormous government expenditures financed by taxpayers.<sup>186</sup> Public opposition to saving Wall Street from a problem of its own creation has prompted some to

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182. KINDLEBERGER, *supra* note 49, at 198.

183. HARRIS, *supra* note 30, at 58 (“Nor is it true that self-interest is generally enlightened; more often individuals acting separately to achieve their own ends are too ignorant or too weak to attain even these.” (quoting JOHN MAYNARD KEYNES, *THE END OF LAISSEZ-FAIRE* 12 (1926)).

184. KINDLEBERGER, *supra* note 49, at 21.

185. CROLEY, *supra* note 65, at 19 (“Precisely because the many are no competition for the few, there are numerous occasions for those able to mobilize to achieve regulatory successes that harm the unorganized substantially.”).

186. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 § A, 122 Stat. 3765 (2008).

argue that the government should “let failed banks fail.”<sup>187</sup> If the market were truly efficient, this would be an appropriate course of action. The government must act, however, to prevent the severe collateral societal instability that would result from the failure of large private institutions such as banks.

### 1. Moral Hazard

Still, saving the financial system creates an unavoidable moral hazard. In his *Manias, Panics and Crashes*, Charles Kindleberger argues that a “lender of last resort,” an entity that has enough money on hand to purchase securities at their true worth, is needed to prevent the scramble for cash that causes a financial market to crash.<sup>188</sup> One obvious candidate for the job is the Federal Reserve, especially considering private banks’ traditional refusal to fill this role, even in order to save themselves.<sup>189</sup> A clear moral hazard would result from explicit policy mandating that the government act as a lender of last resort. “The dilemma, of course, is that if markets know in advance that help is forthcoming under generous dispensations, they break down more frequently and function less effectively.”<sup>190</sup> Although government provision of this public good creates such a moral hazard, the government has little choice when economic disaster strikes.<sup>191</sup> As Kindleberger notes, “Actuality inevitably dominates contingency. Today wins over tomorrow.”<sup>192</sup>

With regard to the 2008 financial crisis, however, this moral hazard does not apply equally to all market participants. Producers, not consumers, destabilized the market by assuming enormous debts in order to purchase unregulated OTC derivatives, and producers campaigned to ensure these

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187. Sean Gabb, *Let Failed Banks Fail*, BRUSSELS J., (Oct. 8, 2008), available at <http://www.brusselsjournal.com/node/3578>; Press Release, Libertarian Alliance, ‘No Bail Out of the British Financial System’ Says Libertarian Alliance: ‘Let Failed Banks Fail’ (Oct. 8, 2008), available at <http://www.libertarian.co.uk/news/nr072.htm>.

188. See KINDLEBERGER, *supra* note 49, at 3 (“Even if there were exactly the right amount of liquidity in the system over the long run, there would still be crises, and need in crises for additional liquidity to be provided by a lender of last resort.”). See also FRIEDMAN, *supra* note 47, at 418 (“The detailed story of every banking crisis in our history shows how much depends on the presence of one or more outstanding individuals willing to assume responsibility and leadership.”) (footnote omitted).

189. KINDLEBERGER, *supra* note 49, at 153–54.

190. *Id.* at 4. Experience supports this conclusion. “Have the money-center banks loaned rather recklessly to Third World countries during the 1970s, secure in the knowledge that they would not be allowed to fail? There have been appearances of that sort.” *Id.* at 196.

191. See *id.* at 146.

192. *Id.* at 149.

instruments remain unregulated.<sup>193</sup> “[Market] insiders destabilize by driving the price up and up, selling out at the top to the outsiders, who buy at the top and sell out at the bottom when the insiders are driving the market down.”<sup>194</sup> While both producers and consumers are responsible for overconsumption, “the professional insiders initially destabilize by exaggerating the upswings and the falls, while the outsider amateurs who buy high and sell low are less price manipulators than the victims of euphoria, which infects them late in the day.”<sup>195</sup> This suggests that the same rational ignorance applies to consumers’ investment decisions as to their political choices. In light of this, a moral hazard argument applies more appropriately to banks and investment companies than to their shareholders, who can hardly be faulted for investing in financial institutions that hold themselves out as archetypes of stability and responsibility. The financial services industry should bear the financial risk of the housing bubble’s collapse, just as it has arguably disproportionately reaped the rewards of its temporary inflation.

The government’s response to the financial crisis fails to acknowledge producers’ higher relative culpability. Rather than purchasing individuals’ mortgages or common stock, the government bailout would purchase bank debt—essentially bailing out AIG’s and Citi’s institutional debtholders by destroying any remaining value that had accrued to common shareholders.<sup>196</sup> The government’s response to the financial crisis represents yet another example of concentrated producer gains at the expense of consumers, whether they engaged in real estate speculation or not.<sup>197</sup> As history has

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193. See Edmund L. Andrews, *A ‘Moral Hazard’ for a Housing Bailout: Sorting the Victims From Those Who Volunteered*, N.Y. TIMES, Feb. 23, 2008, at C1 (“Over the last two decades, few industries have lobbied more ferociously or effectively than banks to get the government out of its business and to obtain freer rein for ‘financial innovation.’”).

194. KINDLEBERGER, *supra* note 49, at 26.

195. *Id.* at 26–27.

196. See Serena Ng, *New AIG Rescue Is Bank Blessing: Buyers of Insurer’s Default Swaps Would Recover Most of Their Money*, WALL ST. J., Nov. 12, 2008, at C1; Editorial, *‘No Line Responsibilities’*, WALL ST. J., Dec. 3, 2008, at A16 (“[Former Treasury Secretary Robert] Rubin was reportedly critical to securing the latest federal bailout of Citi —\$20 billion in preferred shares plus taxpayers taking on most of the risk in a \$306 billion portfolio of dodgy assets. This is on top of the \$25 billion in Citi preferred shares that taxpayers bought in October.”). Bank of America recognized taxpayers’ likely reaction to their bailout proposal, writing, “We believe that any intervention by the federal government will be acceptable only if it is not perceived as a bailout of the bond market[.]” Andrews, *supra* note 193.

197. See KINDLEBERGER, *supra* note 49, at 196 (“There is . . . a political dimension to all rescue operations that are not generalized in the way that open-market operations are: who is helped, and who not.”). As Senator Sarbanes analogized, “if you put a driver in a car and they drive recklessly, and maybe they have a car crash, it’s going to punish them and

shown, the government's free-market policies produce "concentrated group gains [that] 'fall far short of the damage to the rest of the community.'"<sup>198</sup> A deregulated market thus fails to meet its own goal of maximizing wealth.<sup>199</sup>

## 2. 1987 All Over Again

The shortcomings of such policies would be less unsettling if taxpayers had not previously been made aware of the risk "financial innovation" posed. Similar government actions during the 1980s also resulted in a publicly-financed market crash: the Savings and Loan crisis.

In an effort to make savings and loans ("S&L's") more efficient and profitable, the Depository Institutions Deregulation and Monetary Control Act of 1980<sup>200</sup> and the Garn-St. Germain Depository Institutions Act of 1982<sup>201</sup> removed some of the Glass-Steagall Act's restrictions on thrifts, thus permitting the S&L's to make a wide variety of loans and investments that they were previously prohibited from making. The sort of stricter regulation and oversight imposed on fully chartered banks, however, did not accompany the S&L's new powers. Unsurprisingly, the S&L's, which were insured by the Federal Savings and Loan Insurance Corporation, leveraged themselves excessively and engaged in risky transactions, since they received the full benefits of success but did not bear the full cost of failure. Several years later, the Tax Reform Act of 1986,<sup>202</sup> which was intended to increase economic efficiency by limiting the tax reductions available to passive real estate investors, encouraged holders of loss-producing properties to sell those properties on the open market, reducing real estate values across the nation. The disparity between the face values and the actual values of mortgages held by S&L's pushed their directors to further increase leverage and take even

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maybe they will learn their lesson. But in the meantime, a lot of innocent bystanders can get run over." *Hearing, supra* note 26, at 143 (statement of Rep. John Sarbanes, Member, H. Comm. on Oversight and Gov't Reform).

198. CROLEY, *supra* note 65, at 21–22 (citing George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 11 (1971)).

199. Coffee, *supra* note 119, at 4 ("Th[e] claim that financial contracting largely renders regulation irrelevant cannot explain, however, the close correlation between a given country's level of capital market development and the nature of its legal system. The more logical conclusion is that law does matter, and regulation can somehow better promote economic efficiency than can reliance on financial contracting alone.").

200. Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended at 12 U.S.C. §226 (2006)).

201. Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended at 12 U.S.C. §226 (2006)).

202. Pub. L. No. 99-514, Title V, § 501(a), 100 Stat. 2085 (codified as amended at 26 U.S.C. § 469 (2006)).

greater risks, including investing in equity futures.<sup>203</sup> The resulting crash resulted in over 1,000 S&L insolvencies, for which taxpayers paid a total of \$519 billion.<sup>204</sup>

The parallels between the current financial crisis and the S&L crisis reveal a trend: the systematic deregulation of financial institutions that are backed explicitly or implicitly by the government encourages those institutions to engage in inefficiently risky transactions. The government thus internalizes and intensifies market failure, as institutions rationally focus on maximizing short-term concentrated profits without regard to long-term systemic risks.<sup>205</sup>

#### D. Lessons Learned

These failures demonstrate the ECMH's practical limitations. Even Greenspan acknowledged the ECMH's faults in his testimony before Congress, stating, "I found a flaw in the model that I perceived is the critical functioning structure that defines how the world works, so to speak."<sup>206</sup> Indeed, "[t]he proposition that laissez-faire brings about optimality is thus no longer available to argue against regulation."<sup>207</sup> Failed government policies premised upon the ECMH not only demonstrate the hypothesis's theoretical imperfections, but also reveal its promotion of producers' interests at consumers' expense. Minimal regulation of financial markets, far from promoting value-neutral economic efficiency, actually promotes a distinct normative agenda.<sup>208</sup> As such, we may rightly question whether such policies should continue.

In essence, regulators must choose between controlling monetary policy and controlling credit markets. Proponents of monetary policy control see credits markets as stable, and therefore argue that appropriate government

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203. *Giving credit*, *supra* note 154.

204. Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC BANKING REV., Dec. 2000, at 26, 26, available at [http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2\\_2.pdf](http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf) (calling this failure the "greatest collapse of U.S. financial institutions [of its time,] since the 1930s").

205. SELF, *supra* note 14, at 162 (discussing the micro-efficiency drive to minimize costs and maximize profits).

206. *Hearing*, *supra* note 26, at 37 (testimony of Alan Greenspan, former Chairman, Bd. of Governors of the Fed. Reserve Sys.) (discussing the market's failure to effectively price risk).

207. WALDFOGEL, *supra* note 88, at 168.

208. PITELIS, *supra* note 106, at 4 ("[W]hen efficiency was considered, it was for power-distributional motives.").

monetary policy can sufficiently prevent financial crises.<sup>209</sup> Proponents of credit market control argue that credit markets are presently infinitely expandable, and thus see monetary policy as insufficient to forestall financial crises.<sup>210</sup> History has shown the latter view to be correct.<sup>211</sup>

Greenspan acknowledged monetary policy's shortcomings as a regulatory tool, stating that the complexity of the global financial markets makes the necessary accurate forecasting "more than anyone is capable of judging."<sup>212</sup> Although regulators cannot see the future, "we are smart enough as people to have put basic underwriting standards in place or to have preserved basic underwriting standards[.]"<sup>213</sup> as Representative Paul Sarbanes replied. Policymakers face a choice: either accept booms and busts or increase government control over financial institutions and instruments. Put another way, the question is whether government should restrict financial services' activities in order to reduce volatility and promote economic stability.

Given the government purpose identified previously, the answer is yes. Rather than taking individuals' property through force, financial institutions have employed government agencies, promoting policies that incorrectly assume efficient, prepolitical markets. As history demonstrates, the market's invisible hand does not stabilize the market at a equilibrium, as Adam Smith suggested, but destabilizes it.<sup>214</sup> Regulatory minimalism encourages economic booms that pay huge dividends to producers, while relying on taxpaying

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209. Monetarist Milton Friedman believes that regulatory limits on the character of money and financial assets are unnecessary because he is confident that "control of the money supply suffices to prevent major business cycles, and that instability of the credit mechanism is not to be feared . . . ." KINDLEBERGER, *supra* note 49, at 62.

210. See, e.g., Hyman P. Minsky, *The Financial Instability Hypothesis: A Restatement*, in POST KEYNESIAN ECONOMIC THEORY 24, 25 (Philip Arestis & Thanos Skouras eds., 1985) ("The logical flaw in standard economic theory is that it is unable to assimilate capital assets and money of the kind we have, which is created by banks as they finance capital asset production and ownership.").

211. KINDLEBERGER, *supra* note 49, at 63 ("[T]he weight of the historical evidence strongly favors the case that while monetary policy might have moderated booms leading to bust, it would not have eliminated them all."). See also FISHER, *supra* note 48, at 3–5 (noting similarities between the financial crises of 1837 and 1932); KINDLEBERGER, *supra* note 49, at 31 (citing JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY, WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY 709 (7th ed., 1929) (1848) (blaming financial bubbles on speculation)).

212. *Hearing*, *supra* note 26, at 102 (statement of Alan Greenspan, former Chairman, Bd. of Governors of the Fed. Reserve Sys.). The near-impossibility of adjusting the money supply in exactly the right way so as to slow a boom without precipitating a panic provides one reason for this. KINDLEBERGER, *supra* note 49, at 162.

213. *Hearing*, *supra* note 26, at 140 (statement of Rep. John Sarbanes, Member, H. Comm. on Oversight and Gov't Reform).

214. Minsky, *supra* note 210, at 26.

consumers to finance the busts.<sup>215</sup> Considering that the government derives its authority from the people, and that one of the government's important functions is to prevent coercive transactions, any government policy thus enabling producers to exploit consumers is unjust.

#### IV. REFORMING REGULATION

The policy deficiencies responsible for the current financial crisis strongly suggest the need for regulatory reform. Unsurprisingly, Greenspan disagreed, labeling the financial crisis a "once-in-a-century phenomenon"<sup>216</sup> and dismissing the public clamor for a government response, arguing that "the types of regulation that would prevent this from happening in the future are so onerous as to basically suppress the growth rate in the economy, and I think the standards of living of the American people."<sup>217</sup> Greenspan further argued that internal market processes would render any additional regulation redundant, claiming that "whatever regulatory changes are made, they will pale in comparison to the change already evident in today's markets. Those markets for an indefinite future will be far more restrained than with any currently contemplated new regulatory regime."<sup>218</sup> But considering the profitability of risk-taking, the financial services industry's lack of accountability, and the experience of history, Greenspan's claim is unrealistic at best.<sup>219</sup>

Indeed, the market-government balance clearly needs realignment. Equally clear is that any structural change must come on the government side of the equation. Its failures aside, the free market remains the most efficient

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215. See Sanford M. Jacoby, *Finance and Labor: Perspectives on Risk, Inequality, and Democracy*, 30 COMP. LAB. L. & POL'Y J. 17, 18 (2008) ("Upswings in financial development are related to political pressure exerted by elite beneficiaries of financial development."). See also PITELIS, *supra* note 106, at 127 (going so far as to call the state-market relationship "one of agency, of state functionaries working for capital").

216. *Hearing, supra* note 26, at 147 (statement of Alan Greenspan, former Chairman, Bd. of Governors of the Fed. Reserve Sys.).

217. *Id.*

218. *Id.* at 19. See also *Giving credit, supra* note 154 ("With a bit of nudging, the market is reforming itself.")

219. As Representative Stephen Lynch told Greenspan, "I wish I could believe that, but we have short memories around here, and as soon as the urgency and this crisis is over, folks, you know, there's good money being made on those [securities] and so there's an incentive there to push them out into the market. So I wish I could believe you that these things won't come back, but I want to make sure." *Hearing, supra* note 26, at 163 (statement of Rep. Stephen Lynch, Member, H. Comm. on Oversight and Gov't Reform).

way to deliver the majority of goods and services,<sup>220</sup> the byproduct of which is the democratic exchange of goods necessary to secure individual freedom against arbitrary government. It seems unrealistic and undesirable for the market to operate differently; its objective should be to maximize profits. Government policy, however, should force market actors to realize the costs of their actions. In so doing, the government will provide the bulwark against private coercion that it was originally intended to provide.

### A. Should Government Regulate At All?

In order to prevent oppression of both consumers and producers, the government has two choices. It can either increase substantive market regulation by instituting capital markets controls, or it can totally remove regulators' discretion by eliminating federal government intervention in the market altogether. Indeed, neo-Austrian economists such as Friedrich Hayek advocate complete government abstention from market regulation.<sup>221</sup> Under such a regime, the government would not engage in monetary policy at all; any bank, company, or person would be free "to issue 'money' and try to gain its acceptance. The market, they claim, will decide who issues good money."<sup>222</sup>

In addition to the need for government-market tension to safeguard individual rights, decentralizing control of financial markets fails to work in practice. No country has totally abandoned monetary policy as a regulatory tool. Empirical evidence reveals, however, problems even in less extreme decentralization, under which individual states assume regulatory powers. State regulators are more susceptible to special interest pressure than their federal counterparts,<sup>223</sup> which often produces factionalism. With regard to corporate regulation, rational competition for tax revenues among states leads to an irrational "race to the bottom" among state regulators.<sup>224</sup> Such shortcomings render state regulation insufficient to prevent market-failure.<sup>225</sup>

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220. FEINTUCK, *supra* note 12, at 61; *see also* President Barack Obama, Inaugural Address (Jan. 20, 2009) ("[The market's] power to generate wealth and expand freedom is unmatched.").

221. F. A. HAYEK, DENATIONALISATION OF MONEY (1976).

222. KINDLEBERGER, *supra* note 49, at 62 (citation omitted).

223. *See* SUNSTEIN, *supra* note 14, at 22 (stating that the New Deal revealed states to be "peculiarly subject to the power of faction").

224. *See generally* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (discussing how competition for corporate tax revenues encourages states to enact laws favorable to management).

225. Representative Tom Davis noted the ineffectiveness of state regulation of financial markets, stating, "Nobody had a view of what anybody else was doing, and when you

Moreover, crises national in scope require a unified response that only the federal government can provide. Like other public goods, centralized intervention is necessary in the case of financial markets.

## B. Recommendations for Future Strategies

### 1. Contain Externalities

Although secondary costs are inherent in a free market system,<sup>226</sup> there is no reason not to force market actors to internalize these costs.<sup>227</sup> Currently, the law of nuisance provides one vehicle by which to do so, albeit after damaging externalities have already occurred. Public nuisance law permits the government to force private actors to internalize the costs of their actions by either requiring the actor creating the nuisance to compensate the public for the harm done, or imposing restrictions (via injunction) on the actor in order to safeguard others' property. Like any "unreasonable interference with a right common to the general public,"<sup>228</sup> the federal government should compensate taxpayers either by forcing the financial services industry to pay the full cost of its activities or by imposing restrictions limiting the industry's future actions. Obviously, before-the-fact regulation carries the additional benefits of providing stable expectations and preventing damage in the first place.

Such regulation is not an uncompensated government taking.<sup>229</sup> As the Supreme Court noted in *Munn v. Illinois*,<sup>230</sup> government restrictions on industry do not constitute a taking of property, but merely a legitimate regulation of its use in order to protect others from harm. Indeed, the ideological underpinning of 1970s-era regulation was not wealth

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regulate these entities at the state level nobody has a view of what's going on nationally." *Hearing*, *supra* note 26, at 58 (statement of Rep. Tom Davis, Member, H. Comm. on Oversight and Gov't Reform).

226. Calabresi, *supra* note 123, at 53.

227. "Regulatory intervention is often in effect targeted at 'containing the externalities produced by imperfect markets.'" FEINTUCK, *supra* note 12, at 61–62 (citing Norman Lewis, *Markets, Regulation, and Citizenship: a Constitutional Analysis*, in *LAW AND THE PUBLIC INTEREST: PROCEEDINGS OF THE 1992 ALSP CONFERENCE* 126–27 (Roger Brownsword ed., 1993)). *See also* CROLEY, *supra* note 65, at 9 ("[Regulation can] deliver broad-based benefits even over the strong opposition of well-organized and well-funded interests.").

228. RESTATEMENT (SECOND) OF TORTS § 821B (1979).

229. *Cf.* Dorn, *supra* note 1, at 94 (arguing that regulation is a taking on the majority); Epstein, *supra* note 29, at 183 (claiming that the loss of any right in property is akin to a loss of the property itself).

230. 94 U.S. 113, 133–34 (1877).

redistribution, but rather the “internalization of the previously unrecognized costs of industrial growth,—a market-corrective strategy that posed no challenge to the premise of an exchange economy . . . .”<sup>231</sup> On the contrary, a government policy permitting booms and busts more appropriately resembles an uncompensated taking—permitting industry to impose a cost on individuals irrespective of the benefit to them.

## *2. Enable Individual Risk Particularization*

Even in the absence of externalities, the disparity between individual and market tolerances for risk supports the conclusion that active government regulation of financial markets promotes a more efficient outcome than does deregulation. The rule of law imposes ex-ante restrictions on individual action.<sup>232</sup> It secures individual property by preventing infringements from occurring, rather than by compensating individuals for damages incurred.<sup>233</sup> The citizenry’s affinity for such ex-ante government rules reflects its preference for stability of expectations over complete fairness in all outcomes. This desire suggests that individuals are risk-averse rather than completely rational and risk-neutral. Social psychology supports this conclusion; individuals engage in riskier behavior to avoid a loss than to obtain an equal benefit.<sup>234</sup>

The market, conversely, is presumed to be rational and risk-neutral. One proffered justification for deregulation argues that the market maximizes returns by cutting losses short and letting profits run. This tendency implies risk-neutrality. Assuming that government regulation creates market inefficiency, and that efficiency is the ultimate goal, it follows that the government is best that governs least.

Even if the market were to maximize returns, focusing on efficiency ignores what people want from their government. As detailed previously, minimalist regulatory policy permits coercive takings by producers. The desire to prevent nonconsensual transactions is what prompts individuals to

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231. Rabin, *supra* note 34, at 47.

232. See OLIVER WENDELL HOLMES, *THE COMMON LAW* 46 (Little, Brown & Co. 1923) (1881).

233. Ex-ante regulation is also presumably less expensive than ex-post compensation.

234. JOHN NORTON MOORE, *SOLVING THE WAR PUZZLE: BEYOND THE DEMOCRATIC PEACE* 35 (2004) (“[P]rospect theory’ . . . posits that individuals evaluate outcomes with respect to deviations from a reference point and that they may be more risk averse in settings posing potential gain than in settings posing potential loss.”) (citing Lee Ross & Donna Shestowsky, *Contemporary Psychology’s Challenges to Legal Theory and Practice*, 97 NW. U. L. REV. 1081 (2003); Chris Guthrie, *Prospect Theory, Risk Preference, and the Law*, 97 NW. U. L. REV. 1115 (2003)).

form government in the first place. It follows that individuals are not risk-neutral, but risk-averse, and therefore are willing to tolerate lower returns in exchange for the stability, risk-mitigation, and security that ex-ante regulation produces. This justifies an active regulatory policy.

Regulation mitigating systemic risk also permits individuals to personalize their risk. While individuals' risk tolerances vary widely, governmental rules apply to all equally. Individuals have more choices in their market decisions than in their political decisions. These factors suggest that to best serve all members of society, the government should seek to mitigate market risk, while the market should seek to maximize rewards (which it already does). This duality provides a baseline of high government control and little market participation, enabling risk-averse individuals largely to avoid systemic risk. Individuals more tolerant of risk can choose to engage in more market activity, increasing their risk and potential economic benefits accordingly. In this way, a risk-averse regulatory regime allows each individual to assume the amount of risk he or she desires. Obviously, such an outcome is preferable to loose governmental control over financial markets. Under such a system, the government systemizes risky behavior, thereby imposing risk on unwilling individuals.

### 3. Identify Values

Despite the problems resulting from promoting market efficiency through government policy, regulators could justify this agenda because no concrete norms exist to guide regulatory officials' actions.<sup>235</sup> Regulators are merely expected to act in the "public interest,"<sup>236</sup> a vague guideline if ever there was one. Many scholars have written persuasively on how "the public interest" should be defined, seeking to establish a normative basis by which to evaluate the propriety of government behavior in the regulatory sphere.<sup>237</sup> Most such proposals advocate a government policy furthering populist rights such as democracy,<sup>238</sup> free choice,<sup>239</sup> equality,<sup>240</sup> or employment rights.<sup>241</sup> As

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235. See FEINTUCK, *supra* note 12, at 154; THEODORE LOWI, *THE END OF LIBERALISM* (1979), reprinted in SCHUCK, *supra* note 34, at 185, 191–93 (2d ed. 2004).

236. *Charles River Bridge v. Warren Bridge*, 11 Peters 420, 472 (1839) (holding that a duty to the "public good" circumscribes corporate authority to obtain profits).

237. FEINTUCK, *supra* note 12, at 25–26 (arguing for better-defined public rights for government actors to promote).

238. *Id.* at 17 ("In so far as corporate activity and other exercises of private property rights cut across the fundamental democratic expectation of equality of citizenship, the legitimacy of the exercise of such power becomes highly questionable, and the need for regulatory intervention justified.").

support, some scholars point out that the market is not value-neutral, but strongly supports the status quo.<sup>242</sup> Given that individuals' preferences reflect the opportunities available to them, the market, as an aggregate of personal preferences, perpetuates the existing order.<sup>243</sup>

Determining what value should drive government action is beyond the scope of this Note. Regardless of what objective government policy aspires to, the government-market balance appears to mandate that government not pursue the same end as the market, namely the maximization of wealth. The public interest must not be defined by the mathematical processes used to identify it.<sup>244</sup> Otherwise, as Representative Betty McCollum noted, "when financial regulators decide to let the private markets run free, the public interest is left defenseless to the greed of Wall Street."<sup>245</sup> Pursuing market goals removes the government from its proper role as a constraint on market forces and inserts it as facilitator of those forces, jeopardizing individual rights. Any future policy must therefore pursue ends different from the market's.

#### 4. Overcome Self-Interest

It is important to note that regulators had sufficient statutory authority to regulate the market, including lending standards, exotic financial derivatives,

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239. SUNSTEIN, *supra* note 14, at 40 (arguing that the market perpetuates "illegitimate constraints on the process of preference formation").

240. Patrick McAuslan & John F. McEldowney, *Legitimacy and the Constitution, The Dissonance Between Theory and Practice* 1, 7 in LAW, LEGITIMACY AND THE CONSTITUTION (Patrick McAuslan & John F. McEldowney eds., 1985) (noting the "unevenness of the distribution of the costs and benefits of economic growth"); Andrew Gamble & Gavin Kelly, *The New Politics of Ownership*, 220 NEW LEFT REV. 62, 96 (1996) ("[I]f there is marked inequality in a society, it is a result of political choice, not of a deterministic and irresistible economic logic.").

241. SELF, *supra* note 14, at 162.

242. See, e.g., PITELIS, *supra* note 106, at 104 ("[T]he existence of distributional inequities (in production) in this original equilibrium by definition implies a partisan state favouring those better off in the original equilibrium."); SUNSTEIN, *supra* note 14, at 39 (arguing that advocates of regulatory minimalism assume that the status quo is just and "in no need of defense").

243. SUNSTEIN, *supra* note 14, at 39. See also SELF, *supra* note 14, at 160 (noting that normative reliance on the market decreases the "feasibility and ethos of purposeful collective action").

244. FEINTUCK, *supra* note 12, at 11 (citing VIRGINIA HELD, THE PUBLIC INTEREST AND INDIVIDUAL INTERESTS 205 (1970)).

245. *Hearing*, *supra* note 26, at 149 (statement of Rep. Betty McCollum, Member, H. Comm. on Oversight and Gov't Reform).

and credit rating agencies, had they sought to exercise it. As Representative John Tierney reproved Greenspan, the Home Ownership and Equity Protection Act<sup>246</sup> states that the Federal Reserve “by regulation or order, shall, *not may, but shall* prohibit acts or practices in connection with refinancing of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interests of the borrower.”<sup>247</sup> While the CFMA removed CFTC authority to regulate OTC derivatives, the Treasury Department could have imposed effective restrictions on banks and investment companies. With respect to credit-rating agencies, SEC Chairman Christopher Cox acknowledged that the SEC has sufficient authority to regulate these companies.<sup>248</sup>

Rather than lacking the ability to regulate the market, agency heads lacked the will to do so, which creates quite a dilemma. As Representative Bill Sali asked, “[H]ow will giving more regulators more power do anything different when each of you said you weren’t even aware of all the things that [Representative John] Mica pointed out that were a tremendous problem?”<sup>249</sup> For example, an Inspector General’s report indicates that the SEC ignored numerous potential red flags, by failing to audit Bear Stearns (instead allowing that company to audit itself), and by failing to review audit results in a timely fashion.<sup>250</sup>

The nature of this problem rules out some forms that a restoration of the government-market balance might otherwise take. While additional statutory regulation of financial derivatives will no doubt play an important role in addressing future societal risks posed by unregulated financial instruments,<sup>251</sup>

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246. 15 U.S.C. § 1639 (1994).

247. *Hearing, supra* note 26, at 88 (statement of Rep. John Tierney, Member, H. Comm. on Oversight and Gov’t Reform) (emphasis added). *See also id.* at 76 (statement of Rep. Bill Sali) (arguing that Greenspan, Cox, and Snow had sufficient authority to regulate financial markets).

248. *Id.* at 92 (statement of Christopher Cox, Chairman, Sec. & Exch. Comm’n).

249. *Id.* at 76 (statement of Rep. Bill Sali, Member, H. Comm. on Oversight and Gov’t Reform).

250. *See* OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH. COMM’N, REP. NO. 446-B, SEC’S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: BROKER-DEALER RISK ASSESSMENT PROGRAM (2008). *See also Hearing, supra* note 26, at 135 (statement of Rep. Christopher Murphy, Member, H. Comm. on Oversight and Gov’t Reform) (referencing the report).

251. *See, e.g.*, Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339 (2008) (noting the rise of private-market securities offerings); Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1702–16 (2008) (discussing electronic commercial paper, and financial market contracts, or swaps, in bankruptcy).

the fact that regulatory agencies are subject to capture by pro-market interest groups suggests that such laws will do little to address the larger issue of disinterested regulators, and the need to align the government agency's interest with the public interest. Indeed, "no decree will prevent mishaps that arise from weak management oversight."<sup>252</sup> The direct election of agency officials seems likely to encourage even more pandering to interest groups, as bureaucrats seek the resources necessary to run for office.<sup>253</sup>

### 5. *Employ Third-Party Mediation*

More broadly, it seems that the problem arises from the fact that the government is not only part of the market-government dichotomy, but also responsible for delineating the permissible scope of its own authority. The government is simultaneously player and referee. Producers felt understandably threatened.

To resolve this dilemma, it may be necessary to delegate the government's referee authority to an impartial, apolitical body, such as the federal judiciary. Indeed, some scholars<sup>254</sup> have suggested that the Constitution might provide some legal basis for regulating industry.<sup>255</sup> Even the Founders may have contemplated such judicial regulation.<sup>256</sup> As the interpreter of the Constitution—a document designed to overcome the excessive market regulation enabled by the Articles of Confederation without subjecting the union to despotism<sup>257</sup>—the federal judiciary may be the branch best suited to regulate industry, or at least to regulate the agencies responsible

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252. Susan M. Mangiero, *Anyone Up for OTC Derivatives Regulation?*, AFP PULSE (Ass'n for Fin. Prof'ls, Bethesda, Md.), May 2002, at 2 (discussing potential regulation of OTC derivatives).

253. See also THOMPSON, *supra* note 4, at 25 (noting that direct voting on financial initiatives would provide rules that are neither stable nor rational).

254. See, e.g., CROLEY, *supra* note 65, at 101 (noting the potential for judicial review to invalidate special interest legislation); Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, in SCHUCK, *supra* note 34, at 23, 24 (discussing Cass Sunstein's and Frank Michelman's proposals to enable judicial regulation of federal agencies).

255. Congress can engage in fiscal and monetary activities, as well as activities "necessary and proper" to those ends. U.S. CONST. art. I, § 8.

256. PIPES, *supra* note 5, at 232 (citing MARK L. POLLOT, *GRAND THEFT AND PETTIT LARCENY* xxvi (1993) ("If, as is now often the case, the courts abandon their constitutional role as guardians of rights and defer to the judgment of regulatory agencies in all their various functions, then the constitutional system as originally devised is radically altered."). Cf. FRIEDRICH A. HAYEK, *THE CONSTITUTION OF LIBERTY* 190 (1960) ("The [New Deal] Court was clearly overstepping its proper judicial functions and arrogating what amounted to legislative powers.")).

257. SUNSTEIN, *supra* note 14, at 14 (discussing the Constitution's balancing of these interests).

for doing so.<sup>258</sup> In this way, the courts might effectively further a conception of the common good distinct from the market's focus on maximizing wealth, thereby preserving individual property rights and freedom.

### CONCLUSION

It is quite clear that regulation often does more harm than good, promoting minority interests to the majority's detriment. Government policies causing and responding to the recent financial crisis provide a perfect example, furthering producers' interest at consumers' expense.<sup>259</sup> Recognizing this tendency, public choice theory advocates minimizing the government's ability to police the private sector. In many areas of government regulatory policy, a hands-off approach is justified. The need for federal power to shape national economic policy, however, makes this one-size-fits-all prescription improper in the case of financial markets. Rather than restricting the spheres in which the government may act, regulatory reform should seek to align bureaucrats' interests with those of the citizenry. Given the enduring problem of self-interested representatives, delegation of regulatory authority to the federal courts, although not a perfect solution, might be the best option available.

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258. Of course, this would require a reversal of the deferential standard of review adopted in *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978), and *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

259. See President Barack Obama, Inaugural Address (Jan. 21, 2009) (transcript available at [http://www.whitehouse.gov/the\\_press\\_office/President\\_Barack\\_Obamas\\_Inaugural\\_Address](http://www.whitehouse.gov/the_press_office/President_Barack_Obamas_Inaugural_Address)) (“[T]his crisis has reminded us that without a watchful eye, the market can spin out of control. The nation cannot prosper long when it favors only the prosperous.”).