AU BLR
American University Business Law Review

Volume 1 • 2011-2012 • Issue 1

2011 American University Business Law Review Symposium: Law, Finance and Legitimacy After Financial Reform Washington, D.C.; April 8, 2011

AU BLR AMERICAN UNIVERSITY BUSINESS LAW REVIEW

VOLUME 1 · 2011-2012 · ISSUE 1

LETTER FROM THE EDITOR-IN-CHIEF

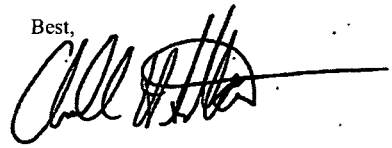
Dear Readers,

Welcome to the American University Business Law Review! The American University Business Law Review is a student-run publication that provides cutting-edge legal analysis for the business law community. It is the only law journal in the Washington, D.C. area dedicated solely to business issues. The Business Law Review publishes fall and spring issues which include scholarly articles, case law analysis, and coverage of developing trends in a variety of areas such as: financial regulation, international trade, antitrust, communications, healthcare, and energy. We welcome articles submitted by both academics and practitioners. Also, the Business Law Review hosts an annual Business Law Symposium with leading academics and practitioners focusing on a current and pertinent arena within business law.

In this inaugural issue, we are proud to include pieces from our 2011 Spring Symposium entitled *Law, Finance, and Legitimacy After Financial Reform*, including the Keynote Address from Brooksley Born, former Commodity Futures Trading Commission Chair and Financial Crisis Inquiry Commission member. The Business Law Review will continue to bring relevant articles to the Washington, D.C. metropolitan area. We look forward to you joining us as we embark on this new chapter in the American University Washington College of Law and Washington, D.C. business law community.

We would like to thank Dean Claudio Grossman and the Office of the Dean as well as former Dean Trishana E. Bowden, Acting Associate Dean Barbara L. Ciconte, and the Office of Development and Alumni Affairs for their continued support. We would also like to thank our faculty advisors, Professors Mary Siegel, Anna Gelpern, Kenneth Anderson and Heather Hughes, Deans Christine Farley and Billie Jo Kaufman, and particularly Professor Benjamin Leff and faculty advisors Professors Walter Effross, David Snyder and Andrew Pike who have been instrumental as we have moved forward to launch our first issue and prepare for our 2012 Spring Symposium. We also extend our thanks to those who have worked over the years to make the publication of this first issue possible. Most importantly, we thank the entire American University Washington College of Law Community, and notably, Sharon Wolfe, Law Review Coordinator, for their unanimous and unwavering support.

Best,



Averell Sutton
Editor-in-Chief
American University Business Law Review
Volume 1, Issue 1

AMERICAN UNIVERSITY
WASHINGTON COLLEGE OF LAW FACULTY

Administration

Claudio M. Grossman, B.A., S.J.D., Doctor of Science of Law, *Dean*
Anthony Varona, A.B., J.D., LL.M., *Associate Dean for Faculty and Academic Affairs*
Stephen Vladeck, B.A., J.D., *Associate Dean of Scholarship*
Trishana E. Bowden, B.S., *Associate Dean of Development and Alumni Relations*
David B. Jaffe, B.A., J.D., *Associate Dean for Student Affairs*
*Billie Jo Kaufman, B.S., M.S., J.D., *Associate Dean of Library and Information Resources*
Rebecca T. Davis, B.S., M.A.T., *Assistant Dean for Academic Services and Registrar*
Khalid R.O. Khalid, B.A., M.A., *Assistant Dean for Finance and Administration*
D. Akira Shiroma, B.A., J.D., *Assistant Dean of Admissions and Financial Aid*
Traci Jenkins, B.A., J.D., *Assistant Dean of Career and Professional Development*
David Aaronson, B.A, M.A., LL.B., LL.M., Ph.D., *Director of the Trial Advocacy Program*
Brenda Smith, A.B., J.D., *Acting Director of Clinical Programs*
David Hunter, B.A., J.D., *Acting Director of the International Studies Program*
Teresa Godwin Phelps, B.A., M.A., M.S.L., Ph.D., *Director of the Legal Writing and Research Program*
Jamin B. Raskin, B.A., J.D., *Director of the Law and Government Program*
Ann Shalleck, A.B., J.D., *Director of the Women and the Law Program*

Full-Time Faculty

David E. Aaronson, B.A., M.A., Ph.D., The George Washington University; LL.B., Harvard Law School; LL.M., Georgetown Law Center. *B.J. Tennery Professor of Law and Director of the Trial Advocacy Program*

Evelyn G. Abravanel, A.B., J.D., Case Western Reserve University. *Professor of Law*

Padideh Ala'i, B.A., University of Oregon; J.D., Harvard Law School. *Professor of Law*

Jonas Anderson, B.S., University of Utah; J.D., Harvard Law School. *Assistant Professor of Law*

*Kenneth Anderson, B.A., University of California at Los Angeles; J.D., Harvard Law School. *Professor of Law*

Isaiah Baker, A.B., Yale University; M.A., DePaul University; M.B.A., J.D., Columbia University; LL.M., Harvard Law School. *Associate Professor of Law*

Jonathan B. Baker, A.B., Harvard University; J.D., Harvard Law School; M.A., Ph.D., Stanford University. *Professor of Law*

Susan D. Bennett, A.B., M.A., Yale University; J.D., Columbia Law School. *Professor of Law and Director of the Community and Economic Development Law Clinic*

Daniel Bradlow, B.A., University of Witwatersrand, South Africa; J.D., Northeastern University School of Law; LL.M., Georgetown University Law Center; L.L.D., University of Pretoria. *Professor of Law*

Pamela Bridgewater, B.A., Florida Agricultural and Mechanical University; J.D., Florida State University College of Law; LL.M., University of Wisconsin Law School. *Professor of Law*

Barlow Burke, Jr., A.B., Harvard University; LL.B., M.C.P., University of Pennsylvania; LL.M., S.J.D., Yale Law School. *Professor of Law and John S. Myers and Alvina Reckman Myers Scholar*

Susan D. Carle, A.B., Bryn Mawr College; J.D., Yale Law School. *Professor of Law*

Michael W. Carroll, A.B., University of Chicago; J.D., Georgetown University Law Center. *Professor of Law and Director of the Program on Information Justice and Intellectual Property*

David F. Chavkin, B.S., Michigan State University; J.D., University of California at Berkeley School of Law. *Professor of Law and Direction of General Practice Clinic*

Janie Chuang, B.A., Yale University; J.D., Harvard Law School. *Associate Professor of Law*

Mary Clark, A.B., Bryn Mawr College; J.D., Harvard Law School. *Associate Professor of Law*

John B. Corr, B.A., M.A., John Carroll University; Ph.D., Kent State University; J.D., Georgetown University Law Center. *Professor of Law*

Angela Jordan Davis, B.A., Howard University; J.D., Harvard Law School. *Professor of Law*

Robert D. Dinerstein, A.B., Cornell University; J.D., Yale Law School. *Professor of Law and Director of Disability Rights Clinic*

*Walter A. Effross, B.A., Princeton University; J.D., Harvard Law School. *Professor of Law and Director of the Program on Counseling Electronic Commerce Entrepreneurs*

Lia Epperson, B.A., Harvard University; J.D., Stanford Law School. *Associate Professor of Law*

*Christine Haight Farley, B.A., State University of New York at Binghamton; J.D., State University of New York at Buffalo Law School; LL.M., J.S.D., Columbia Law School. *Professor of Law*

Amanda Frost, A.B., Harvard College; J.D., Harvard Law School. *Professor of Law*

*Anna Gelpern, A.B., Princeton University; M. Sc., London School of Economics and Political Science; J.D., Harvard Law School. *Professor of Law*

Robert K. Goldman, B.A., University of Pennsylvania; J.D., University of Virginia School of Law. *Professor of Law and Louis C. James Scholar*

Claudio M. Grossman, Licenciado en Ciencias Juridicas y Sociales, Universidad de Chile, Santiago; Doctor of the Science of Law, University of Amsterdam. *Dean, Professor of Law, and Raymond I. Geraldson Scholar in International and Humanitarian Law.*

Lewis A. Grossman, B.A., Yale University; J.D., Harvard Law School; Ph.D., Yale University. *Professor of Law and Associate Dean of Scholarship*

Egon Guttman, LL.B., LL.M., University of London. *Professor of Law and Levitt Memorial Trust Scholar Emeritus*

*Heather L. Hughes, B.A., University of Chicago; J.D., Harvard Law School. *Professor of Law.*

David Hunter, B.A., University of Michigan; J.D., Harvard Law School. *Professor of Law and Director of International Legal Studies Program*

Darren L. Hutchinson, B.A., University of Pennsylvania; J.D., Yale Law School. *Professor of Law*

Peter A. Jaszi, A.B., Harvard University; J.D., Harvard Law School. *Professor of Law*

Cynthia E. Jones, B.A., University of Delaware; J.D., American University, Washington College of Law. *Associate Professor of Law*

*Billie Jo Kaufman, B.S., M.S., University of Indiana at Bloomington; J.D., Nova Southeastern University. *Professor of Law and Associate Dean of Library and Information Resources*

Nicholas N. Kittrie, A.B., M.A., LL.B., University of Kansas; LL.M., S.J.D., Georgetown Law Center. *University Professor*

Candace S. Kovacic-Fleischer, A.B., Wellesley College; J.D., Northeastern University. *Professor of Law*

Benjamin Leff, B.A., Oberlin College; M.A., University of Chicago; J.D., Harvard Law School. *Assistant Professor of Law*

Amanda Leiter, B.S., M.S., Stanford University; M.S., University of Washington; J.D., Harvard Law School. *Associate Professor of Law*

James P. May, B.A., Carleton College; J.D., Harvard Law School. *Professor of Law*

Binny Miller, B.A., Carleton College; J.D., University of Chicago Law School. *Professor of Law and Director of Criminal Justice Clinic*

Elliott S. Milstein, B.A., University of Hartford; J.D., University of Connecticut School of Law; LL.M., Yale Law School. *Professor of Law*

Anthony C. Morella, A.B., Boston University; J.D., American University, Washington College of Law. *Professor of Law Emeritus*

Fernanda Nicola, B.A., Law Degree, University of Turin; Ph.D., Trento University; LL.M., S.J.D., Harvard Law School. *Assistant Professor of Law*

Diane F. Orentlicher, B.A., Yale University; J.D., Columbia Law School. *Professor of Law*

Teresa Godwin Phelps, B.A., M.A., Ph.D., University of Notre Dame; M.S.L., Yale Law School. *Director of Legal Writing and Research Program and Professor of Law*

*Andrew D. Pike, B.A., Swarthmore College; J.D., University of Pennsylvania Law School. *Professor of Law*

Nancy D. Polikoff, B.A., University of Pennsylvania; M.A., George Washington University; J.D., Georgetown University Law Center. *Professor of Law*

Andrew F. Popper, B.A., Baldwin-Wallace College; J.D., DePaul University College of Law; LL.M., George Washington University Law School. *Professor of Law*

Jamin B. Raskin, B.A., Harvard College; J.D., Harvard Law School. *Professor of Law, Director of the Law and Government Program and Director of LL.M. Program in Law and Government*

Jayesh Rathod, A.B., Harvard University; J.D., Columbia Law School. *Assistant Professor of Law*

Paul R. Rice, B.B.A., Marshall University; J.D., West Virginia University College of Law; LL.M., Yale Law School. *Professor of Law*

Song Richardson, B.A., Harvard University; J.D., Yale Law School. *Associate Professor of Law*

Ira P. Robbins, A.B., University of Pennsylvania; J.D., Harvard Law School. *Professor of Law and Justice, Director of the J.D./M.S. Dual Degree Program in Law and Justice, and Barnard T. Welsh Scholar*

Jenny Roberts, B.A., Yale University; J.D., New York University School of Law. *Associate Professor of Law*

Ezra Rosser, B.A., Yale University; J.D., Harvard Law School; M. Phil, University of Cambridge. *Associate Professor of Law*

Herman Schwartz, A.B., Harvard University; J.D., Harvard Law School. *Professor of Law*

Ann C. Shalleck, A.B., Bryn Mawr College; J.D., Harvard Law School. *Professor of Law, Director of the Women and the Law Program, and Carrington Shields Scholar*

*Mary Siegel, B.A., Vassar College; J.D., Yale Law School. *Professor of Law*

Brenda V. Smith, B.A., Spelman College; J.D., Georgetown Law Center. *Professor of Law*

*David Snyder, B.A., Yale University; J.D., Tulane Law School. *Professor of Law and Director of Business Programs*

Michael Tigar, B.A., J.D., University of California at Berkeley. *Professor of Law Emeritus*

Robert L. Tsai, B.A., University of California at Los Angeles; J.D., Yale Law School. *Professor of Law*

Anthony E. Varona, A.B., J.D., Boston College; LL.M., Georgetown Law Center. *Professor of Law and Associate Dean for Faculty and Academic Affairs*

Robert G. Vaughn, B.A., J.D., University of Oklahoma; LL.M., Harvard Law School. *Professor of Law and A. Allen King Scholar*

Stephen I. Vladeck, B.A., Amherst College; J.D., Yale Law School. *Professor of Law*

Perry Wallace, Jr., B.S., Vanderbilt University; J.D., Columbia Law School. *Professor of Law and Director of the J.D./M.B.A. Dual Degree Program*

Lindsay Wiley, B.A., J.D., Harvard University; M.H.P., John Hopkins University. *Assistant Professor of Law*

Paul R. Williams, A.B., University of California at Davis; J.D., Stanford Law School; Ph.D., University of Cambridge. *Professor of Law and Director of the J.D./M.A. Dual Degree Program*

Richard J. Wilson, B.A., DePauw University; J.D., University of Illinois College of Law. *Professor of Law and Director of the International Human Rights Law Clinic*

Law Library Administration

Christine Dulaney, B.A., State University of New York at Buffalo; M.A., University of Virginia; M.L.S., University of Chicago. *Associate Law Librarian*

John Q. Heywood, B.S., Northern Arizona University; J.D., American University, Washington College of Law. *Associate Law Librarian*

*Billie Jo Kaufman, B.S., M.S., University of Indiana at Bloomington; J.D., Nova Southeastern University, Shepard Broad Law Center. *Professor of Law and Associate Dean of Library and Information Resources*

Susan Lewis-Somers, B.A., University of California at Los Angeles; J.D., Southwestern Law School; M.Lbr., University of Washington. *Law Librarian*

Sima Mirkin, B.S.C., Byelorussian Polytechnic Institute, Minsk, Belarus; M.L.S., University of Maryland. *Assistant Law Librarian*

Adeen Postar, B.A., J.D. Washington University; M.L.S., The Catholic University of America. *Associate Law Librarian*

William T. Ryan, B.A., Boston University; J.D., American University, Washington College of Law; M.L.S., University of Maryland. *Law Librarian*

John A. Smith, B.A., St. Michaels College; M.S.L.S., The Catholic University of America. *Assistant Law Librarian*

Ripple L. Weistling, B.A., Brandeis University; M.A., King's College (London); J.D., Georgetown Law Center; M.S.L.S., The Catholic University of America. *Assistant Law Librarian*

Emeriti

Egon Guttman, LL.B., LL.M., University of London. *Professor of Law and Levitt Memorial Trust Scholar Emeritus*

Anthony Morella, A.B., Boston University; J.D., American University, Washington College of Law. *Professor of Law Emeritus*

Michael E. Tigar, B.A., J.D., University of California at Berkeley School of Law. *Professor of Law Emeritus*

Special Faculty Appointments

Nancy S. Abramowitz, A.B., Cornell University; J.D., Georgetown Law Center. *Professor of Practice of Law, Director of Janet R. Spragens Federal Tax Clinic*

David Baluarte, B.A., Brown University; J.D., American University, Washington College of Law. *Practitioner in Residence*

Elizabeth Beske, A.B., Princeton University; J.D., Columbia Law School. *Legal Writing Instructor*

Elizabeth Boals, B.S., Virginia Polytechnic Institute and State University; J.D., George Mason University School of Law. *Associate Director of the Trial Practice Program*

Yael Cannon, B.A., University of Maryland; J.D., Stanford Law School. *Practitioner in Residence*

Shelly Cole, B.H.S., University of Louisville; J.D., University of Texas School of Law; LL.M, New York University School of Law. *Practitioner in Residence*

Llezlie Green Coleman, B.A., Dartmouth College; J.D., Columbia Law School. *Practitioner in Residence*

Jorge Contreras, B.A., B.S.E.E., Rice University; J.D., Harvard Law School. *Practitioner in Residence*

Gary Edles, B.A., Queens College, City University of New York; J.D., New York University School of Law; LL.M., S.J.D., George Washington University Law School. *Fellow in Administrative Law*

Paul Figley, B.A., Franklin & Marshall College; J.D., Southern Methodist University School of Law. *Legal Writing Instructor*

Horacio Grigera Naon, J.D., LL.D., School of Law of the University of Buenos Aires; LL.M., S.J.D., Harvard Law School. *Professor of Practice of Law*

Nabila Isa-Odidi, B.S., University of Toronto; J.D., American University, Washington College of Law. *Practitioner in Residence*

Elizabeth A. Keith, B.A., University of North Carolina at Chapel Hill; J.D., George Mason University School of Law. *Legal Writing Instructor*

Elizabeth Keyes, B.A., Carlton College; M.P.A., Princeton University; J.D., Georgetown Law Center. *Practitioner in Residence*

Daniela Kraiem, B.A., University of California at Santa Barbara; J.D., University of California at Davis School of Law. *Associate Director of the Women and the Law Program*

Jerome I. Levinson, B.A., Harvard University; LL.B., Harvard Law School. *Distinguished Lawyer in Residence*

Jeffery S. Lubbers, A.B., Cornell University; J.D., University of Chicago Law School. *Professor of Practice in Administrative Law*

Daniel Marcus, B.A., Brandeis University; LL.B., Yale Law School. *Fellow in Law and Government*

Claudia Martin, Law Degree, Universidad de Buenos Aires; LL.M., American University, Washington College of Law. *Professorial Lecturer in Residence (2004-2005)*

Juan Mendez, Law Degree, Stella Maris Catholic University. *Visiting Professor of Law*

Carl Monk, B.A., Oklahoma State University; J.D., Howard University School of Law. *Visiting Professor of Law*

Amy Myers, B.A., University of the South; J.D., University of Michigan Law School. *Practitioner in Residence*

Victoria Phillips, B.A., Smith College; J.D., American University, Washington College of Law. *Professor of Practice of Law and Director of the Glushko-Samuelson Intellectual Property Law Clinic*

Heather E. Ridenour, B.B.A., Texas Women's University; J.D., Texas Wesleyan School of Law. *Director of Academic Support and Legal Writing Instructor*

Diego Rodriguez-Pinzon, Law Degree, Universidad de los Andes; LL.M., American University, Washington College of Law; S.J.D., George Washington University Law School. *Professorial Lecturer in Residence.*

Macarena Saez, Law Degree, University of Chile School of Law; LL.M., Yale Law School. *Practitioner in Residence and Fellow in ILSP*

William Snape, B.A., University of California at Los Angeles; J.D., George Washington University Law School. *Fellow in Environmental Law*

David H. Spratt, B.A., College of William and Mary; J.D., American University, Washington College of Law. *Legal Writing Instructor*

Glen Staszewski, B.A., University of Wisconsin; J.D., Vanderbilt University Law School. *Visiting Associate Professor of Law*

Andrew Taslitz, B.A., Queens College, City University of New York; J.D., University of Pennsylvania Law School. *Visiting Professor of Law*

Richard Ugelow, B.A., Hobart College; J.D., American University, Washington College of Law; LL.M., Georgetown Law Center. *Practitioner in Residence*

Rangeley Wallace, J.D., American University, Washington College of Law; LL.M., Georgetown Law Center. *Practitioner in Residence*

Stephen Wermiel, A.B., Tufts University; J.D., American University, Washington College of Law. *Fellow in Law and Government*

Sofia Yakren, B.A., J.D., Yale University. *Practitioner in Residence*

William R. Yeomans, B.A., Trinity College; J.D., Boston University Law School; LL.M., Harvard Law School. *Fellow in Law and Government*

**Business Law Review* Faculty Advisory Committee

AMERICAN UNIVERSITY BUSINESS LAW REVIEW

Volume 1 · 2011-2012 · Issue 1

TABLE OF CONTENTS

2011 AMERICAN UNIVERSITY BUSINESS LAW REVIEW SYMPOSIUM: LAW, FINANCE AND LEGITIMACY AFTER FINANCIAL REFORM
WASHINGTON, D.C.; APRIL 8, 2011

KEYNOTE ADDRESS

2011 AMERICAN UNIVERSITY BUSINESS LAW REVIEW SYMPOSIUM: LAW, FINANCE AND LEGITIMACY AFTER FINANCIAL REFORM*

"FINANCIAL REFORM AND THE CAUSES OF THE FINANCIAL CRISIS"

BROOKSLEY BORN†

I congratulate the American University Business Law Review in holding this symposium on the important subject of financial regulatory reform. The recent financial crisis and the economic crisis that has followed it have demonstrated how vital financial regulatory reform is to the welfare of the American people.

These crises have been devastating. Trillions of taxpayer dollars have been spent to rescue large financial institutions and to support the financial system. Millions of Americans are out of work, cannot find full-time work or have given up looking for work. About 4 million families have lost their homes to foreclosure, and another 4.5 million are in the foreclosure process or are seriously behind on their mortgage payments. Nearly $11 trillion in household wealth has vanished, with retirement accounts and life savings swept away.

---

*Symposium was held at the American University Washington College of Law in Washington, D.C. on April 8, 2011.

†Brooksley Born was a Commissioner on the Financial Crisis Inquiry Commission from mid-2009 until February 2011. She is a retired partner of Arnold & Porter LLP and served as Chairperson of the Commodity Futures Trading Commission, the federal independent regulatory agency for futures and options, from 1996 to 1999. In that role she warned about the dangers of unregulated derivatives.

We all need answers to why these crises occurred. Unless we find those answers and respond appropriately to what we learn, the country and the global economy may well face recurrent crises.

I recently served as a Commissioner on the Financial Crisis Inquiry Commission, which was created by statute in 2009 to examine the causes of the financial and economic crisis in the United States and to report to the President, Congress and the American people on those causes.[1] The Commission issued its report on January 27, 2011 after 18 months of investigation, including 19 days of public hearings, interviews with about 700 persons and review of millions of pages of documents. We found that profound failures in financial regulation and supervision along with failures of corporate governance and risk management at major financial firms were the prime causes of the financial crisis.

Let me outline for you our major conclusions.[2]

First, the Commission concluded that the financial crisis was avoidable. It was the result of human failures, mistakes and reckless behavior. Even though we heard a great deal of testimony by senior regulatory officials and executives of financial services firms that the crisis could not have been foreseen, we found that there were clear warning signs that were ignored or discounted. Among other things, there was an explosion in risky subprime lending and securitization, an unsustainable rise in housing prices, widespread reports of egregious and predatory lending practices, dramatic increases in household mortgage debt, and exponential growth in financial firms' trading activities, in unregulated derivatives trading, and in short-term lending markets.

The Commission concluded that widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. Policymakers and regulators failed in their responsibilities to protect the public in large part because of a widely accepted belief in the self-regulating nature of financial markets and the ability of financial firms to police themselves. Former Federal Reserve Board Chairman Alan Greenspan championed deregulation and was joined by policy makers in successive Presidential Administrations and successive Congresses in supporting widespread deregulation of financial markets and institutions. As a result, gaps in government oversight of key parts of the financial system were created, including the enormous shadow banking system and the over-the-counter derivatives market. Moreover, supervision of financial firms was weakened, and firms were able in many cases to

---

[1] Fraud Enforcement and Recovery Act of 2009, Section 5, Public Law 111-21, 123 Stat. 1617 (May 20, 2009).

[2] *See* Financial Crisis Inquiry Report, pp. xv-xxviii (Jan. 27, 2011).

select among supervisors, leading to a regulatory race to the bottom. The financial sector effectively pressed for this deregulation, spending almost $4 billion in federal lobbying expenses and campaign contributions in the decade leading up to the crisis.

The Commission concluded that dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of the crisis. Too many of these firms acted recklessly, taking on too much risk with too little capital and too much dependence on short-term funding. The largest investment banks and bank holding companies focused increasingly on risky trading activities. Many of these companies took on enormous exposures by acquiring or supporting subprime lenders and creating and selling trillions of dollars in mortgage related securities. Firms expanded in ways that left them too big to manage as well as too big to fail. They placed undue reliance on mathematical risk models, and their compensation systems imprudently rewarded short-term gain and ignored potential downside risks.

The Commission concluded that a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis. Financial firms and American households borrowed too much and left themselves susceptible to financial distress if the value of their investments declined even modestly. National mortgage debt almost doubled in the six years leading up to the crisis. The five major investment banks in the U.S. had leverage ratios in 2007 as high as 40 to 1. They also relied heavily on short-term borrowing in the overnight repo market, which dried up during the crisis. The two enormous government-sponsored enterprises, Fannie Mae and Freddie Mac, had combined leverage ratios of 75 to 1. Moreover, many systemically important firms took on large positions in risky mortgage loans and securities. With the growth of the shadow banking system to a size rivaling the traditional banking system, large portions of the financial system were opaque, including the repo lending market, off balance sheet entities, and the over-the-counter derivatives market. When the housing bubble burst, the lack of transparency, extraordinary debt levels and risky assets created large losses and panic.

The Commission also concluded that the government was ill-prepared for the crisis and that its inconsistent response added to the uncertainty and panic in the financial markets. The Treasury Department, the Federal Reserve Board, and the Federal Reserve Bank of New York were caught off-guard as the events of 2007 and 2008 unfolded. The lack of transparency in key markets meant that they did not have a clear grasp of the financial system in all its complexity and interrelationships. They believed, for example, that securitization of mortgage assets and the use of over-the-counter derivatives had resulted in safely spreading risk when in

fact risk had become dangerously concentrated in systemically important financial institutions. Senior public officials did not recognize that the bursting of the housing bubble could threaten the entire financial system. They also had little or no information about the interconnections among firms via the over-the-counter derivatives market. The inconsistency of the government decisions to rescue Bear Stearns and to place Fannie Mae and Freddie Mac into conservatorship, followed by the decisions to let Lehman Brothers collapse into bankruptcy and then to bail out AIG, stoked uncertainty and panic in the markets and exacerbated the financial crisis.

The Commission also concluded that there was a systemic breakdown in accountability and ethics. Examples include borrowers who defaulted on their mortgages so rapidly after taking out a loan that it appeared that they never had the capacity or intention to pay. Mortgage brokers worked with lenders to put many qualified borrowers into higher-cost loans so brokers would reap bigger fees. Subprime lenders wrote loans that they knew the borrowers could not afford. Major financial institutions securitized such toxic loans and sold them to investors without full disclosure of the poor quality of the loans. The Commission placed special responsibility for these failures on public policy makers charged with protecting the financial system, those entrusted to run the regulatory agencies, and the chief executives of companies whose failures drove us to the crisis.

The Commission examined certain components of the financial system that it concluded had contributed significantly to the financial meltdown. For example, it found that collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis. Many mortgage lenders became so eager to originate loans that they took borrowers' qualifications on faith, often willfully disregarding the borrowers' inability to pay. The Federal Reserve Board was aware of this increase in irresponsible lending, including predatory and fraudulent practices, but failed to exercise its statutory responsibility to restrict such behavior. The securitization process led lenders and securitizers to believe that they were able to pass the risk of these toxic mortgages to investors in mortgage-backed securities and collateralized debt obligations or CDOs. However, the financial crisis revealed that in fact a number of systemically important institutions remained significantly exposed to them and were brought to the brink of failure with the collapse of the housing bubble.

The Commission concluded that over-the-counter or OTC derivatives contributed significantly to this crisis. After being fully deregulated by federal statute in 2000, the OTC derivatives market grew exponentially to almost $673 trillion in notional amount on the eve of the crisis in June 2008. This unregulated market was characterized by uncontrolled leverage, lack of transparency, lack of capital and margin requirements, rampant speculation, interconnections among firms, and concentration of risk in

systemically important institutions. Derivatives known as credit default swaps fueled the securitization frenzy by encouraging investors in mortgage-related securities to believe they were protected against default. Credit default swaps were also used to create synthetic CDOs, which were merely bets on real mortgage securities. Such bets significantly amplified the losses from the collapse of the housing bubble. Insurance giant AIG's sale of credit default swaps without adequate capital reserves brought it to the brink of failure and necessitated its rescue by the government, which ultimately committed more than $180 billion because of concerns that AIG's collapse would trigger cascading losses throughout the financial system. In addition, the existence of millions of OTC derivative contracts of all types created interconnections among a vast web of financial institutions through counterparty credit risk, exposing the system to contagion and helping to precipitate the massive government bailouts.

The Commission also concluded that the failures of credit rating agencies were essential cogs in the wheel of financial destruction. Without the high ratings issued by credit rating agencies, the mortgage-related securities at the heart of the crisis could not have been marketed and sold in such vast quantities. The credit rating agencies issued top ratings to tens of thousands of mortgage securities, which reassured investors and allowed the market to soar. Then they downgraded them, wreaking havoc across markets and firms. These rating failures resulted from pressure by the securities issuers that paid for the ratings, the use of flawed computer models, the desire to increase or maintain market share and the absence of meaningful government oversight.

* * *

We must ask ourselves whether financial regulatory reform has effectively addressed the problems that the Financial Crisis Inquiry Commission has reported. As the Commission found, some problems, such as concentration in the financial sector, have gotten even worse since the crisis. As a result of the government rescues and consolidations of our largest financial institutions through failures and mergers during the crisis, we have a few even larger firms which are too big and too interconnected to fail and which may well also be too big to manage and too big to supervise or regulate.

The financial regulatory reforms contained in the Dodd-Frank Act[3] passed last year certainly are a step in the right direction in addressing this and other problems. However, the Act's provisions must be fully implemented by the adoption of regulations and must be fully enforced if the Act is to be effective.

---

[3] Public Law 111-203, 124 Stat. 1376 (July 21, 2010).

There is now a concerted effort by some large financial institutions and their trade associations to prevent full implementation and enforcement. Alan Greenspan is warning about dire consequences of some provisions of the Act.[4] Bills are pending in Congress that would repeal or weaken the Act. Efforts to persuade agencies to issue watered down regulations or otherwise fail to fully implement provisions of the Act are underway. Moreover, Congressional threats to cut the funding of key regulators imperil regulatory reform. For example, the SEC and the CFTC, the agencies with responsibility to impose needed regulation on the over-the-counter derivatives market, are threatened with cuts that would significantly impair their operations.

The political power of the financial sector is still enormous, but our policy makers must have the political will to resist these efforts to derail regulatory reform. If they do not learn from the financial crisis and insist on regulatory reforms addressing its causes, we all will be doomed to repeated financial crises. The American people deserve better, and I urge readers to consider how they can contribute to the country's adoption of truly effective financial regulatory reform.

---

[4] Alan Greenspan, *Dodd-Frank fails to meet test of our times*, FINANCIAL TIMES.COM (March 29, 2011, 06:31 PM) http://www.ft.com/cms/s/0/14662fd8-5a28-11e0-86d3-00144feab49a.html.

ARTICLES

TRANSPARENCY IS THE NEW OPACITY: CONSTRUCTING FINANCIAL REGULATION AFTER THE CRISIS

CAROLINE BRADLEY†

Many of the main actors constructing financial regulation in the wake of the global financial crisis era have a stated commitment to transparency. However, transparency in financial regulation is undermined because the information disclosed is simultaneously limited and excessive. On one hand, the communications are limited: transnational standard-setters publish their documents in a small number of languages (or only in English). Some institutions publish the full text of responses to consultations whereas others collate and condense responses (sometimes in ways that the responders regard as inaccurate). The characteristics of the bodies which respond to consultations, and their relationships with those whose interests they claim to represent may be visible or hidden.

On the other hand, the communications are overwhelming. Even partial transparency is of limited usefulness to observers of financial regulation because it is characterized by multiple complexities: financial transactions and the rules which apply to them are complex. Responsibility for financial regulation is shared among public and private bodies, and among transnational, national and sub-national entities. As a result, proposals for new rules and standards multiply among these different entities, creating an information glut.

The inadequacy of transparency mechanisms can be remedied, for example, by translating proposals into more languages or by providing and requiring improved disclosure of responses and responders. But the opacity which results from complexity is much more difficult to remedy and more fundamental. If this problem cannot be solved, transparency

---

†Professor of Law, University of Miami School of Law, PO Box 248087, Coral Gables, FL, 33124, cbradley@law.miami.edu; http://blenderlaw.umlaw.net/.

alone cannot be relied on to legitimate the new financial order.

INTRODUCTION

In this article I focus on the development of standards of financial regulation,[1] and argue that transparency in financial regulation is undermined because the information disclosed is simultaneously limited and excessive. Transparency is limited because policy-makers who develop the rules of financial regulation could do much more than they do to publicize their work. Transparency is excessive because financial regulation is complex, intersectional, multilayered, and transnational:[2] more disclosure to more people in more effective forms about more proposals for new rules and standards adds to an information glut and undermines the ability of citizens to understand what is happening.

Transparency, conceived of as a desirable feature of government, is not new. [3] Brandeis noted in 1914 that sunlight was the best disinfectant,[4] and Florida is the sunshine state not only as a matter of meteorology but also because of its commitment to shining light on the workings of government.[5] But although policies to promote transparency are not

---

[1] Thus I am focusing essentially on transparency with respect to the process by which standards and rules are generated. This ignores other issues of transparency with respect to financial regulation, such as transparency with respect to compliance and enforcement, and to the costs of the regulatory system; transparency about what the rules require (legal certainty), and the idea that many rules of financial regulation involve requirements of transparency. *See, e.g.*, Christine Kaufmann & Rolf H. Weber, *The Role of Transparency in Financial Regulation*, 13 J. INT'L ECON. L. 779 (2010).

[2] *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-216, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM (2009) (noting the complexity of financial regulations). *Cf.* Sheila Jasanoff, *Transparency in Public Science: Purposes, Reasons, Limits*, 69 L. & CONTEMP. PROBS. 21, 24 (2006) ("[M]odern societies' increasing dependence on science has proceeded hand in hand with developments that disable most citizens, even the most technically expert, from effectively addressing the larger set of questions: Is it good science; what is it good for; and is it good enough? Science has not only become infused with multiple social and political interests; it is also in danger of escaping effective critical control. Too often scientific knowledge seems to be 'sequestered,' concealed from those who could benefit from it or who could comment meaningfully on its quality and relevance.").

[3] *See, e.g.*, Christopher Hood, *Accountability and Transparency: Siamese Twins, Matching Parts or Awkward Couple?* 33 W. EUR. POL. 989 (2010) (explaining the relationship between accountability and transparency).

[4] Louis D. Brandeis, OTHER PEOPLES' MONEY: AND HOW THE BANKERS USE IT, 92 (1914) ("Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

[5] *See, e.g.*, Mary K. Kraemer, *Exemptions to the Sunshine Law and the Public Records Law: Have They Impaired Open Government in Florida*, 8 FLA. ST. U. L. REV. 265, 266-7 (1980) (describing the enactment of the Sunshine Law in 1967). Florida has had a Public Records Law since 1909. *See, e.g.*, R.D. Woodson & Ricki Lewis Tannen,

entirely novel,[6] they are becoming more pervasive, more extensive, and even more controversial than in the past.[7] Technological development encourages new modes of transparency as governments make more information available online via databases,[8] web pages,[9] and blogs.[10] Governments promote transparency through commitments to access to information,[11] and to consultation about policy.[12] International organizations encourage states to adopt policies of transparency[13] as an

---

Federal Constitutional Privacy and the Florida Public Records Law: Resolving the Conflict 33 U. FLA. L. REV. 313, 328 (1981) (noting that the Florida statute of 1909 was one of the first in the country).

[6] *See, e.g.*, Juliet Lodge, *Transparency and Democratic Legitimacy* 32 J. COMMON MKT. STUDS. 330 (1994) (discussing transparency and democracy in the EU).

[7] *E.g.*, Jeannine E. Relly & Meghna Sabharwal, *Perceptions of Transparency of Government Policymaking: A Cross-national Study*, 26 GOV'T INFO. Q. 148, 149 (2009) (noting increasing adoption of access to information laws over the preceding decade); *see, e.g.*, *EU Struggles with Being Open about Transparency*, EURACTIV, (Mar. 24, 2011) http://www.euractiv.com/en/pa/eu-struggles-open-transparency-news-503484 (noting controversy); *cf.* Mark Fenster, *The Opacity of Transparency*, 91 IOWA L. REV. 885 (2006).

[8] For examples of such databases see LEGISLATION.GOV.UK, http://www.legislation.gov.uk (last visited Aug. 21, 2011) and EUR-LEX, http://eur-lex.europa.eu/en/index.htm (last visited Aug. 21, 2011). *See also, e.g.*, DATA.GOV.UK: OPENING UP GOVERNMENT, http://data.gov.uk (last visited Aug. 21, 2011); *cf.* CABINET OFFICE, *Government ICT Strategy*, 6 (Mar. 2011) *available at* http://www.cabinetoffice.gov.uk/sites/default/files/resources/uk-government-government-ict-strategy_0.pdf ("Information and communications technology (ICT) is critical for the effective operation of government and the delivery of the services it provides to citizens and businesses. It offers key benefits by enabling: access to online transactional services, which makes life simpler and more convenient for citizens and businesses; and channels to collaborate and share information with citizens and business, which in turn enable the innovation of new online tools and services.").

[9] Government departments and agencies have their own web pages. *E.g.*, USA.GOV: THE U.S. GOVERNMENT'S OFFICIAL WEB PORTAL, http://www.usa.gov/ (last visited Aug. 21, 2011); DIRECTGOV: PUBLIC SERVICES ALL IN ONE PLACE, http://www.direct.gov.uk/en/index.htm (last visited Aug. 21, 2011); REGIERUNONLINE, http://www.bundesregierung.de/Webs/Breg/EN/Homepage/home.html (last visited Aug. 21, 2011) (official website of the German Government).

[10] *See, e.g.*, THE WHITE HOUSE BLOG, http://www.whitehouse.gov/blog (last visited Aug. 21, 2011).

[11] *E.g.*, Ben Worthy, *More Open but Not More Trusted? The Effect of the Freedom of Information Act 2000 on the United Kingdom Central Government*, 23 GOVERNANCE 561, 564 (2010) (noting increasing transparency as part of the motivation for the UK's Freedom of Information Act).

[12] *See, e.g.*, Caroline Bradley, *Consultation and Legitimacy in Transnational Standard-Setting*, 20 MINN. J. INTL. L. 480, 490-1 (2011) (describing consultation as a component of Governmental policy-making which combines ideas of transparency and citizen involvement).

[13] Whether the idea of transparency has any universal meaning is a complex question. *Cf.* Mark Bevir, *Public Administration as Storytelling*, 89 PUB. ADMIN. 183, 188 (2011) ("Our beliefs, concepts, actions, and practices are products of particular traditions or discourses. Social concepts (and social objects), such as 'bureaucracy' or 'democracy',

aspect of good government,[14] and adopt policies of transparency with respect to their own activities as a way of enhancing their own legitimacy.[15] Courts approve of administrative transparency.[16] Private sector organizations from Wikileaks to foundations[17] to newspapers[18] and individuals[19] also contribute to transparency of public sector actions.

---

do not have intrinsic properties and objective boundaries. They are artificial inventions of particular languages and societies. Their content varies with the wider webs of belief in which they are situated.").

[14] *See, e.g.*, ORG. FOR ECON. CO-OPERATION AND DEV., RECOMMENDATION OF THE COUNCIL ON IMPROVING THE QUALITY OF GOVERNMENT REGULATION C(95)21/FINAL 9 (Mar. 9, 1995), *available at* http://acts.oecd.org/Instruments/ShowInstrumentView.aspx?InstrumentID=128&InstrumentPID=124&Lang=en&Book=False ("These questions reflect principles of good decision-making that are used in OECD countries to improve the effectiveness and efficiency of government regulation by upgrading the legal and factual basis for regulations, clarifying options, assisting officials in reaching better decisions, establishing more orderly and predictable decision processes, identifying existing regulations that are outdated or unnecessary, and making government actions more transparent.").

[15] *See, e.g.*, IMF, TRANSPARENCY IS KEY TO ACCOUNTABILITY (Jan. 11, 2010), *available at* http://www.imf.org/external/np/exr/cs/news/2010/cso110.htm ("Greater transparency in the IMF's policies and decisions makes it more accountable to the people and governments at the center of its work, the organization concluded after a policy review"); IMF, *Review of the Fund's Transparency Policy—Background* (Oct. 27, 2009), *available at* http://www.imf.org/external/np/pp/eng/2009/102609a.pdf (reporting on the IMF's outreach to external stakeholders and analyzing the IMF's transparency policy); Interinstitutional Agreements: Agreement Between the European Parliament and the European Commission on the Establishment of a Transparency Register for Organisations and Self-employed Individuals Engaged in EU Policy-Making and Policy Implementation, 2011 OJ (L 191) 29-32 (Jul. 22, 2011) (establishing a Transparency Register for the registration and monitoring of organizations and individuals engaged in EU policy-making and implementation).

[16] *See, e.g.*, Hazelhurst v. Solicitors Regulation Authority [2011] EWHC (Admin) 462, [38] ("It is of note that the SDT has not published Indicative Sanctions Guidance. Such guidance identifies the purpose, parameters and range of sanctions. It permits those who appear before it to better understand the proceedings and the thinking of the SDT. It assists the transparency of the proceedings. Such guidance has been used by other regulatory bodies for some years and is a valuable reference point both for the tribunal and for those who appear in front of it, as practitioners or advocates.").

[17] For an example of such a foundation, see SUNLIGHT FOUNDATION, http://sunlightfoundation.com/ (last visited Aug. 18, 2011).

[18] Consider, for example the Guardian's use of crowd-sourcing with respect to data on MP expense claims. *E.g.*, Michael Andersen, *Four Crowdsourcing Lessons from the Guardian's (Spectacular) Expenses-Scandal Experiment*, NIEMAN JOURNALISM LAB (Jun. 23, 2009), http://www.niemanlab.org/2009/06/four-crowdsourcing-lessons-from-the-guardians-spectacular-expenses-scandal-experiment/print; Simon Rogers, *How to Crowdsource MPs' Expenses*, THE GUARDIAN (Jun. 18, 2009, 3:34 PM) http://www.guardian.co.uk/news/datablog/2009/jun/18/mps-expenses-houseofcommons.

[19] *See, e.g.*, *About*, OPENREGS, http://openregs.com/about (last visited August 20, 2011) ("OpenRegs.com is an alternative to the federal government's Regulations.gov regulatory dockets database. That site can be confusing and difficult to use for average citizens and experts alike. The goal of OpenRegs.com is to make the proposed and final

During the financial crisis market participants discovered that governmental decisions about whether or not to rescue financial institutions in trouble were unpredictable. For example, commentators have criticized decisions of the US Government in September 2008 as undermining confidence in the financial markets.[20] Whereas the US Government allowed Lehman Brothers to go into Chapter 11,[21] it rescued AIG.[22] Opaque financial transactions contributed to the market participants' lack of confidence in their ability to value assets.[23] Apparent transfers of risk

---

regulations published in the Federal Register easy to find and discuss, so that citizens can become better informed and more involved in the regulatory process.").

[20] *See, e.g.*, U.S. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, xxi (2011), *available at* http://www.gpoaccess.gov/fcic/fcic.pdf ("[T]he government's inconsistent handling of major financial institutions during the crisis—the decision to rescue Bear Stearns and then to place Fannie Mae and Freddie Mac into conservatorship, followed by its decision not to save Lehman Brothers and then to save AIG—increased uncertainty and panic in the market."); Fin. Stability Bd., *Consultative Document: Effective Resolution of Systemically Important Financial Institutions*, 7 (Jul. 19, 2011) *available at* http://www.financialstabilityboard.org/publications/r_110719.pdf ("The disorderly collapse of Lehman Brothers in September 2008 provided a sharp and painful lesson of the costs to the financial system and the global economy of the absence of powers and tools for dealing with the failure of a SIFI. Lehman Brothers was the last SIFI allowed to fail during the last financial crisis. All other SIFIs at risk were supported by public capital injections, asset or liability guarantees, or exceptional liquidity measures undertaken by central banks. While this was necessary for economic and financial stability reasons, public bail-outs placed taxpayer funds at unacceptable risks and has increased moral hazard in a very significant way.").

[21] *See, e.g.*, David Zaring, *Administration by Treasury*, 95 MINN. L. REV.187, 187 (2010) ("Treasury . . . issued death sentences against other financial institutions, including Lehman Brothers and Washington Mutual . . . .").

[22] *See, e.g.*, CONG. OVERSIGHT PANEL, THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY, 195 (Jun. 10, 2010) ("By providing a complete bailout that called for no shared sacrifice among AIG and its creditors, FRBNY and Treasury fundamentally changed the rules of America's financial marketplace.").

[23] *E.g.*, Int'l Monetary Fund, Global Financial Stability Report: Sovereigns, Funding, and Systemic Liquidity, at 59 (Oct. 2010), *available at* http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/text.pdf (stating that the "complex and opaque nature of securitized products made valuation difficult"); *see e.g.*, Fin. Stability Bd., *Thematic Review on Risk Disclosure Practices: Peer Review Report*, at 2 (Mar. 18, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110318.pdf ("The financial crisis highlighted that reliable and relevant valuations and disclosures of the risks to which financial institutions are exposed are important to maintain overall market confidence. High quality risk disclosures contribute to financial stability by providing investors and other market participants with a better understanding of firms' risk exposures and risk management practices."); *cf.* TREASURY COMMITTEE, FINANCIAL STABILITY AND TRANSPARENCY, 2007-8, H.C. 371, at 3 (U.K.) *available at* http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/371/371.pdf ("It is clear that the search for yield and short–termism encouraged many investors to invest in high–yielding and increasingly complex products that it turns out they did not always fully understand.").

turned out not to be real.[24]

As a result, many changes and proposed changes to rules of financial regulation in the wake of the crisis have sought to improve transparency.[25] For example, new rules require credit rating agencies to disclose characteristics of the models they use in developing ratings.[26] Policy-makers have focused on establishing banking regimes that will allow banks to fail, improving market discipline, and reducing moral hazard.[27]

Many of the main actors constructing financial regulation in the wake of the global financial crisis era have stated commitments to transparency. The members of the Financial Stability Board (FSB) agreed to subject themselves to peer reviews of their implementation of transnational standards of financial regulation,[28] and the FSB publishes the reviews.[29]

---

[24] *See, e.g.* INT'L MONETARY FUND, *Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness*, at xii (April 2008), *available at* http://www.imf.org/external/pubs/ft/gfsr/2008/01/pdf/text.pdf ("[A] surprising amount of risk has returned to the banking system from where it was allegedly dispersed.").

[25] *See* Donald C. Langevoort, *Global Securities Regulation after the Financial Crisis*, 13 J. INT'L ECON. L. 799, 805 (2010) (pointing out that whereas transparency may be critical for securities regulation it may not be so critical for risk regulation, stating "Separation between the domains of securities regulation and substantive risk regulation also has a second, more normative value. Put simply, those two domains are inherently at odds, and whenever combined under one roof, securities regulation tends to lose. Securities regulation is about truth-telling, and under stressful conditions, risk regulators almost always prefer concealing the truth to exposing it. To be sure, it is far from clear that truth-telling is always the right course, but preserving a regulatory capacity that favors transparency is generally preferable to folding it into the risk regulator's task with some vague mandate to value disclosure.").

[26] *See, e.g.*, Council Regulation 1060/2009, art. 8, 2009 O.J. (L 302) 1, 12 (providing that a "credit rating agency shall disclose to the public the methodologies, models and key rating assumptions it uses in its credit rating activities").

[27] *See, e.g.*, *Commission Communication on An EU Framework for Crisis Management in the Financial Sector*, at 2, COM (2010) 579 final (Oct. 20, 2010) *available at* http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf ("Banks must be allowed to fail, like any other business. Authorities must be equipped with tools that enable them to prevent the systemic damage caused by disorderly failure of such institutions, without unnecessarily exposing taxpayer to risk of loss and causing wider economic damage. Alongside tougher regulation reducing the chances of a bank becoming distressed, a credible regime is needed to re-instill market discipline associated with the threat of failure and to reduce moral hazard—the implicit protection from failure that those in the banking sector currently enjoy.").

[28] Fin. Stability Bd., *FSB Framework for Strengthening Adherence to International Standards*, at 1-2 (Jan. 9, 2010), *available at* http://www.financialstabilityboard.org/publications/r_100109a.pdf (stating the commitment of FSB Member States to undergo peer review "to evaluate their adherence to international standards in the regulatory and supervisory area").

[29] For an example of a published peer review see Fin. Stability Bd., *Country Review of Mexico: Peer Review Report* (Sep. 23, 2010) *available at* http://www.financialstabilityboard.org/publications/r_100927.pdf [hereinafter *Mexico Country Review*] and Fin. Stability Bd., *Peer Review of Italy: Review Report* (Jan. 27, 2011) *available at* http://www.financialstabilityboard.org/publications/r_110207b.pdf

The Basel Committee now publishes consultative documents online[30] and has even published some responses to consultation.[31] The White House has adopted a policy of transparency and open government.[32] Open government includes moves to make government datasets, including those relating to spending, more visible.[33] It also involves efforts to make the regulatory process more transparent.[34] Administrative agencies have invited the public to make comments about how they should go about making rules, rather than merely responding to specific regulatory proposals.[35] All of these initiatives are facilitated by developments in information technology.

[hereinafter *Italy Peer Review*].

[30] *See, e.g.*, Basel Committee on Banking Supervision, Press Release, *Pillar 3 Disclosure Requirements on Remuneration - Consultative Document* (Dec. 27, 2010), *available at* http://www.bis.org/publ/bcbs191.htm ("The Basel Committee welcomes comments on this consultative document. Comments should be submitted by Friday, 25 February 2011 by email to: baselcommittee@bis.org. Alternatively, comments may be sent by post to the Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland. All comments may be published on the Bank for International Settlements' website unless a commenter specifically requests confidential treatment.").

[31] *See, e.g.*, Basel Committee on Banking Supervision, *Comments Received on the Consultative Documents "Strengthening the Resilience of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring," available at* http://www.bis.org/publ/bcbs165/cacomments.htm (last visited Aug. 24, 2011) (listing and linking to comments received on consultation documents).

[32] *See, e.g.*, Memorandum for the Heads of Executive Departments and Agencies, Transparency and Open Government, 74 Fed. Reg. 4685 (Jan. 26, 2009) (announcing a new policy of transparency and open government); OFFICE OF MGMT. & BUDGET, EXEC. Office of the President, Memorandum for the Heads of Executive Departments and Agencies, Open Government Directive (Dec. 8, 2009), *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/memoranda_2010/m10-06.pdf (discussing how a move towards e-government, which is a component of open government, antedated the Obama Administration); *see also*, The E-Government Act of 2002, Pub. L. 107-347, 116 Stat. 2899 (2002) (codified at 44 U.S.C. § 3601) (2002)) (promoting the use of electronic government services). *But see*, Daniel Schuman, *Budget Technopocalypse: Proposed Congressional Budgets Slash Funding for Data Transparency*, SUNLIGHT FOUNDATION BLOG (Mar. 23, 2011), http://sunlightfoundation.com/blog/2011/03/23/transparency-technopocalypse-proposed-congressional-budgets-slash-funding-for-data-transparency/ (noting that as of March 2011 future funding for these programs is uncertain).

[33] *See, e.g.*, DATA.GOV, http://www.data.gov/ (last visited Sept. 9, 2011); FOIA.GOV, http://www.foia.gov (last visited Sept. 9, 2011) (providing information about how to acquire more information from the government).

[34] *E.g.*, REGULATIONS.GOV, http://www.regulations.gov/ (last visited Sept. 9, 2011) (facilitating access to and participation in the federal regulatory process).

[35] *See, e.g.*, Press Release, SEC, SEC Chairman Schapiro Announces Open Process for Regulatory Reform Rulemaking (Jul. 27, 2010) http://www.sec.gov/news/press/2010/2010-135.htm ("Under a new process, the public will be able to comment before the agency even proposes its regulatory reform rules and amendments. . . . The new process goes well beyond what is legally required and will provide expanded opportunity for public comment and greater transparency and accountability. The SEC also expects to hold public hearings on selected topics.").

This is a very brief and incomplete description of the ways in which governments and supranational organizations have worked towards transparency. However, it illustrates that transparency is an important element of the way in which policy-making bodies conceive of and describe their roles. Nevertheless, transparency may not achieve effective communication.[36]

FINANCIAL REGULATION AND TRANSPARENCY

In many ways domestic initiatives to reform or adjust financial regulation are transparent in the same way as any other domestic changes in the law. The activities of legislative bodies are visible via the internet[37] and television,[38] and sometimes by video over the internet,[39] and are also reported on by the news media. Regulators publish proposed regulations for public comment.[40] But despite policy-makers' efforts to make information

---

[36] *See, e.g.*, Onora O'Neill, *Ethics for Communication?* 17 EUR. J. PHIL.167, 170 (2009) ("It is all too common for material that is publicly *disclosed* or *disseminated*, thereby achieving transparency, not to be read, heard or seen by any or many audiences; even where it is read, heard or seen, it may not to be grasped or understood by those audiences. Transparency counters secrecy, but it does not ensure communication . . . Sometimes it is even used to maintain secrecy: one effective way to ensure that information is not communicated is not to keep it secret, but to 'release' it with no fanfare.").

[37] *E.g.*, U.S. HOUSE OF REPRESENTATIVES, http://www.house.gov/ (last visited Sept. 9, 2011) (providing access to information about proceedings in the US House of Representatives); U.S. SENATE, http://www.senate.gov/ (last visited Sept. 9, 2011) (providing access to information about proceedings in the US Senate); *State Legislative Websites Directory*, NATIONAL CONFERENCE OF STATE LEGISLATURES, http://www.ncsl.org/?tabid=17173 (last visited Sept. 9, 2011) (providing links to websites of state legislatures in the US); ASSEMBLEE NATIONALE, http://www.assemblee-nationale.fr/index.asp (last visited Sept. 9, 2011) (providing access to information about proceedings in the French Assemblée Nationale); U.K. PARLIAMENT, http://www.parliament.uk/ (last visited Sept. 9, 2011) (providing access to information about proceedings in the UK Parliament).

[38] *See, e.g.*, Timothy E. Cook, *House Members as Newsmakers: The Effects of Televising Congress*, 11 LEGIS. STUD. Q. 203 (1986) (discussing the impact of televising Congress).

[39] *E.g.*, *Parliamentary Television of the German Bundestag*, GERMAN BUNDESTAG, http://www.bundestag.de/htdocs_e/press/tv/index.html (last visited Sept. 9, 2011) (providing access to live and recorded video of proceedings in the German Bundestag); *see* legislative websites cited *supra* note 37 (providing access to live and recorded video of legislative proceedings).

[40] *E.g.*, REGULATIONS.GOV, http://www.regulations.gov/#!aboutProgram (last visited Sept. 9, 2011) (noting that "Federal regulations have been available for public comment for many years, but people used to have to visit a government reading room to provide comments. Today, the public can share opinions from anywhere on Regulations.gov."); *see also, e.g.*, Harold C. Relyea, *The Federal Register: Origins, Formulation, Realization, and Heritage*, 28 GOV'T INFO. Q. 295 (2011) (describing the introduction of the Federal Register); *cf.* Erwin N. Griswold, *Government in Ignorance of the Law – A Plea for Better Publication of Executive Legislation*, 48 HARV. L. REV. 198, 208 (1934) ("[A]part from the United States, it would be very difficult to find a

about what they are doing available to the public, the public is often not well-informed about the law or proposals for its reform.[41]

One reason citizens may be under-informed about law and policy is that some policy issues seem, as a general matter, less salient to them than others. Scandals and crises can increase salience,[42] but many areas of financial regulation are less salient for citizens, even at times of financial scandal or crisis.[43] Policy networks and entrepreneurs influence the development of regulation by taking advantage of opportunities to promote their own preferred policy ideas.[44]

---

nation of importance which does not use some method to make available and accessible a record of the acts of its executive authorities.").

[41] *See, e.g.*, Howard Schuman & Stanley Presser, *Public Opinion and Public Ignorance: The Fine Line Between Attitudes and Nonattitudes*, 85 AM. J. SOC. 1214 (1980) (analyzing people's willingness to express views on issues they do not know about).

[42] *Cf.* Michael D. Jones & Hank C. Jenkins-Smith, *Trans-Subsystem Dynamics: Policy Topography, Mass Opinion, and Policy Change*, 37 POLICY STUD. J. 37, 42 (2009) ("Salience disruption is initiated by large-scale events that focus public attention on specific subsystems (or groups of them) and thereby generates enormous effort, resources, and change in those subsystems, while simultaneously drawing attention and resources away from others.").

[43] For example, in 2010 the Securities and Exchange Commission published proposed rules on an end-user exception to the mandatory clearing of security-based swaps. *See* End-User Exception to Mandatory Clearing of Security Based Swaps, 75 Fed. Reg. 79,992 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240). The SEC received sixteen comments on this proposal. *See Comments on Proposed Rule: End-User Exception to Mandatory Clearing of Security-Based Swaps*, SEC, http://www.sec.gov/comments/s7-43-10/s74310.shtml (last visited Sept. 20, 2011). *But see Debit Interchange Rule Delayed*, WOLTERS KLUWER FIN. REFORM NEWS CTR. (Mar. 31, 2011, 4:11 PM), http://financialreform.wolterskluwerlb.com/2011/03/debit-interchange-rule-delayed.html (noting more than 11,000 comments on a proposed rule).

[44] The corporate governance community promotes changes in governance as a solution to a range of issues. For example, proposals to change banking regulation now include changes to corporate governance requirements for banks. *See, e.g.*, European Commission, *Proposal for a Directive of the Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms and Amending Directive 2002/87/EC of the European Parliament and of the Council on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate*, at 3, COM (2011) 453 final (Jul. 20, 2011) ("The collapse of financial markets in autumn 2008 and the credit crunch that followed can be attributed to multiple, often inter-related, factors at both macro- and micro-economic levels, as identified in the Report of the High-Level Group on Financial Supervision in the EU published on 25 February 2009, and in particular to the accumulation of excessive risk in the financial system. This excessive accumulation of risk was in part due to the weaknesses in corporate governance of financial institutions, especially in banks. Whilst not all banks suffered from systemic weaknesses of governance arrangements, the Basel Committee on Banking Supervision (BCBS) referred to 'a number of corporate governance failures and lapses.'"). *Cf.* Diane Stone, *Private Philanthropy or Policy Transfer? The Transnational Norms of the Open Society Institute*, 38 POL'Y AND POL. 269, 272 (2010) ("[E]lite forms of associational life. . . . professional bodies with substantial financial resources or patronage (and sometimes interlock). . . . are aimed at influencing policy and engaged in transferring

How policy issues are characterized may affect how salient those issues are: issue characterization is key. Policy-makers who characterize issues relating to sub-prime lending as "predatory lending" may engage more citizens in discussions about proposals to change the law than if they used some other more neutral characterization.[45] Narratives help with characterization: different versions of sub-prime lending narratives would suggest different regulatory responses. If the sub-prime lending problems were caused by inadequate risk management at financial firms, the appropriate regulatory solution would focus on encouraging or requiring financial firms to adopt improved risk management strategies and to engage in responsible lending. If the problems were caused by borrowers who enthusiastically took on "liar loans" they could not afford, the appropriate solution would encourage responsible borrowing.[46]

Statutes and regulations are frequently written in very technical language and one way of improving the transparency of law is to write the law, and proposals to change the law, in language citizens are able to understand.[47] Policy-makers may draft plain language regulations and explanatory documents in simple language to improve communication with citizens. But moving from complex technical language to plainer language takes time,[48] and even where explanations of financial rules are expressed in plain language the rules are often complex,[49] and the activities they would

---

experts and policy ideas between countries and professional communities.").

[45] *Cf.* Anne Schneider & Mara Sidney, *What Is Next for Policy Design and Social Construction Theory?*, 37 POL'Y STUD. J. 103, 106 (2009) ("The policy design approach directs scholars to examine who constructs policy issues, and how they do so, such that policy actors and the public accept particular understandings as 'real,' and how constructions of groups, problems and knowledge then manifest themselves and become institutionalized into policy designs, which subsequently reinforce and disseminate these constructions.").

[46] The EU has attempted to compromise with proposals which focus on "irresponsible lending and borrowing." *See Commission Proposal for a Directive on Credit Agreements Relating to Residential Property*, at 2 COM (2011) 142 final (Mar. 31, 2011).

[47] *E.g.*, Plain Writing Act of 2010, 5 U.S.C. § 301 (2006 & Supp. IV 2011); *see, e.g.*, Improving Regulation and Regulatory Review, 76 Fed. Reg. 3821 (Jan. 21, 2011) ("Our regulatory system must . . . ensure that regulations are accessible, consistent, written in plain language, and easy to understand.").

[48] *See* FED. DEPOSIT INS. CORP., PLAIN WRITING IMPLEMENTATION PLAN – JUNE 2011 (2011), http://www.fdic.gov/plainlanguage/implementationplan.html (pointing out that the FDIC published its implementation plan in June 2011).

[49] *See* Andrew G. Haldane, Exec. Dir., Fin. Stability, Bank of England, Speech at the American Economic Association, Denver, Colo.: Capital Discipline (Jan. 9, 2011), *available at* http://www.bankofengland.co.uk/publications/speeches/2011/speech484.pdf (suggesting that simple rules might be appropriate for complex activities, stating "As a thought experiment, imagine instead we were designing a regulatory framework from scratch. Finance is a classic complex, adaptive system. What properties would a

control are also complex. This layering of complexities produces and intensifies opacity.

Financial regulation is increasingly a transnational, rather than a merely domestic, phenomenon. For many years, regulators have worked with their counterparts in other jurisdictions to develop standards for financial regulation.[50] Securities regulators have worked together in the International Organisation of Securities Commissions (IOSCO),[51] insurance supervisors work through the International Association of Insurance Supervisors (IAIS),[52] and central banks and bank regulators form the Basel Committee on Banking Supervision.[53] These groups are essentially collaborative, technocratic networks of regulators with the power to develop recommendations, principles and standards which are not, as a formal matter, legally binding. However, although the principles and standards are not legally binding as such, states whose regulators participate in their articulation may feel obliged to implement them domestically. And states which depend on the IMF's[54] financial resources will be subject to the IMF's examination of their economies, including their bank regulatory systems.[55] The global financial crisis has increased demand for funds from the IMF.[56] The IMF's interest in monitoring the financial soundness of its

---

complex, adaptive system such as finance ideally exhibit to best insure about future crises? Simplicity is one. There is a key lesson, here, from the literature on complex systems. Faced with complexity, the temptation is to seek complex control devices. In fact, complex systems typically call for simple control rules. To do otherwise simply compounds system complexity with control complexity.").

[50] *See, e.g.*, ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER, 36 (2004) (describing regulators as "the new diplomats.").

[51] *The International Organization of Securities Commissions*, OICU-IOSCO, http://www.iosco.org/ (last visited Sept. 9, 2011).

[52] *International Association of Insurance Supervisors*, IAIS, http://www.iaisweb.org (last visited Oct. 28, 2011).

[53] *About BIS*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/index.htm (last visited Sept. 9, 2011).

[54] *See generally*, IMF, *Articles of Agreement of the International Monetary Fund*, http://www.imf.org/external/pubs/ft/aa/index.htm (last visited Sept. 9, 2011) (explaining that the IMF is a treaty-based international organization which was founded in 1944 to govern the international monetary system to assure exchange rate stability and encourage IMF members to do away with exchange restrictions).

[55] *See, e.g.*, Int'l Monetary Fund, *Iceland: Financial System Stability Assessment Update*, IMF Country Report No. 08/368 (Aug. 19, 2008), *available at* http://www.imf.org/external/pubs/ft/scr/2008/cr08368.pdf (evaluating Iceland's financial system including financial supervision and regulation).

[56] *See, e.g.*, Christine Lagarde, Managing Dir., IMF, Speech at the Council on Foreign Relations: Challenges and Opportunities for the World Economy and the IMF (Jul. 26, 2011), *available at* http://www.imf.org/external/np/speeches/2011/072611.htm ("Over the last few years, the IMF's role has grown tremendously. It was an intellectual leader during the crisis, with its early call for coordinated policy stimulus. It has been a flexible financial partner, reforming its lending instruments and making available a record amount of support, totaling about $330 billion. And it is helping build a stronger

members, especially of its borrowers, gives it an interest in regulation as a mechanism for promoting financial stability.[57] In response to criticism, the IMF has recently been working to address some of the concerns about its role by emphasizing transparency as an accountability mechanism.[58]

Transnational standard-setters have incentives to be transparent about their work partly because regulated firms wish to express their views on proposed standards, and partly in order to legitimize their work to critics. Although the Basel Committee has not clearly articulated its views about transparency and consultation, IOSCO has done so. In 2005 IOSCO published a document describing its policies with respect to public consultation.[59] The document described IOSCO's objectives in carrying out public consultations as including benefiting from "the expertise of the international financial community," promoting "understanding of IOSCO's mission as the international standard setter for securities markets" and continuing to increase transparency about IOSCO's work.[60]

The Basel Committee and IOSCO, as networks of regulators, co-operate across territorial boundaries to address systemic problems and to be more effective domestically. But their activities have an impact on the competitiveness of financial firms. Financial firms which are subject to relaxed regulation in their home state may benefit from a competitive advantage with respect to firms based in jurisdictions with more demanding regulatory regimes. Governmental support for financial firms may function as a subsidy. The original Basel Accord which was introduced in 1988 provided for states to impose capital adequacy requirements on international banks, even if those states addressed risks to financial stability in other ways (such as through governmental guarantees). The Accord was agreed to after the US and the UK announced they would apply stringent capital adequacy requirements to foreign banks doing business in their

---

global economy, through its policy advice and technical assistance efforts."). *But cf.* Harold James, *International Order After the Financial Crisis*, 87 INT'L AFFAIRS 525, 535 (2011) ("The China–America dispute has shown the essential helplessness of the IMF, an institution which had been trying desperately to reassert its usefulness in the course of the global financial crisis.").

[57] *See, e.g.*, JOSÉ VIÑALS ET AL., IMF STAFF POSITION NOTE: SHAPING THE NEW FINANCIAL SYSTEM, 6 (2010) *available at* http://www.imf.org/external/pubs/ft/spn/2010/spn1015.pdf ("The IMF, for its part, also has a unique role to play, given its universal membership, its macro-financial mandate, and its well-established roles in the area of bilateral and multilateral surveillance and technical assistance.").

[58] *See, e.g.*, IMF, TRANSPARENCY IS KEY TO ACCOUNTABILITY, *supra* note 15.

[59] Exec. Comm. of the Int'l Org. of Sec. Comm'ns, *IOSCO Consultation Policy and Procedure*, at 2, (2005), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD197.pdf.

[60] *Id.*

jurisdictions.[61]

The story of the genesis of the original Basel Accord illustrates that the interests of private firms have an impact on regulation at the transnational level as well as at the domestic level. The multi-level governance model of regulation focuses on the idea of levels of regulation, but financial regulation involves not just levels of regulation but multiple intersections between different spheres of regulation: intersections between governmental and non-governmental or private spheres; between the spheres of expertise and of politics; and between the domestic and foreign or international spheres. These spheres are interconnected. Governmental authorities work together across territorial borders. There is some overlap between the private sphere and the sphere of expertise, and the market-based sphere of expertise is transnational, rather than being entirely domestic. The intricacies of the interconnections between the different spheres of financial regulation form an additional layer of opacity over the complexities of the markets and transactions which occur on those markets. Thus financial regulation involves complex activities and markets, intricate and diffuse processes for assessing and deciding on rules and standards, and many complicated rules.

Before the crisis, financial firms had considerable success in persuading governments and the networks of regulators to defer to a large extent to the expertise of the private sector. IOSCO said that the "regulatory regime should make appropriate use of Self-Regulatory Organizations."[62] When the crisis hit, the idea of self-regulation seemed suddenly less attractive. For example, in late 2008 Christopher Cox, then Chairman of the SEC, said that it had become "abundantly clear that voluntary regulation does not work."[63] The language of the IOSCO Objectives and Principles was

---

[61] *See e.g.*, Stavros Gadinis, *The Politics of Competition in International Financial Regulation*, 49 HARV. INT'L L. J. 447, 500-503 (2008) (describing the background to the adoption of the 1988 Basel Accord).

[62] Int'l Org. of Sec. Comm'ns, *Objectives and Principles of Securities Regulation*, at 12, (Feb. 2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD265.pdf.

[63] Press Release, Christopher Cox, Chairman, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008) http://www.sec.gov/news/press/2008/2008-230.htm. *Compare* Commission Guidance and Amendment to the Rules Relating to Organization and Program Management Concerning Proposed Rule Changes Filed by Self-Regulatory Organizations, Release No. 34-58092, 73 Fed. Reg. 40144, 40144 (Jul. 11, 2008) (reflecting the SEC's reliance on self-regulation, expanding the range of SRO rule changes which would become immediately effective and stating that "Self-regulation, with oversight by the Commission, is a basic premise of the Exchange Act."), *with* SEC, OFFICE OF INSPECTOR GEN., OFFICE OF AUDITS, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED-SUPERVISED ENTITY PROGRAM 81 (2008), *available at* http://www.sec.gov/about/oig/audit/2008/446-a.pdf (noting defects in the SEC's voluntary Consolidated Supervised Entity program).

amended to reflect this new nervousness about self-regulation—the 2010 version backtracks from the earlier exhortation to make appropriate use of self-regulation and merely refers to the possibility that the regulatory system will involve self-regulation.[64]

In another example of public reliance on private regulation, Basel II allowed regulators to permit sophisticated banks to use their own models for credit risk. Adair Turner has argued forcefully since the crisis began that everyone put too much faith in these models: "Mathematical sophistication ended up not containing risk, but providing false assurance that other prima facie indicators of increasing risk (e.g. rapid credit extension and balance sheet growth) could be safely ignored."[65]

The crisis disturbed the complacency with which policy-makers viewed self-regulation in the financial markets. But the private sector reacted by developing new self-regulatory principles and practices. Industry groups have focused on the securitization process, for example by developing guidelines for limiting reliance on credit ratings,[66] and addressing issues of transparency.[67] The International Swaps and Derivatives Association (ISDA), has developed protocols for novations of credit derivatives and interest rate transactions to address backlogs.[68]

Industry groups have actively negotiated and lobbied over changes to the financial regulatory structure and rules. They have done so with the knowledge that circumstances have changed, and earlier habits of deference to industry views have been disrupted.[69] For example, the

---

[64] Int'l Org. of Sec. Comm'ns, *Objectives and Principles of Securities Regulation* (June 2010), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf.

[65] FIN. SERV. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 22 (Mar. 2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf [hereinafter *Turner Review*].

[66] EUROPEAN FUND & ASSET MGMT. ASS'N, EUROPEAN SECURITISATION FORUM & INV. MGMT. ASS'N, ASSET MANAGEMENT INDUSTRY GUIDELINES TO ADDRESS OVER-RELIANCE UPON RATINGS 4 (Dec. 11, 2008).

[67] *E.g.*, EUROPEAN SECURITISATION FORUM & INT'L CAPITAL MKT. ASS'N, *INDUSTRY INITIATIVES TO INCREASE TRANSPARENCY: ISSUER AND INVESTOR TRANSPARENCY INITIATIVES* (June 2008), *available at* http://www.europeansecuritisation.com/Communications/Archive/Current/Issuer%20and%20Investor%20Transparency%20Initiatives.pdf (describing industry initiatives to promote transparency in securitization transactions).

[68] ISDA NOVATION PROTOCOL, INT'L SWAPS AND DERIVATIVE ASS'N, http://www.isda.org/isdanovationprotII/isdanovationprotII.html (last visited October 17, 2011).

[69] *Cf.* Nout Wellink, Chairman, Basel Comm. on Banking Supervision, President, De Nederlandsche Bank, Remarks at the FSI High-Level Meeting on the New Framework to Strengthen Financial Stability and Regulatory Priorities: Basel III: a Roadmap to Better Banking Regulation and Supervision, 3, (May 24, 2011), http://www.bis.org/speeches/sp110524.pdf ("We have come a long way from light touch regulation to what some like to call 'intrusive' supervision. And this means that

Securities Industry and Financial Markets Association (SIFMA), a trade group formed after the merger of the Securities Industry Association and the Bond Market Association, submitted a 71-page response to the SEC's proposals for new regulations on issues of asset backed securities.[70] The response included this passage: "SIFMA's members have directly experienced the pain of the recent financial crisis and the collapse of the structured finance markets, and are acutely sensitive to what is at stake as both government and the private sector work to rebuild these vital markets. There is a long way to go."[71]

The development of financial regulation involves conversations and negotiations between market participants and the networks of regulators which develop standards for their behavior. These processes of conversation and negotiation take place across territorial borders,[72] and are reasonably transparent to regulators and market participants, but they are much less transparent to citizens. Many believe that it is entirely appropriate for business regulation to be constructed within expert policy networks,[73] and it is difficult to imagine how financial regulation (complex as it is) could be made entirely transparent to non-expert citizens. But politicians and regulators do make grand claims to be transparent, and these grand claims make deficits in transparency problematic.[74] Politicians and regulators do not tend to make fine distinctions in their discussions of the role and modalities of transparency in different policy contexts. Perhaps they should.[75]

---

supervisors sometimes need to take actions that are unpopular with individual banks or with prevailing public opinions.").

[70] Letter from Richard A. Dorfman & Timothy W. Cameron, Esq., Managing Dirs., Sec. Indus. & Fin. Mkts. Ass'n, to SEC (Aug. 2, 2010), http://www.sifma.org/issues/item.aspx?id=914.

[71] *Id.* at 1.

[72] *See, e.g.*, Eric Helleiner & Stefano Pagliari, *The End of an Era in International Financial Regulation? A Postcrisis Research Agenda*, 65 INT'L ORG. 169, 169-70 (2011) (discussing how transnational financial regulation is constructed).

[73] *E.g.*, Walter Mattli & Tim Büthe, *Global Private Governance: Lessons From a National Model of Setting Standards in Accounting*, 68 L. & CONTEMP. PROBS. 225, 230-31 (2005) (discussing the benefits of taking advantage of and maintaining expertise, and of avoiding blame as reasons for delegating to private actors); *id.* at 235-36 (noting that accounting standards are often delegated to private entities). *Contra* Geoffrey R. D. Underhill & Xiaoke Zhang, *Setting the Rules: Private Power, Political Underpinnings, and Legitimacy in Global Monetary and Financial Governance*, 84 INT'L AFF. 535, 536 (2008) ("The prevalence of private interests in rule-making processes undermines the establishment of an accountable and legitimate financial order.").

[74] *Cf.* Fenster, *supra* note 7, at 889 ("[T]ransparency is not merely a political norm; candidates, partisans, and activists utilize it as a rhetorical weapon to promise full-scale political and social redemption.").

[75] *Cf.* Robert Hoppe, *Institutional Constraints and Practical Problems in*

The financial markets and the regulations that apply to them are impenetrable for most citizens who are not involved in activities related to the financial markets. Citizens' lack of understanding of financial matters leads governments and international organizations to work to improve financial literacy.[76] Although citizens may need to make decisions about their own mortgages and investment for retirement they do not need to participate in developing rules of financial regulation. This activity remains in the hands of the experts. But the experts are not always right about what needs to be done, and when they are wrong it is others, including the taxpaying citizens, who pick up the pieces.[77]

The following sections of the article examine ways in which the processes for development of transnational standards of financial regulation are both insufficiently and excessively transparent.

CRITIQUE PART 1: INSUFFICIENT TRANSPARENCY

The Basel Committee and IOSCO both publish documents denominated consultation documents.[78] But such publication is an example of formal rather than real transparency (or of transparency as opposed to communication). Publication of a document on the standard-setter's web pages does not ensure that anyone reads it.[79] Financial crises may be front

---

Deliberative and Participatory Policy Making, 39 POL'Y & POL. 163, 172 (2011) (discussing "four broad categories of participatory-cum-deliberative projects").

[76] *E.g.*, ORG. FOR ECON. CO-OPERATION AND DEV., IMPROVING FIN. LITERACY: ANALYSIS OF ISSUES AND POL'YS (2005) (analyzing methods for improving financial literacy).

[77] *E.g.*, Toby Helm & Daniel Boffey, *Ministers Admit Family Debt Burden Is Set to Soar*, THE GUARDIAN (Apr. 2, 2011), http://www.guardian.co.uk/politics/2011/apr/02/family-debt-burden-government-figures/print/. The effects of financial crises may be felt far away from the markets where they occur. *See, e.g.*, Sophie Chauvin & André Geis, *Who Has Been Affected, How and Why? The Spillover of The Global Financial Crisis To Sub-Saharan Africa And Ways to Recovery*, Eur. Central Bank Occasional Paper Ser. No. 124, 8 (Mar. 2011) http://www.ecb.int/pub/pdf/scpops/ecbocp124.pdf ("the first wave of the crisis, characterised by the rapid spread of financial turmoil in the United States to other developed economies and some emerging markets via their closely interconnected financial systems, left Sub-Saharan Africa, with the exception of South Africa, comparatively unscathed. . . . However, the second wave of the turmoil, when the disorder in the financial sector began to have an impact on the real economy, had profound consequences for the continent.").

[78] *E.g.*, BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT: CAPITALISATION OF BANK EXPOSURES TO CENT. COUNTERPARTIES, (Dec. 2010), http://www.bis.org/publ/bcbs190.pdf; TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'N, ISSUES RAISED BY DARK LIQUIDITY, CONSULTATION DOCUMENT (Oct. 2010), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf.

[79] *Cf.* Onora O'Neill, *supra* note 36, at 173 ("The activity by which information is made transparent places it in the public domain, but does not guarantee that anybody will find it, understand it or grasp its relevance.").

page news, but the technical details of rules and standards are not. Online newspapers do not consistently provide links to government reports and consultation documents on transnational standards. Individuals, firms, and organizations of firms do respond to the consultation documents, although the responses of firms and organizations are more numerous than those of individuals.[80] Trade associations draw their members' attention to consultations on issues about which those members might have views.[81] When trade associations publicize consultations to their members they draw attention to the consultations and they also show that they are working on behalf of their members. Such publicity does help to increase the number of people who are aware of the proposals in consultation documents, but the people who learn about consultations from trade associations are within the zone of expertise. Those who do are not members of trade associations or who do not subscribe to newsletters which track proposed new standards are less likely to find out about the proposals. The proposals may be transparent in the sense that they are available, but this transparency has limited impact in terms of informing non-expert citizens about standards which may affect them.

Transnational consultations on proposed standards suffer from a further lack of effective transparency in that they are usually conducted in a limited number of languages, and sometimes only in English. In contrast to the EU's commitment to multilingualism, international organizations and standard-setters which focus on financial regulation have not been committed from the outset to publicizing their work in multiple language versions. This fact suggests some limits to those organizations' commitment to effective, rather than to formal, transparency. Successful trade associations can operate across borders and communicate in many languages, but processes for the development of transnational standards which are carried out solely in English, or in a limited number of other languages, have the effect of excluding some people from participation. This issue is being identified, if not resolved: for example, commentators on the IMF's transparency policy suggested that the IMF should translate more of its documents into languages other than English.[82] The Bank for

---

[80] *See Comments Received on the Consultative Document "Capitalisation of Bank Exposures to Central Counterparties*, BANK FOR INT'L SETTLEMENTS, (Dec. 2010), http://www.bis.org/publ/bcbs190/cacomments.htm (showing that the Basel Committee's listing of responses to its consultative document includes responses from two individuals, both knowledgeable about finance and the financial markets).

[81] *See, e.g., Global Weekly Update March 28 – April 1, 2011*, SEC. INDUS. AND FIN. MKTS. ASS'N, http://www.sifma.org/blastemails/Global_Weekly_Update/Global_Weekly_Update-04-01-11.html (last visited Aug. 16, 2011) (noting, for example, the 14 April deadline for comment on HMT consultation on financial reform).

[82] *Consultation Roundtable on IMF Transparency: Summary of Comments from Civil*

International Settlements (BIS) publishes all of its documents in English and some in German, Spanish, French, and Italian.[83] IOSCO relies more on publication in English. At the same time, some trade associations communicate with domestic regulators in the regulators' own languages. ISDA has written comment letters in a range of languages from Romanian[84] to Japanese.[85]

Trade associations are frequent commentators on proposed standards of financial regulation, but, unsurprisingly their comments are designed more to further their own institutional interests and those of their members than to divine truth. They seek to shape the standards, even if their comments do not promote much in the way of public debate about the standards. Frequently trade associations submit comments at the last minute, limiting the ability of others to respond to assertions in their comment letters. Trade associations may submit their comments on proposed rules and standards late because of the pressure of work and the need to solicit and incorporate feedback from their members rather than to make it difficult for others to counter the content of their submissions. But late submission of comments by influential trade associations effectively limits public discussion. Trade associations co-ordinate their responses with each other[86] and with their members,[87] but the behavior of trade associations is often not fully transparent to outside observers.

The relationships between trade associations and those they represent or

---

Society Organizations, INT'L MONETARY FUND (Sept. 30, 2011), http://www.imf.org/external/np/pdr/trans/2009/052809.htm.

[83] *Frequently Asked Questions: BIS Publications*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/about/faq.htm (last visited Oct.17, 2011).

[84] *See, e.g.*, Letter from Peter M. Werner, Senior Dir. Int'l Swaps and Derivatives Ass'n, to Ion Dragulin, Dir., Nat'l Bank of Romania, Fin. Stability Dep't (Mar. 28, 2011), http://www.isda.org/speeches/pdf/ISDALetter_NBR_25march2011_EnglishRomanian.FINAL.pdf (commenting on Draft Amendments to Romanian Implementation of EU Collateral Directive in both English and Romanian).

[85] *See, e.g.*, Letter from Int'l Swaps and Derivatives Ass'n, to Japanese Fin. Servs. Agency (Oct. 11, 2011), http://www2.isda.org/attachment/MzYzNQ==/2011.9.6_Comment_Letter_to_FSA_2011.10.6.pdf (commenting on notice of transactions excluded from the scope of the license for the Financial Instruments Obligation Assumption Service).

[86] For example, the Global Financial Markets Association is an organization with three trade associations as members: the Association for Financial Markets in Europe (AFME), the Asia Securities Industry & Financial Markets Association (ASIFMA), and the Securities Industry and Financial Markets Association (SIFMA). *See* WHO IS GFMA? GLOBAL FIN. MKTS. ASS'N, http://www.gfma.org (last visited Oct. 17, 2011).

[87] For example, trade associations establish committees to focus on particular regulatory issues. *E.g.*, *Committees*, SEC. INDUS. AND FIN. MKT. ASS'N, http://www.sifma.org/about/committees/ (last visited Oct. 17, 2011) (listing committees).

claim to represent are not always transparent. Other sophisticated organizations such as law firms may also offer expert comment on regulatory proposals without explaining to what extent their comments are designed to further their clients' interests.[88] Policy-makers have begun to focus on this issue and ask organizations that respond to consultations to explain how they decided to adopt the positions they take in their responses.[89]

Another aspect of transparency with respect to the development of standards involves the publication of responses to consultations. Different organizations have adopted different approaches to this issue. Until recently the Basel Committee did not publish individual comment letters on its website.[90] IOSCO tends to characterize rather than to publish the full text of comments it receives,[91] although it does sometimes refer to commentators by name[92] (which means that those who are interested may

---

[88] For example, Jennifer Marshall et al., *Technical details of a possible EU framework for bank recovery and resolution: Response to the European Commission's January 2011 consultation*, ALLEN AND OVERY, (Mar. 3, 2011), http://elink.allenovery.com/getFile.aspx?ItemType=Bulletin&id=f9ca8a1f-2199-4e27-8cee-57e0d3b02370 is one such document. It also includes comments on the economic cost of the proposals. *Id.* at 6.

[89] *See, e.g., Call for Evidence: Convention on International Interests in Mobile Equipment and Protocol thereto on Matters Specific to Aircraft 4 (U.K.)*, DEP'T FOR BUS. INNOVATION AND SKILLS, (July 2010), http://www.bis.gov.uk/assets/biscore/corporate/docs/c/10-1032-call-for-evidence-mobile-aircraft-equipment.pdf ("When responding please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents, and how the views of your members were assembled. It would also be useful to know whether you are a small, medium or large size enterprise.").

[90] *See, e.g., Comments Received on the Consultative Documents "Strengthening the Resilience of the Banking Sector" and "International Framework for Liquidity Risk Measurement, Standards and Monitoring"*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/publ/bcbs165/cacomments.htm (last visited Oct. 17, 2011).

[91] *See, e.g.*, TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'N, HEDGE FUNDS OVERSIGHT FINAL REPORT, 8 (Jun. 2009), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf ("Having considered the public comments received on the Consultation Report, the IOSCO Technical Committee has developed the six high level principles below which should be applied to the regulation of hedge funds."). In addition, the document has an annex reporting on the results of the consultation and conclusions in light of responses. *Id.* at 17-23. In some cases the Report refers to the responses of specific entities with attribution. *See, e.g., id.* at 19 ("Considering the international dimension of the hedge funds activities, all respondents supported the need for more convergence on the regulation of hedge fund managers in order to minimise the risk of regulatory arbitrage and ensure better level playing field.") (citing *Intl. Council of Sec. Assn's' Pub. Response to the IOSCO Consultation Report on Hedge Funds Oversight*). *But see, e.g., id.* at 20 ("One respondent challenged that the wider publication of details on business plan and fees charged could create commercial problems for the managers.") (showing that comments are not always attributed to particular respondents).

[92] *See, e.g.*, TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMMISSIONS, HEDGE

be able to read the comments on the commentators' own web pages). Collation and condensation of responses may make the results of a consultation more accessible than making the full text of all responses available, but it also risks eliding some of the subtleties in individual responses.

In domestic regulatory regimes, the choices agencies make about how to characterize public comments on proposed rule-makings and about what facts revealed in comments justify regulatory action are subject to review by courts.[93] Transparency in the domestic context facilitates judicial review. Courts may police the requirement that reasons be given for administrative or legislative action in order to ensure effective judicial review.[94] Transparency of domestic governmental activity may not be perfect,[95] but it is supported by binding legal rules enforced by courts. Transnational standard-setters such as the Basel Committee and IOSCO are subject to no such rules. They are as transparent as they choose to be, and there is no reliable coercive mechanism to force greater transparency upon them.[96] For example, whereas citizens can force governmental agencies to disclose some information under freedom of information laws,[97] the Basel Committee and IOSCO are subject to no such laws. When the Basel Committee publishes standards documents following consultations, the documents do not clearly demonstrate reasoned connections between the consultation process and the resulting standards.[98] The transnational

---

FUNDS OVERSIGHT FINAL REP., *supra*, note 91, at 19 (citing *Intl. Council of Sec. Assn's' Pub. Response to the IOSCO Consultation Report on Hedge Funds Oversight*).

[93] *See, e.g.*, Cass Sunstein, *Factions, Self-Interest, and the APA: Four Lessons since 1946*, 72 VA. L. REV. 271, 281-82 (1986) ("Of central importance here is the task of ensuring that the relevant considerations, including the actual value judgments by the agency, are disclosed to the public and subjected to general scrutiny and review. Administrative and judicial efforts to solve this problem have come in the form of a deliberative conception of administration, a conception that amounts to a significant reformulation of previous understandings.").

[94] *See, e.g.*, P.P. Craig, *The Common Law, Reasons and Administrative Justice*, 53 CAMBRIDGE L. J. 282, 283 (1994) (discussing the common law's requirement that agencies give reasons for their decisions).

[95] *E.g.*, Fenster, *supra* note 7, at 889-91 (noting Governmental invocations of exceptions to transparency).

[96] *Cf.* Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT'L L. 15, 17 (2006) ("[T]he Basel process . . . demonstrates the possibility for enhanced accountability and legitimacy in international regulation.").

[97] *But see* Fenster, *supra* note 7 (noting some of the deficiencies of such laws).

[98] *See, e.g.*, BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT: SOUND PRACTICES FOR THE MANAGEMENT AND SUPERVISION OF OPERATIONAL RISK (Dec. 2010), http://www.bis.org/publ/bcbs183.pdf. In 2011, the Committee published a final document and made comments available online. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, PRACTICES FOR THE SOUND MANAGEMENT AND SUPERVISION OF OPERATIONAL RISK (Jun. 2011), http://www.bis.org/publ/bcbs195.pdf. However the final document does

standards process may be formally transparent in some ways, but in important ways it is neither reliably nor effectively transparent.

CRITIQUE PART 2: EXCESSIVE TRANSPARENCY

Although in some ways citizens may find it difficult to know when standard setters are proposing new standards and what those standards and their implications are, at the same time, the volume of information about standard setting published by different organizations is overwhelming. Consumer advocates recognize that consumers' ability to make good financial choices may be hampered by information overload,[99] and consumers are far more likely to feel they need to make personal financial choices than that they need to wrestle with the details of financial regulation. Information overload tends to impede real communication about standards.

The previous section of this article focused on transparency deficits in transnational standard-setters, but, as noted earlier, financial regulation is developed in multiple fora: responsibility for financial regulation is shared among public and private bodies, and among transnational, national and sub-national entities. Proposals for new rules and standards multiply among these different entities, together with the responses of trade associations and their members, creating an information glut. The financial crisis has increased this glut, by prompting the development of new complex standards at the transnational level as well as legislative and regulatory action around the globe. Even organizations which represent consumer interests have noted the volume of work caused by financial regulatory reform.[100]

Since the middle of 2010, in addition to publishing peer reviews of regulation,[101] the Financial Stability Board has published short background

---

not refer to the comments. *Comments Received on the Consultative Document "Sound Practices for the Management and Supervision of Operational Risk"*, BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/publ/bcbs183/cacomments.htm (last visited Sept. 16, 2011).

[99] *See, e.g.*, FIN. SERVS. CONSUMER PANEL, RESPONSE TO INTERIM REP. AND CONSULTATION ON REFORM OPTIONS, 5 (Jul. 4, 2011), http://www.fs-cp.org.uk/publications/pdf/response_icb_report.pdf ("Transparency in charging and costs is essential in providing customers with a basis on which to make a choice, but this transparency will simply result in information overload if the complexity of charging, costs and contingent fees continue to prevail.").

[100] *See, e.g.*, Adam Phillips, *Foreword to* FIN. SERV. CONSUMER PANEL ANNUAL REPORT 2010/2011, at 4 (2011) *available at* http://www.fs-cp.org.uk/publications/pdf/annual_report11.pdf (last visited Oct. 18, 2011) ("Given the scope and size of the reforms to UK regulation it has been an arduous process to ensure that the FCA will be an effective body that has the consumer interest at heart.").

[101] *See, e.g.*, FIN. STABILITY BD. *supra* note 28, at 2.

notes on shadow banking[102] and exchange traded funds,[103] four progress reports on the development of financial regulation since the crisis,[104] and a consultation document on systemically important financial institutions.[105] In the same period the Basel Committee published consultation papers on a countercyclical capital buffer,[106] on loss absorbency of regulatory capital,[107] on the alignment of risk and remuneration,[108] on deposit insurance,[109] on operational risk,[110] on capitalization of bank exposures to

---

[102] FIN. STABILITY BD., SHADOW BANKING: SCOPING THE ISSUES (Apr. 12, 2011), http://www.financialstabilityboard.org/publications/r_110412a.pdf.

[103] FIN. STABILITY BD., POTENTIAL FIN. STABILITY ISSUES ARISING FROM RECENT TRENDS IN EXCHANGE-TRADED FUNDS (ETFS) (Apr. 12, 2011), http://www.financialstabilityboard.org/publications/r_110412b.pdf.

[104] FIN. STABILITY BD., OTC DERIVATIVES MKT. REFORMS: PROGRESS REP. ON IMPLEMENTATION (Apr. 15, 2011), http://www.financialstabilityboard.org/publications/r_110415b.pdf; FIN. STABILITY BD., PROGRESS IN THE IMPLEMENTATION OF THE G20 RECOMMENDATIONS FOR STRENGTHENING FIN. STABILITY (Apr. 10, 2011), http://www.financialstabilityboard.org/publications/r110415a.pdf; FIN. STABILITY BD., PROMOTING GLOBAL ADHERENCE TO REG. AND SUPERVISORY STANDARDS ON INT'L COOPERATION AND INFO. EXCH.: PROGRESS REP. (Apr. 29, 2011), http://www.financialstabilityboard.org/publications/r_110429.pdf; FIN. STABILITY BD. & IMF, THE FIN. CRISIS AND INFO. GAPS, IMPLEMENTATION PROGRESS REP. (Jun. 2011), http://www.financialstabilityboard.org/publications/r_110715.pdf.

[105] FIN. STABILITY BD., CONSULTATIVE DOCUMENT, EFFECTIVE RESOLUTION OF SYSTEMICALLY IMPORTANT FIN. INST., RECOMMENDATIONS AND TIMELINES (Jul. 19, 2011), http://www.financialstabilityboard.org/publications/r_110719.pdf. The Basel Committee published a related consultation document at the same time. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT, GLOBAL SYSTEMICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT (Jul. 2011), http://www.bis.org/publ/bcbs201.pdf.

[106] BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT: COUNTERCYCLICAL CAPITAL BUFFER PROPOSAL (Jul. 2010), http://www.bis.org/publ/bcbs172.pdf.

[107] BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT, PROPOSAL TO ENSURE THE LOSS ABSORBENCY OF REG. CAPITAL AT THE POINT OF NON-VIABILITY (Aug. 2010), http://www.bis.org/publ/bcbs174.pdf.

[108] BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT: RANGE OF METHODOLOGIES FOR RISK AND PERFORMANCE ALIGNMENT OF REMUNERATION (Oct. 2010), http://www.bis.org/publ/bcbs178.pdf; BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT, PILLAR 3 DISCLOSURE REQUIREMENTS FOR REMUNERATION (Dec. 2010), http://www.bis.org/publ/bcbs191.pdf.

[109] BASEL COMM. ON BANKING SUPERVISION & INT'L ASS'N OF DEPOSIT INSURERS, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT, CORE PRINCIPLES FOR EFFECTIVE DEPOSIT INS. SYS., A PROPOSED METHODOLOGY FOR COMPLIANCE ASSESSMENT (Nov. 2010), http://www.bis.org/publ/bcbs182.pdf.

[110] BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT: SOUND PRACTICES FOR THE MGMT. AND SUPERVISION OF OPERATIONAL RISK (Dec. 2010), http://www.bis.org/publ/bcbs183.pdf; BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT,

central counterparties,[111] and on systemically important banks.[112] During the same period, IOSCO issued a number of publications that included documents relating to credit rating agencies,[113] securitization,[114] and systemic risk and securities regulation.[115] The EU has been busy generating new rules and proposed rules on these topics, as have domestic legislators and regulators. The US Congress enacted the Dodd-Frank Act, which was more voluminous than the statutes which preceded it,[116] and mandated a number of different regulatory agencies to develop many complex sets of new rules.[117] In the EU and the US policy-makers have focused on issues identified by transnational bodies, such as remuneration of financial services employees,[118] and problems of crisis management in financial firms.[119] Trade associations have argued that rules in force in different jurisdictions should be consistent in order to ensure a level playing field

---

OPERATIONAL RISK – SUPERVISORY GUIDELINES FOR THE ADVANCED MEASUREMENT APPROACHES (Dec. 2010), http://www.bis.org/publ/bcbs184.pdf.

[111] BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, CONSULTATIVE DOCUMENT, CAPITALISATION OF BANK EXPOSURES TO CENT. COUNTERPARTIES (Dec. 2010), http://www.bis.org/publ/bcbs190.pdf.

[112] BASEL COMM. ON BANKING SUPERVISION, *supra* note 105.

[113] *E.g.*, TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'N, REG. IMPLEMENTATION OF THE STATEMENT OF PRINCIPLES REGARDING THE ACTIVITIES OF CREDIT RATING AGENCIES, FINAL REP. (Feb. 2011), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD346.pdf.

[114] *E.g.*, TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS, REG. IMPLEMENTATION OF THE STATEMENT OF PRINCIPLES REGARDING THE ACTIVITIES OF CREDIT RATING AGENCIES, FINAL REP. (Feb. 2011), http://www.iosco.org/library/pubdocs/pdf/ioscopd346.pdf.

[115] TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, MITIGATING SYSTEMIC RISK: A ROLE FOR SECURITIES REGULATORS, DISCUSSION PAPER, (Feb. 2011), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf.

[116] *E.g.*, J.C. Boggs, Melissa Foxman & Kathleen Nahill, *Dodd-Frank at One Year: Growing Pains*, 2 HARV. BUS. L. REV. ONLINE 52 (July 28, 2011), http://www.hblr.org/?p=1614.

[117] *See id.* at 52-54 (describing the enlarging financial regulatory structure under Dodd-Frank).

[118] *E.g.*, Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (proposed Apr. 14, 2011) (to be codified at 12 C.F.R. pt. 42, 12 C.F.R. pt. 236, 12 C.F.R pt. 372, 12 C.F.R. pt 563h, 12 C.F.R. pts. 741 and 751, 17 C.F.R. pt. 248, and 12 C.F.R. pt. 1232); *Comm'n of the Eur. Cmtys., Recommendation on Remuneration Policies in the Financial Services Sector*, SEC (2009) 580, 581 (Apr. 30, 2009), http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf; FIN. SERVS. AUTH., CONSULTATION PAPER, REFORMING REMUNERATION PRACTICES IN FIN. SERVS., (Mar. 2009), http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf.

[119] *E.g.*, Certain Orderly Liquidation Auth. Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Prot. Act, 76 Fed. Reg. 41,626 (July 15, 2011) (to be codified at 12 C.F.R. pt. 380); *Commission Communication on An EU Framework for Crisis Management in the Financial Sector*, *supra* note 27.

and/or limit regulatory arbitrage.[120] But private sector initiatives add to the information overload.[121]

Added to the difficulties associated with multiple differing proposals emanating from different organizations is the underlying complexity of the financial activity and of existing regulation.[122] Complex transactions lead to complex rules and standards and this complexity impedes transparency. But efforts to make transnational standard-setting processes more transparent risk making the information overload problem worse rather than better.

Some of the participants in transnational standard-setting may have an interest in opacity similar to the interest of lawyers who engage in discovery abuse, but part of the excessive transparency problem derives from the reality of different institutional actors carrying out their own institutional missions without considering that better coordination might improve the transparency of the process as a whole. Conceptualizing the transparency issue as the need to make everything visible to those who choose to look can lead to practices which are counter-productive viewed from the perspective that useful transparency enables citizens to understand, and not merely to find when they look.[123]

FINAL THOUGHTS: RESOLVING TRANSPARENCY

Transparency in standard-setting suffers from two weaknesses: at the

---

[120] *See, e.g.*, EUR. COMM'N, OVERVIEW OF THE RESULTS OF THE PUBLIC CONSULTATION ON TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RESOLUTION AND RECOVERY 20 (May 5, 2011), http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_overview_en.pdf ("Respondents have a range of ideas on how to avoid regulatory arbitrage and restructuring of debt: the power and circumstances under which authorities could write down debt and the classes of bail-inable debt should be clearly defined to prevent regulatory arbitrage; the consistency at global level to avoid geographical relocation of debt; the interaction with the new capital rules, buffers and capital surcharges for SIFIs should be further considered.").

[121] *E.g.* The Conference Bd., Conference Board Task Force on Executive Compensation 26-27 (2009), http://www.conference-board.org/pdf_free/ExecCompensation2009.pdf (describing a private sector initiative which was developed while regulators were discussing domestic regulatory measures, rather than a citation to a place where someone else says that private sector initiatives add to the information overload).

[122] *See, e.g.*, Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 212-13 (2009) (arguing that complexity in financial markets is "the greatest financial-market challenge of the future.").

[123] *Cf.* Schneider & Sidney, *supra* note 45, at 111 ("Policy designs need to be transparent rather than opaque, straightforward rather than deceptive, contain positive constructions of all social groups and points of view even of those who are 'losing,' logical connections between means and ends, implementation processes that grant equal access to information and subsequent points of contestation, and arenas for discourse that engage multiple 'ways of knowing' the issue.").

same time there is insufficient transparency and too much. A radical (perhaps even an essential) solution would be to focus on eliminating some unnecessary complexities from standards of financial regulation.[124] Complexity in standards and in regulation promotes opacity, and privileges those who have the time and resources to build expertise with respect to the complexities.[125] But fixing the complexity of financial regulation is not at the top of the agenda. If anything, recent initiatives in standards and regulation only increase complexity.

Complexity is one aspect of the information overload problem. Smart uses of technology could ameliorate other aspects of this problem.[126] The US government has worked to improve the accessibility and manageability of the data in the federal register system, and transnational standard-setters (whose members are after all based in domestic systems of governance) could learn from this and similar work. At the same time the standard-setters should recognize this problem of excessive transparency and try to co-ordinate with other standard-setters working on similar issues. A third possible solution may be to try to tap into the wisdom of the crowd.[127] Crowd-sourcing has been used to track radiation levels in Japan after the earthquake and tsunami,[128] and to pore over the details of expense claims by Members of Parliament in the UK,[129] and academics propose crowd-sourcing to improve machine translation.[130] It is one thing to note that

---

[124] *Cf.* Haldane, *supra* note 49, at 3.

[125] *Cf.* Underhill & Zhang, *supra* note 73, at 553 ("[T]he influence of private actors on the input side has not only rendered public authorities dependent on the information and expertise provided by these actors but also consistently aligned public policy objectives with private sector preferences. This has raised fears that the enhanced rule-setting power of private interests may have severely undermined the authority of public actors to formulate financial and regulatory policies in line with the broader public interest, a situation approximating policy capture.").

[126] *But cf.* Robin Gauld, Shaun Goldfinch & Simon Horsburgh, *Do they want it? Do they use it? The 'Demand-Side' of e-Government in Australia and New Zealand*, 27 GOV'T INFO. Q. 177, 184 (2010) ("Much of the literature on e-government suffers from an overly technological focus. It is assumed that once the correct technology is developed and in place, and citizens given access, benefits will be delivered in terms of reduced costs and technical efficiency, greater access and greater accountability and transparency, the transformation of government operations, and even greater 'e-participation' and 'e-democracy'. . . The downsides and limitations of e-government are often downplayed or ignored altogether.").

[127] *But see, e.g.*, Dan Woods, *The Myth of Crowdsourcing*, FORBES.COM, (Sept. 29, 2009), http://www.forbes.com/2009/09/28/crowdsourcing-enterprise-innovation-technology-cio-network-jargonspy.html (critiquing crowdsourcing).

[128] *E.g.*, Steve Lohr, *Online Mapping Shows Potential to Transform Relief Efforts*, N.Y. TIMES (Mar. 28, 2011) at B3.

[129] *E.g.*, Andersen *supra* note 18.

[130] Vamshi Ambati, et al., *Active Learning and Crowd-Sourcing for Machine Translation*, INT'L CONF. ON LANGUAGE RESOURCES AND EVALUATION 2010 PROCEEDINGS (2010), http://www.lrec-

crowd-sourcing can effectively address some collective action issues and another to conclude that we can rely on crowd-sourcing to manage excess information about proposed financial standards. Making crowd-sourcing work requires some effort to motivate and manage the crowds.[131]

There are some possible remedies for the insufficiencies in transparency identified above, although they would be expensive. The article focuses on three aspects of transparency insufficiency: limited translation of consultation documents; limited information about the identity and agendas of participants in the process; and limited information about the results of consultations.

With respect to the first issue, the EU has half a century of experience in managing the costs and benefits of multilingualism, although in a space where the number of relevant languages is limited. The United Nations, which has six official languages—Arabic, Chinese, English, French, Russian, and Spanish[132]—has recently been discussing multilingualism as an aspect of its work.[133] Resolving the tensions between allowing for full participation by the world's citizens through multilingualism and making decision-making affordable and efficient by limiting the number of languages of decision is one of the critical problems of global governance, and is an issue which implicates all areas of policy, not merely the setting of standards of financial regulation.

The second and third sets of limitations to transparency could be resolved by requiring improved disclosure about those who respond to consultations and what they say. But the opacity which results from complexity is much more difficult to remedy and more fundamental. All of the methods this article suggests to address the insufficiencies of transparency exacerbate problems of excessive transparency. Making more information available to more people worsens problems of information glut. If this problem cannot be solved, transparency alone cannot be relied on to legitimate the new financial order.

---

conf.org/proceedings/lrec2010/pdf/244_Paper.pdf.

[131] HARVARD HUMANITARIAN INITIATIVE, DISASTER RELIEF 2.0: THE FUTURE OF INFORMATION SHARING IN HUMANITARIAN EMERGENCIES 8-9 (2011), http://www.globalproblems-globalsolutions-files.org/gpgs_files/pdf/2011/DisasterResponse.pdf.

[132] Not all aspects of the UN's work involve all of these languages. *E.g.*, U.N. Secretary-General, Multilingualism: Rep. of the Secretary-General, UN Doc. A/65/488 (Oct. 4, 2010), http://daccess-dds-ny.un.org/doc/UNDOC/GEN/N10/566/15/PDF/N1056615.pdf?OpenElement.

[133] *E.g.*, G.A Res. 61/266, U.N. Doc. a/RES/61/266 (Jun. 8, 2007) http://daccess-dds-ny.un.org/doc/UNDOC/GEN/N06/510/33/PDF/N0651033.pdf?OpenElement.

TRANSPARENCY AND CONTRARIAN EXPERTS IN FINANCIAL REGULATION: A BRIEF RESPONSE TO PROFESSOR BRADLEY

DANIEL SCHWARCZ[†]

INTRODUCTION

Transparency is a notoriously malleable concept. Nowhere is this clearer than in Professor Bradley's article, *Transparency is the New Opacity: Constructing Financial Regulation After the Crisis.*[1] Focusing on the development of transnational standards for financial regulation, Professor Bradley argues that entities such as the Basel Committee on Banking Supervision (Basel Committee), International Association of Insurance Supervisors (IAIS), and International Organization of Securities Commissioners (IOSCO) are unreasonably opaque because they simultaneously produce too much and too little information. This assessment is largely driven by the premise that transnational standard setters (and financial regulators more generally) have an obligation to make their processes understandable and accessible to ordinary citizens, in addition to sophisticated, and generally self-interested, private entities. Professor Bradley thus suggests—with varying degrees of certainty—that standard setters in financial regulation should translate regulatory documents into multiple languages, draft rules in plain language, pursue simpler regulatory strategies, reduce the volume of information they produce, and coordinate the dissemination of this information to make it less overwhelming. At various times, Professor Bradley summarizes her basic argument as an attempt to promote "communication" about financial regulation, or "real transparency" to "citizens."[2]

[†] Daniel Schwarcz (schwarcz@umn.edu) is an Associate Professor of Law at the University of Minnesota Law School.

[1] Caroline Bradley, *Transparency Is The New Opacity: Constructing Financial Regulation After The Crisis*, 1 AM. U. BUS. L. REV. 7 (2011).

[2] *See id.* at 22 ("But such publication is an example of formal rather than real

This brief response is pessimistic that better communication to ordinary people about financial regulation can meaningfully address regulatory problems such as capture, democratic accountability, and group think. Instead, it argues that the architects of financial regulation should focus their transparency-related efforts on facilitating participation by experts with alternative perspectives on the optimal contours of regulation. Such experts might include public interest groups, academics, designated regulatory staff, and government officials that do not regulate directly in the domain under consideration. But it is not enough to make regulatory processes transparent to these groups. Regulators and standard setters must also affirmatively facilitate and incentivize participation in rule-making and standard-setting by these experts with alternative perspectives and interests. To accomplish this, they might initiate experiments grounded in Tripartism, seeking to empower public interest groups with procedural rights.[3] Alternatively, they could establish affiliated regulatory contrarians to serve as "devils' advocates" or "proxy advocates."[4] Whatever the mechanism, financial regulators and standard setters must affirmatively court informed engagement from knowledgeable sources with alternative perspectives, as both history and logic suggest that this type of engagement will otherwise be substantially absent.

I. THE PROMISES AND PERILS OF TRANSPARENCY IN FINANCIAL REGULATION

As Professor Bradley aptly documents, regulatory transparency has become a dominant theme in recent years. There is good reason for this: transparency can promote pluralism in regulatory processes[5] and ensure regulatory accountability by harnessing the threat of public scrutiny.[6] These forces, in turn, may counteract various well-known regulatory

---

transparency or of transparency as opposed to communication.").

[3] *See generally*, IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEGREGULATION DEBATE 54-100 (1992) (advocating for Tripartism, which would empower designated public interest groups with the capacity to participate in the negotiation of regulatory outcomes and challenge industry behavior through the same mechanisms as those available to the regulator).

[4] *See generally*, Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629 (2011) (arguing that regulation can be improved through the use of "regulatory contrarians," which are entities that possess persuasive authority over regulatory outcomes, are affiliated with, but independent of, specific regulators and are tasked with reporting on deficiencies and potential improvements in regulation).

[5] Mark Seidenfeld, *Empowering Stakeholders: Limits on Collaboration as Basis for Flexible Regulation*, 41 WM. & MARY L. REV. 411, 417-18 (2000).

[6] *See generally* Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols versus Fire Alarms*, 28 AM. J. POL. SCI. 165 (1984).

failings, including loafing, intransigence, and capture. Of course, the extent to which transparency can deliver on these lofty goals depends substantially on the underlying regulatory context. In at least some settings, transparency may actually exacerbate regulatory dysfunction by facilitating "information capture,"[7] encouraging the politicization of regulatory decision-making, and perhaps even chilling valuable communication between market participants and regulators.[8]

In the context of financial regulation, the net benefits of existing efforts at regulatory transparency often seem minimal. Professor Bradley emphasizes this point in the context of entities such as the Basel Committee, IOSCO, and IAIS, which purport to embrace transparency while, in practice, relying almost entirely on the work-product of a narrow range of government technocrats and industry lobbyists.[9] But the limits of transparency in financial regulation run deep. For instance, a notable recent study by Kim Krawiec found that industry dominated implementation of the Volcker Rule in the Dodd Frank Act.[10] While the public "formally" participated in the process by submitting thousands of comments, almost all of these were either form letters prepared by public interest groups or comments that did not meaningfully engage the issues.[11] Other studies have shown that this pattern is hardly unique to financial regulation: in various domains, regulatory participation is dominated by regulated entities with similar, self-interested, perspectives.[12]

Professor Bradley suggests that a core explanation for this pattern is a lack of *real transparency*, meaning that the processes of financial regulation are unreasonably opaque for the vast majority of ordinary individuals. First, she argues that financial standard setters make an insufficient amount of information accessible to the public when it comes to specific regulatory documents and industry feedback: regulatory documents are available in a limited number of languages and may be scattered in various locations, while the financial interests of stakeholders are not always apparent. Second, and more fundamentally, Professor

---

[7] *See generally* Wendy Wagner, *Administrative Law, Filter Failure, and Information Capture*, 59 DUKE L. J. 1321 (2010).

[8] ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASONING IN THE GLOBAL FINANCIAL MARKETS (2011).

[9] Bradley, *supra* note 1, at 17-18.

[10] Kimberly Krawiec, *Don't "Screw Joe the Plummer": The Sausage-Making of Financial Reform* (Sept. 16, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1925431.

[11] *Id.* at 19-25.

[12] *See, e.g.*, Jason Webb Yackee & Susan Webb Yackee, *A Bias Toward Business? Assessing Interest Group Influence on the U.S. Bureaucracy*, 68 J. Pol. 128 (2006).

Bradley emphasizes that standard setting bodies produce too much information. Not only is financial regulation inherently complex and technical, but there are multiple regulatory bodies at both the domestic and international levels. Collectively, these forces prevent ordinary individuals from meaningfully engaging with, and even understanding, the underlying regulatory issues.[13]

Although clear-eyed about some of the difficulties of remedying these problems, Professor Bradley exhorts international financial standard setters to work harder to "communicate" with "citizens" about their regulatory efforts. She thus suggests initiatives such as translating regulatory documents into more languages and requiring disclosure of commentators' financial interests. More controversially, she suggests that international standard setters should draft rules in plain language and work to coordinate, and perhaps even limit, their production of information. At one point she argues that they should embrace simpler regulatory approaches because that would improve citizen information (such an approach might be justified on the alternative ground that it places less reliance on regulatory expertise).

Unfortunately, Professor Bradley's pessimism regarding the prospects of "real transparency" in financial regulation is not only understandable, but understated. This is for two basic sets of reasons. First, neither "real transparency" nor better "communication" is likely to increase consumers' actual understanding or interest in financial regulation. Most fundamentally, this is because the beneficiaries of financial regulation are quite diffuse, consisting either of the consumers of financial services (in the case of consumer protection regulation) or taxpayers (in the case of systemic risk regulation).[14] These individuals have limited incentives to invest effort or time in learning about relevant issues, even when that information is readily available.[15] Additionally, most ordinary citizens do not care about financial regulation even when they do have a substantial economic stake in outcomes: the blunt truth is that non-experts generally view financial regulation to be boring, at least when it comes to micro-level issues of implementation.[16] Not only does this further limit the public's

---

[13] Krawiec, *supra* note 10, at 21-26.

[14] Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 420 (2006) ("One critical factor stands out: larger, more diffuse groups, such as retail investors, encounter greater difficulty in organizing themselves for collective action, and only exert significant pressure on regulators when their interests are severely affected.").

[15] Saule Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. (forthcoming 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1924546.

[16] Even the current "Occupy Wall Street" movement, which is quite distinctive, is

willingness to consume information about financial regulation, but it also impedes the fund raising capacity of public interest groups who might do this on their behalf.[17]

Second, even if ordinary citizens could somehow be convinced to take an interest in the details of financial regulation, it would be impossible to simplify these details sufficiently to allow citizens to deeply understand, much less meaningfully contribute to, their development. Financial regulation is inherently complex because finance is itself complex. Moreover, financial institutions are dynamic and evolving, often in ways that are specifically motivated by efforts to avoid regulation.[18] These facts require evolving and detailed regulatory structures. Moreover, understanding and contributing to the debate about how these structures should be designed typically requires engagement with industry perspectives on these points. Yet as Wendy Wagner has persuasively argued, industry participation in financial regulation is not only extensive, but often excessively so, because of the lack of any filter that is imposed on this feedback.[19] This is exacerbated, of course, by the financial interests that industry typically has in particular regulatory outcomes as well as the resources at their disposal in presenting and justifying this perspective.[20]

Nowhere were these limitations in transparency more apparent than in the context of pre-crises domestic financial regulation. Although there were clearly numerous problems with financial regulation in the United States during this time period, it is hard to argue that regulatory transparency (as opposed to market transparency) was anywhere near the top of the list.[21] Financial regulators were perfectly upfront about their decisions: indeed, they openly celebrated and defended deregulation in numerous contexts, ranging from derivatives trading to subprime mortgage

---

focused on vague and difficult-to-define public distrust of Wall Street rather than specific regulatory ideas. *See, e.g.*, Paul Krugman, *Confronting the Malefactors*, N.Y. TIMES, Oct. 6, 2011, http://www.nytimes.com/2011/10/07/opinion/krugman-confronting-the-malefactors.html?_r=1 ("A better critique of the protests is the absence of specific policy demands. It would probably be helpful if protesters could agree on at least a few main policy changes they would like to see enacted.").

[17] Omarova, *supra* note 15, at 47.

[18] McDonnell & Schwarcz, *supra* note 4, at 1631.

[19] Wagner, *supra* note 7, at 1416.

[20] Rachel Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15, 22 (2010); Christie Ford, *Macro and Micro Level Effects on Responsive Financial Regulation*, 44 U. B.C. L. REV. (2011) (emphasizing the capacity of industry to shape the implementation of flexible regulation).

[21] While it can certainly be argued that industry influenced these results through opaque mechanisms, none of the regulatory improvements that Professor Bradley suggests for international financial standard setters would have shined a light on this influence.

origination to capital requirements.[22] Regulatory processes were subject to the transparency requirements of federal law, including notice and comment rulemaking and Freedom of Information statutes. And this information was available in a language that any domestic constituency could understand. Despite these facts, the participation and influence of ordinary citizens in domestic financial regulation was obviously de minimis.

All of this suggests that the efforts of financial standard setters or regulators to engage "ordinary citizens" in the nuances of their regulatory processes are ultimately as futile as efforts to coax water from a stone. However, that does not mean that the instrumental goals of regulatory transparency—promoting alternative perspectives in regulatory processes and ensuring democratic accountability among regulators—are unachievable. Instead, it means that these goals must be met through a targeted set of reforms that cultivate and promote non-industry involvement in regulatory processes in ways that include, but extend beyond, transparency. It is to this issue that Part II briefly turns.

II. ADDRESSING THE PROBLEM: EMPOWERED CONTRARIAN EXPERTS

Throughout her article, Professor Bradley often treats "experts" as a monolithic group, composed of individuals with similar ideas and financial interests that stand in opposition to the interests of citizens.[23] In some ways, this perspective is historically accurate: most of the outside experts who have participated in financial regulation are industry funded and therefore, broadly speaking, have similar sets of interests. At the same time, though, there is nothing inevitable about the alignment of expertise and industry. Numerous experts exist who have contrarian orientations and no direct financial interest in regulated industries, including public interest group members, academics, and government officials that do not regulate directly in the domain under consideration.[24]

---

[22] *See, e.g.*, KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 7-9 (2011) (describing federal lawmakers' openly deregulatory policies regarding subprime lending).

[23] *See, e.g.*, Bradley, *supra* note 1, at 22 ("Although citizens may need to make decisions about their own mortgages and investment for retirement they do not need to participate in developing rules of financial regulation. This activity remains in the hands of the experts. But the experts are not always right about what needs to be done, and when they are wrong it is others, including the taxpaying citizens, who pick up the pieces.").

[24] Susan Webb Yackee, *Capture in the Regulatory Process*, in PREVENTING CAPTURE: SPECIAL INTEREST INFLUENCE IN REGULATION AND HOW TO LIMIT IT (David Moss & Daniel Carpenter, eds.) (forthcoming, 2012 on file with author) (finding that public comments by sub-national government officials exerted significant influence in federal rulemaking).

If we are to achieve the ends that Professor Bradley seeks in financial regulation, it is absolutely necessary to engage these experts in regulatory processes. Accomplishing this would help to defuse some of the cognitive biases that may impact financial regulators and would, in any event, promote consideration of a diverse set of perspectives in the regulatory process.[25] It would also mitigate the risk of capture by increasing the threat of public scrutiny: knowledgeable and expert participants in the regulatory process are well suited to generate public scrutiny in the face of obvious or salient instances of capture.[26]

Various potential strategies might be attempted to actively cultivate this type of broad-based participation in financial regulation. The first, and probably most important, such strategy is indeed transparency.[27] Outside groups cannot meaningfully participate in or police regulatory proceedings without access to relevant information. But this type of transparency is much different—and narrower—than that which Professor Bradley advances. It does not require regulators to translate documents into multiple languages, at least assuming that most potential experts in financial regulation are conversant in English. Nor does it require industry commentators to disclose their financial interests, at least when those interests would otherwise be apparent to a person knowledgeable in the underlying field. Instead, it simply requires that those who are motivated to understand the regulatory process can easily do so if they possess a baseline set of information and knowledge.

But while this narrow form of transparency is surely necessary to promote participation in financial regulation by contrarian experts, it is also hardly sufficient. Most experts with alternative perspectives on financial regulation do not currently have clear incentives to devote a substantial amount of time, effort, and resources to the nuts and bolts of regulation. Public interest groups interested in financial regulation are scarce and those that do exist rarely spend their time on issues that do not fit squarely within the consumer protection domain.[28] Academics are generally not rewarded for direct participation in financial regulation, which is often viewed as insufficiently theoretical to enhance their (or their institution's) reputations.[29] And government officials typically have strong incentives to

---

[25] McDonnell & Schwarcz, *supra* note 4, at 1644-51.

[26] Daniel Schwarcz, *Preventing Capture Through Consumer Empowerment Programs: Some Evidence from Insurance Regulation*, in PREVENTING CAPTURE: SPECIAL INTEREST INFLUENCE IN REGULATION AND HOW TO LIMIT IT (David Moss & Daniel Carpenter, eds.) (forthcoming 2012 on file with author).

[27] *See* AYRES & BRAITHWAITE, *supra* note 3, at 57.

[28] *See* Omarova, *supra* note 15, at 32-34.

[29] *See* David Moss & John Cisternino, *Introduction* to NEW PERSPECTIVES ON REGULATION 7 (David Moss & John Cisternino eds., 2009).

direct their energies entirely within the narrow confines of their job descriptions.

Tripartism represents one promising approach for incentivizing these groups to participate in financial regulation.[30] Broadly construed, tripartism involves empowering designated public interest groups or academics with certain procedural rights that enhance their capacity to influence regulatory outcomes. So long as this enhanced authority is contestable by alternative groups, tripartism may be able to counteract regulatory capture by requiring industry to expend resources to capture two separate groups. Tripartism can also promote democratic accountability simply because the perspectives that public interest groups and/or academics offer are historically under-represented in financial regulation. Recently, Saule Omarova has proposed a specific tripartite structure for systemic risk regulation.[31] And tripartism already exists in the context of domestic financial regulation and consumer protection.[32]

An alternative approach is for financial regulators or standard setters to establish "regulatory contrarians" that are affiliated with these entities but specifically tasked with presenting alternative perspectives on regulatory issues.[33] Although such contrarians enjoy privileged access to regulators, they do not themselves possess regulatory powers. Instead, they use persuasion and pressure to inform and help shape regulatory policy. In doing so, of course, contrarians are meant to challenge prevailing wisdom and advocate for perspectives that are insufficiently represented in the existing regulatory fray. Examples of such contrarians include inspectors general, research arms of regulatory bodies, and independent "proxy advocates" such as the Taxpayer Advocate in the Internal Revenue Service.[34]

These are hardly the only promising strategies for actively encouraging participation in financial regulation by contrarian experts. For instance, regulators and standard setters could offer monetary payments or prestigious awards for public-benefiting comments or consultations.[35] Alternatively, they could maintain advisory panels comprised of experts

---

[30] AYRES & BRAITHWAITE, *supra* note 3, at 57.

[31] *See* Omarova, *supra* note 15, at 4.

[32] Schwarcz, *supra* note 26. Similarly, the Consumer Safety Product Commission reimbursed non-industry participation in notice and comment rulemaking for some time. *See generally* Carl Tobias, *Great Expectations and Mismatched Compensation: Government Sponsored Public Participation in Proceedings of the Consumer Product Safety Commission*, 64 WASH. U. L.Q. 1101 (1986).

[33] *See* McDonnell & Schwarcz, *supra* note 4, at 1644-51.

[34] *See id.* at 1651-66.

[35] Wagner, *supra* note 7, at 1416.

with distinctive viewpoints.[36] Yet another approach would be for regulators to encourage firms themselves to hire individuals with different perspectives in an attempt to generate more diverse perspectives from within regulated firms.[37]

CONCLUSION

Financial regulation is a technical, difficult, and inherently opaque topic. In this context, regulatory transparency can only do so much. Rather than seeking to reach unachievable levels of democratic accountability, financial regulators and standard setters should attempt to ensure that their efforts are guided by a diverse set of informed, outside perspectives. Their best chance of achieving this goal is to selectively target contrarian experts such as academics, public interest groups, and government officials and incentivize their participation in regulatory processes through initiatives such as tripartism and the establishment of regulatory contrarians.

---

[36] *See generally*, Barkow, *supra* note 20, at 78 (discussing Dodd-Frank's creation of a "Consumer Advisory Board" to advise and consult with the Consumer Financial Bureau, but suggesting that such a structure is a poor substitute for a vigorous, full-time public advocate).

[37] *Cf.* Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL'Y 807, 836-37 (2010).

OF THE CONDITIONAL FEE AS A RESPONSE TO LAWYERS, BANKERS AND LOOPHOLES

CLAIRE HILL & RICHARD PAINTER†

I. INTRODUCTION

Crises inevitably bring cries for new legislation, and the 2008 financial crisis was no exception. Dodd-Frank[1] is approximately 850 pages long, and the regulations it contemplates will be voluminous as well.

There are radically differing views as to whether Dodd-Frank took the right approach, and whether it will be successful or even beneficial. But even the most optimistic scenario leaves a significant problem unaddressed. One important cause of the crisis was that some banks and their lawyers had been looking for—and finding—clever ways to honor the letter of the law while violating its spirit, including by "pushing the envelope" as far as it will go (and in some cases, further). The legal opinion rendered in Lehman Brothers' Repo 105 transaction, discussed more fully below, is but one example of the type of lawyering that gave clients what they wanted in the short term while ignoring the true meaning of the law. We call this type of lawyering "loophole lawyering."

This type of lawyer behavior presents a significant challenge for regulation. Rules-based approaches are of limited value. Indeed, the "better"—the more specific—the rule, the better a roadmap it may provide for finding loopholes. Standards-based regulation could be more effective, but ultimately, it has significant limitations. In the business context, predictability is highly valued, including by courts. Predictability and broad standards are in considerable tension, insofar as the standards' reach is only determined *ex post*, after the conduct occurs. Moreover, once

---

†Hill is Professor and James L. Krusemark Chair in Law, University of Minnesota Law School; Painter is S. Walter Richey Professor of Corporate Law, University of Minnesota Law School. Thanks to participants in the American University Business Law Review symposium on Law, Finance and Accountability After Financial Reform.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law No: 111-203, 12 Stat. 1376 (to be codified as 12 U.S.C. § 5301) (Supp. IV 2010).

standard-based regulations are interpreted, they become more rule-like, and hence more vulnerable to avoidance using loophole lawyering.

In this essay, we make a concrete proposal to limit the extent to which lawyers facilitate problematic transactions of the sort that contributed to, and may have caused, the financial crisis. We propose that the fees of securities lawyers and perhaps other regulatory lawyers such as banking lawyers be "conditional." If the client became insolvent and was found to have materially violated the relevant regulations in the period leading up to insolvency, outstanding legal fees would not be payable and any fees paid to the lawyers by the client during the period of the violation would be disgorged. A finding of legal malpractice or other fault on the part of the lawyer would not be necessary, nor would proof that the violation caused the insolvency be required.

Constraints on bad lawyer behavior in this area are quite limited. First, existing malpractice law discourages lawyers from giving incompetent legal advice, but only to a limited extent: the doctrine of *in pari delicto* makes it difficult for bankruptcy trustees to assert claims against lawyers, accountants and other professional service providers in many jurisdictions including, most notably, New York.[2] A bankrupt entity that became bankrupt due in part to its wrongful conduct cannot proceed against those who helped the entity act wrongfully; thus, the bankrupt entity's estate cannot assert a claim that the bankrupt could not have asserted. Second, lawyers will very rarely be liable for their client's securities fraud. The federal courts have held that aiders and abettors of securities fraud[3] and even co-conspirators[4] cannot be sued by injured investors. It will be almost impossible to sue lawyers as primary violators in their clients' frauds; in 2011, the Supreme Court defined the category of primary violator very narrowly.[5] Third, bar disciplinary authorities rarely bring charges against securities and banking lawyers. Fourth, while the Securities and Exchange Commission (SEC) has been given authority in the Sarbanes-Oxley Act (SOX) to promulgate professional responsibility rules for securities lawyers,[6] and did enact the up-the-ladder reporting rule that Congress mandated in SOX (this provision requires securities lawyers to report

---

[2] *See* Kirschner v. KPMG LLP, 938 N.E.2d 941, 950, 958-59 (N.Y. 2010) (applying principles of *in pari delicto* to bar a trustee's suit against professional services providers to a failed entity).

[3] *E.g.*, Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164,177-80 (1994).

[4] *E.g.*, Stoneridge Inv. Partners v. Scientific Atlanta, Inc., 552 U.S. 148, 153, 166-67 (2008).

[5] Janus Capital Grp. v. First Derivative Traders, 131 S. Ct. 2296, 2301-02 (2011).

[6] Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7245 (2006).

securities law violations, breaches of fiduciary duty and similar violations to the board of directors of a client if lower-level reporting does not result in an appropriate response to the violation)[7] the SEC has not promulgated additional rules to address the problem of loophole lawyering. Furthermore, there have been few if any SEC enforcement proceedings under the SOX rules. Most important, all of these rules and enforcement mechanisms require a finding of fault on the part of the lawyer—e.g. that the lawyer did not follow the rule—to impose a sanction. This lawyer regulation regime would be much more effective if lawyers, including those not at fault, had an economic incentive to do their best to assure that clients follow the law, particularly in situations where the clients might become insolvent. The conditional fee and fee disgorgement mechanism we propose here provide that incentive. A conditional fee and fee disgorgement mechanism could be enacted by regulation; it also, however, could be voluntarily adopted by boards of directors, perhaps as a result of shareholder activism directed to that end.

II. THE SKEWED INCENTIVES OF BANKERS

An important cause of the financial crisis was badly-understood low-quality financial instruments conceived and marketed as high-quality, and financial techniques that ingeniously concealed deeply flawed finances; both were crafted by bankers who were richly compensated for doing so. This banker behavior is not uncommon or new. Enron provides a plethora of examples. It used novel and complex techniques crafted by bankers (and lawyers) to create a wholly false financial appearance. One banker described to another banker Enron's reaction to a technique his bank had developed: "Enron loves these deals as they are able to *hide* debt from their equity analysts because they (at the very least) book it as deferred rev[enue] or (better yet) *bury* it in their trading liabilities."[8]

In some cases, such as Enron and more recently, when bankers helped Greece hide significant amounts of debt, bankers engaged in or aided and abetted concealment.[9] In other cases, bankers structured, marketed and sold

---

[7] Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3 (2011).

[8] *The Role of the Financial Institutions in Enron's Collapse: Hearing Before the Subcomm. of Investigations of the S. Comm. on Governmental Affairs*, 107th Cong. 232 (2002) (emphasis added) (quoting email from one Chase banker to another, November 11, 1998).

[9] *See, e.g.*, Beat Balzli, *How Goldman Sachs Helped Greece Mask its True Debt*, DER SPIEGEL ONLINE (Feb. 8, 2010, 6:55 PM), http://www.spiegel.de/international/europe/0,1518,druck-676634,00.html (discussing Goldman's transactions for Greece), *and* Claire Hill, *Why Did the Rating Agencies Do Such A Bad Job Rating Subprime Securities?* 71 U. PITT. L. REV. 585 (2010) (discussing concealment in the case of Enron).

subprime securities and credit default swaps, with little regard for the risk to their customers, their banks, and to some extent, themselves.

Financial institutions can be difficult clients for securities and banking lawyers precisely because the economic incentives of the persons running those institutions are skewed toward risk taking, and away from the conservative approach with which lawyers often are most comfortable. Financial institutions are run by people who can take enormous risks on the institutions' behalf and profit personally when those risks pay off, yet have no personal liability for the institutions' debts. We have elsewhere considered how banker behavior might be improved.[10] We have proposed that senior managers in financial institutions should have some personal liability if their institutions become insolvent.[11] We made two specific proposals: (1) that highly-compensated bankers would be subject to personal liability up to all but a few million dollars of their assets, and/or (2) that such bankers would receive some proportion of their compensation in stock for which additional payment (an "assessment") could be required. Thus, if the financial institution became insolvent, bankers would be required to make payments to the institution for the benefit of its creditors. Our personal liability proposal would allow bankers to keep some of their assets even if their financial institution's creditors were not repaid in full; thus, it is more lenient than the unlimited personal liability regime that prevailed when most investment banks were general partnerships up through the 1980s.[12] Our proposal would, we think, bring back some of the conservatism and sound judgment that used to be associated with investment banking and financial institutions generally.

III. THE LAWYERS

What can be done about lawyers? How can we minimize their willingness to aid irresponsible bankers in structuring and selling problematic financial instruments (such as subprime securities constructed of defective mortgages) and techniques (such as debt-concealment techniques)?

Lawyers help structure transactions and write the necessary disclosure; they also provide legal opinions that say that their clients' transactions will

---

[10] Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173 (2010) ("Imposing genuine downside risk through [various] vehicles for personal liability may be the best way to make bankers approach risk in a manner that reflects the potential for externalities of the sort the crisis has so dramatically demonstrated."). *Id.* at 1174.

[11] *Id.* at 1189-92.

[12] *Id.* at 1187.

have the legal effects that the clients desire. Throughout this process, they are giving advice as to what the law requires. Difficulties arise when what is contemplated is aggressive or even arguably deceptive.

Clients typically want to structure their securities to obtain the most favorable regulatory treatment possible. Lawyers have sometimes become involved in transactions involving securities that can be "all things to all people"—debt to the taxing authorities, equity to rating agencies, etc.[13] As discussed below, these arbitrage opportunities are controversial: some people may consider them unobjectionable, but others may feel, especially if many regimes are being arbitraged, that a transaction goes too far.

Lawyers also may help issuers with strategies to improve financial appearance. An issuer might want to appear to have very little debt; it might want to appear to have very few assets as well, in order to appear to have a higher "return on assets." Thus, an issuer might "sell" income-producing assets rather than borrowing money secured by those assets. Lawyers would be involved in structuring these transactions, and are often asked to give an opinion that the desired treatment is appropriate.

The applicable laws in these areas are often rule-based, and reward creative envelope-pushing. Rules necessarily draw lines; clever structuring gets a client on the desired side of the line. If a client does not want to "own" an asset, the client leases the asset. Leasing cannot be identical to ownership but for the label: for instance, the lease cannot be for the whole useful life of the asset. A line is drawn (by the relevant authorities, tax or accounting) at, say, 80%; the client leases the asset for 79% of its useful life. Is this acceptable conduct or not? Reasonable people differ. There are many other examples such as a "triple-dip lease:" a transaction where elements of differing regimes are combined to give regulatory advantages—'dips' in each regime.[14] The advantages tend to come from different—one might say conflicting—characterizations. X and Y might

---

[13] *See generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010) for a discussion of regulatory arbitrage. The author defines regulatory arbitrage as "the manipulation of a structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment." *Id.* at 230. As Fleischer notes, regulatory arbitrage is "perfectly legal." *Id.* at 229.

[14] One definition of "triple-dip lease" is: a lease that uses significant tax or funding incentives from three sources, usually involving at least two countries. The American Society of Appraisers Principles of Valuation, Student Manual, *ME204: Machinery and Equipment Valuation—Advanced Topics and Report Writing* 121 (2005), *available at* http://www.asaeduc.com/index.php?page=shop.getfile&file_id=80&product_id=19&option=com_virtuemart&Itemid=26 (change the name of the file downloaded from index.php to index.zip and then unzip the file ME204stu122905.pdf); *see also* Christian Broderson et al., *Germany Sees the First Stirrings of an Appetite*, 2 INT'L TAX REV., no. 9, Supp., Sept. 1991, at 35, 40 (describing how double or triple dip leasing can be achieved in Germany).

both, for instance, count as owners of the same asset. Another example involves financial instruments intended to obtain favorable characterizations from regulators and quasi-regulators such as rating agencies. As described in a publication by a leading San Francisco law firm, Morrison and Foerster:

> JPMorgan Securities structured a winning product with CENts, Capital Efficient Notes. In July 2006, we represented the underwriters, led by JPMorgan, in the first CENts transaction for Morrison & Foerster client Capital One Financial Corporation. CENts represents a real innovation in hybrids. It was the attainment of what bankers have referred to as the Holy Grail—a hybrid that qualifies for D-basket equity credit from ratings agencies, qualifies for Tier 1 capital treatment for bank holding company issuers, and permits issuers to make tax-deductible interest payments.[15]

Going further, some transactions would seem to have as their entire purpose the tax or accounting treatment they permit. A continuum can be drawn, with transactions done purely to achieve a regulatory or quasi-regulatory purpose such as reducing taxes or improving financial appearance at one end and, at the other end, transactions with a straightforward business purpose,[16] done without regard to regulatory or other costs, and accounting treatment. Many—probably most—transactions are somewhere in between. While non-wealthy individuals in their daily lives engage in transactions without regard to regulatory and like costs with some regularity, businesses generally do not; no matter what kind of transaction they are doing, they typically take into account minimization of tax and other costs, as well as the most advantageous accounting treatment.[17] To restate the question asked above: how far will they go? How far should they go? If they err and go too far—i.e. break the law—who should have to pay for that mistake?

In some cases, banks and other clients go too far, with the help of their lawyers—too far for society's comfort and too far in the eyes of the law. Sometimes there is technical compliance with the particular laws that lawyers are asked to opine on, but other legal obligations—such as general disclosure obligations to investors—are violated. When this occurs, the

---

[15] *Hybrids: A Case Study: Saving Tax Dollars Makes CENts*, MORRISON & FOERESTER LLP, www.mofo.com/files/Uploads/Documents/Cents.pdf.

[16] We are mindful of the difficulties in articulating, much less applying these concepts. *See* Fleischer, *supra* note 13, at 257 for a discussion of anti-abuse doctrines in tax such as "economic substance" and "business purpose" that have attempted to do so with pretty dismal results. But for purposes of our account, appealing to common-sense interpretations of this language suffices.

[17] We suspect that few people really oppose *all* efforts by corporations to minimize their tax liability or improve their financial appearance—the problem is when they go too far.

lawyers who blessed a transaction bear part of the blame and should perhaps bear part of the cost.

One of the most notorious transactions at issue in the financial crisis was Lehman Brothers' Repo 105.[18] In Repo 105, lawyers assisted Lehman with its efforts to conceal $50 billion in debt on its quarterly balance sheets. Lehman sold some of its lower-quality assets to other financial institutions for cash, which it used to pay down debt at the end of each quarter. But the "sales" and the "repayments" were temporary, to be unwound a few days later. Even though Lehman and the counterparty agreed that the transaction would be soon unwound, English law apparently allowed it to be treated as a "sale" if the assets were valued at 105% or more of the cash "paid" for them. It did not matter that the parties contemplated that substantially equivalent assets would be transferred back to Lehman and the cash returned a few days later.[19] Lehman could not find New York lawyers who would agree to characterize the transaction as a sale under United States law, but Linklaters in London was willing to opine that the sale coupled with a repurchase agreement was a true sale under English law.[20] To accomplish its aim, Lehman had to transfer the securities involved to London (this transaction no doubt was done with the knowledge if not the assistance of United States lawyers). In London, the transaction was executed through LBIE, Lehman's European broker-dealer in London. It was reported to Lehman's auditors in the United States as a true sale under English law—something a hyper-technical reading of the rules could be stretched to support—and recorded as such on Lehman's consolidated balance sheet for its quarterly report. After the transaction was unwound, it could be repeated at the end of the next quarter and so on. Substantial fees were paid to the counterparty each time, all for only one apparent purpose: dressing up Lehman's quarterly balance sheet to look better than it actually was.

There is no mention in the Linklaters opinion of the reason why Lehman wanted to do the transaction. There is no mention of the fact that even if the transaction was a true sale under U.K. law, there was still a risk that Lehman Brothers could violate U.S. securities laws if it reported quarterly financial results based on the transaction without also telling its investors in the United States that Lehman Brothers contemplated unwinding the

---

[18] Report of Exam'r at 783-86, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (JMP) (Bankr. S.D.N.Y Mar.11, 2011).

[19] *Id.*

[20] *See id.* app. 17 at 20, 31 (Linklaters Letter to Lehman Brothers International (Europe) on May 31, 2006) (reading in part as follows: "Subject to the qualifications set out in this opinion, in respect of each Transaction, following the transfer by Seller to Buyer of the Purchased Securities, in our opinion, Seller will have disposed of its entire proprietary interest in the Purchased Securities by way of sale.").

transaction shortly thereafter. There is no mention in the opinion letter that Lehman Brothers' senior management should at least tell Lehman Brothers' board of directors about the transaction and its purpose.

Lehman engaged in Repo 105 to falsely improve its financial appearance. Lehman "sold" some assets (for amounts in the tens of billions of dollars) and used the proceeds to "pay off" liabilities. But the "sales" were actually borrowings—Lehman was to repurchase the assets it had purportedly sold, at higher prices several days later, something not reflected on its balance sheet.

An article on Repo 105 discussed the unsuccessful search for a New York law firm, the subsequent choice of the well-regarded English firm Linklaters, and the substance of the opinion given:

> When Lehman first designed Repo 105 in 2001, however, there was one catch. The firm couldn't get any American law firms to sign off on the aggressive accounting, namely that these transactions were true sales instead of what amounted to the parking of assets. From the firm's own Repo 105 accounting policy document, according to the report:
>
> > Repos generally cannot be treated as sales in the United States because lawyers cannot provide a true sale opinion under U.S. law.
>
> Enter Linklaters, which grounded its legal brief in English, rather than American, law. The firm explicitly said: "This opinion is limited to English law as applied by the English courts and is given on the basis that it will be governed by and construed in accordance with English law."
>
> Otherwise, Linklaters provided Lehman with exactly what it wanted to hear. The law firm decreed in its briefs, at least as outlined in the 2006 iteration obtained by Mr. Valukas [the Bankruptcy Examiner], that intent matters. If two parties intend to exchange assets for cash, and then later the party receiving the assets decides to hand back "equivalent assets (such as securities of the same series and nominal value) rather than the very assets that were originally delivered," that amounts to a sale.[21]

Contrast the foregoing description to a sale by an ordinary individual. Smith sells his house to Jones, who wants the house. Smith walks away with money, and Jones has the house. Assume Smith had debt equal to the amount of the house proceeds, which he repays with the house proceeds. Jones may or may not keep the house, but neither he nor Smith would contemplate that he would resell it to Smith—after all, if Smith wanted the house, why would he sell it? Someone looking to lend money to Smith after he sells the house will see in Smith's financial statements no house

---

[21] Michael J. De La Merced & Julia Werdigier, *The Origins of Lehman's 'Repo 105'*, N.Y. TIMES DEALBOOK, (Mar. 12, 2010, 7:02 AM), http://dealbook.nytimes.com/2010/03/12/the-british-origins-of-lehmans-accounting-gimmick/.

and lower debt. Someone looking to lend money to Jones after he buys the house will see in his financial statements the house and less money (or an obligation to pay the bank). What Lehman wanted with Repo 105 was for people to see the financial statements with no "house"—in fact, assets of very questionable value—and less debt; Lehman intended, however, to quickly repurchase the assets for more money than it had been "paid" for them. Anyone looking at Lehman's financial statements during the period when the assets had been sold would—and did—get a profoundly false picture of Lehman's financials.

Even relatively unsophisticated individuals structure some, and certainly their more consequential, transactions to minimize adverse tax and regulatory consequences. For instance, the availability of a mortgage interest deduction encourages people to buy homes rather than rent. But when structuring is tantamount to deception, something is amiss. We take no position as to whether there is 'acceptable' planning of this type[22]—our position here is simply that whether because of differences in degree or in kind from what is acceptable, certain types of lawyer behavior need to be constrained. Business clients use lawyers to help them with structuring transactions and in particular, with minimizing costs and maximizing benefits (such as accounting appearances). Whether or not the lawyers are instigators, they are necessary participants in transactions and share responsibility for the outcome of those transactions.[23] Constraining lawyers—or creating incentives for lawyers to constrain themselves—should help limit this behavior.

IV. THE CONDITIONAL FEE

Contingent fees (usually based on a percentage of a judgment or a transaction) are common in the United States, but prohibited in many other jurisdictions.[24] In some of those jurisdictions, such as England, conditional fees are used to align the lawyers' interests with those of the client.[25] If the client succeeds in accomplishing its objectives the lawyer is paid a fixed fee; if the client does not succeed the lawyer is not paid all or most of the fee. Because the fee is conditional, it is usually higher than a fee that must be paid regardless of the results obtained.

---

[22] *See, e.g.*, David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 220-22 (2002) (arguing that there is no "right" to do tax planning).

[23] *See* Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507, 511-12 (1994).

[24] *See* Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625, 626-27 (1995) (discussing contingent fees in the United States).

[25] *See id.* at 627 n.10 (discussing the conditional fee in England and other jurisdictions that prohibit contingent fees).

We propose that fees for securities lawyers representing financial institutions and perhaps some bank regulatory lawyers be conditional. If the client complies with the law during the legal representation, the fee is paid. If the client does not comply and yet remains solvent, the fee still is paid—the client should not be permitted to avoid paying the lawyer because of its own misconduct (if the lawyer truly neglected his duties, the client can sue for malpractice). If, however, the client violates the laws in connection with which the lawyer has been retained and becomes insolvent within a period of three years, the lawyer is not paid any amounts still due and must disgorge for the benefit of the client's creditors legal fees paid during the period of noncompliance. The lawyer's fault is irrelevant, although the lawyer can work hard to protect a conditional fee by making sure that the client takes steps to comply with the law, particularly if there is a risk of future insolvency. While a lawyer might seek to protect a portion of his or her fees by delaying client insolvency, there is a limited amount lawyers can do to stop a client from sliding into insolvency other than what they are supposed to do, which is to get senior management, directors, and perhaps even the outside creditors to focus on rectifying the situation. In any event, a lawyer who cannot prevent either illegal client conduct or client insolvency will end up doing a substantial amount of legal work for free.

We also propose that lawyers writing opinions relied upon by a client's accountants be required to disgorge fees if 1) the client subsequently becomes insolvent, 2) the lawyers' opinion was relied upon by the accountants, and 3) a causal connection is established between the opinion and the accountants' improper certification of financial statements (this part of our proposal would require an adjudication—probably by a court—before a fee disgorgement could be ordered). A showing of causal connection with the insolvency would not be required.

Although the category of lawyers who should receive conditional fees can be expanded (either by regulation or by private agreement with a client), we suggest starting with lawyers who are "practicing before the SEC"—a term broadly defined under SEC rules to include the provision of any securities compliance advice[26]—and lawyers such as Linklaters in the Repo 105 transaction, who provide legal opinions that are relied upon by the auditors of a client that is a publicly held company, whether or not they practice before the SEC. Some banking and other regulatory lawyers could be included as well, either through voluntary private arrangements with clients or through regulations promulgated by the relevant banking regulators. This proposal might be enacted by regulation. But we must be

---

[26] Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(a) (2011).

realistic: such a regulation is probably unlikely. What may be more realistic, though, is private adoption. Some client boards of directors might ask lawyers for a conditional fee premised upon a combination of client compliance and solvency, both as a way of improving the quality of services from lawyers charged with compliance work, and, if the arrangement is publicized, as a way to reassure investors, counterparties, and regulators that the client wants to do everything possible to assure its own compliance and solvency. And shareholder activists might submit proposals urging adoption of conditional fee and disgorgement arrangements.

A conditional fee approach avoids many of the difficulties present in a fault-based malpractice regime. A fault-based regime requires finding counsel to sue other lawyers; it also requires establishing fault or failure to adhere to the prevailing standard of care, and loss causation. Moreover, fault-based regimes may allow for the *in pari delicto* defense, under which professional service providers for a failed entity can attribute wrongdoing of their client's officers and directors to a trustee representing the now-bankrupt client's creditors.[27] Civil litigation is in any event unpredictable and in all events costly, further limiting the ex ante motivations of lawyers to avoid bad behavior, and the ex post ability to recover for lawyer bad behavior.

While we do not suggest replacing the malpractice regime with a conditional fee, we believe that a conditional fee could be useful for avoiding the type of loophole lawyering that brings clients too close to legal lines and too close to insolvency, a combination likely to injure persons other than the client, including its creditors, and to potentially cause harm to the financial system as a whole. The conditional fee provides an additional incentive for cautious lawyering without many of the costs that would be incurred from an alternative approach of making legal malpractice suits easier to win or increasing the size of judgments against lawyers.

The conditional fee also fills an enforcement gap in bar association regulation of the legal profession. As noted above, very few bar disciplinary proceedings are brought against lawyers for advice they give clients about compliance with securities laws and banking regulations. Many disciplinary authorities do not fully understand these practice areas, and have difficulty determining when lawyers have been incompetent[28] or have assisted with a client crime or fraud.[29] Disciplinary authorities are

---

[27] *See, e.g.*, Kirschner v. KPMG LLP, 938 N.E.2d 941, 950 (N.Y. 2010).

[28] *See* MODEL RULES OF PROF'L CONDUCT R. 1.1 (2009) (describing compliance).

[29] *See* MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2009) (prohibiting lawyer assistance with client crime or fraud).

reluctant to pursue charges of lawyer malfeasance except in the rare cases when the lawyer has been subject to an administrative sanction by a government agency or a criminal conviction.[30]

Regulation of lawyers by the SEC or bank regulators is somewhat more vigorous because these agencies are experts in the relevant area. Congress gave the SEC new powers to regulate lawyers in SOX, and the SEC's professional responsibility rules have addressed some areas of responsibility such as reporting corporate client noncompliance up the ladder to boards of directors. The more general responsibilities of securities lawyers to assure client compliance with the law, are not, however, addressed in the SEC's rules. The SEC rules also do not address the consequences for lawyers who render legal opinions blessing transactions despite warning signs that those transactions are part of a plan to deceive investors. Furthermore, the rules contain confusing language defining when evidence of a violation has to be reported up the ladder.[31] The rules also only apply to lawyers representing issuers (lawyers representing underwriters and other financial advisors are excluded unless the lawyers represent these entities as issuers of their own securities), and there is a broad carve-out for foreign lawyers (it is debatable, for example, whether Linklaters was practicing before the Commission when its London office issued the Repo 105 opinion letter with a specific disclaimer saying the letter was not providing advice under U.S. securities laws, even though the opinion also said that Lehman's auditors would rely upon the opinion in blessing the financial statements attached to its 10K filed with the SEC).[32] In any event, there have been few, if any, SEC proceedings against lawyers for violating the SEC's SOX rules even in situations where it is clear that the rules do apply.

We do not propose that the SEC rules for securities lawyers be abandoned—indeed they should probably be expanded to address new

---

[30] This concern about lack of enforcement by state bar disciplinary committees motivated one of the authors of this article to urge the federally mandated up-the-ladder reporting requirement that eventually was adopted in Section 307 of SOX. *See* Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 261 (1996).

[31] *See* 17 C.F.R. §205.2(e) (defining evidence of a material violation as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur").

[32] *See id.* § 205.2(a)(2)(ii) (stating that the definition of an attorney appearing and practicing before the Commission "[d]oes not include an attorney who . . . is a non-appearing foreign attorney"). Other difficulties with pursing Linklaters under the SEC's SOX rules include that it may not have been apparent at the time—particularly to Linklaters—that Lehman was violating the securities laws (although serious inquiry into the purpose of the Repo 105 transaction would likely have revealed that Lehman was trying to dress up its balance sheet).

areas such as legal opinions[33]—but we do not believe these rules, alone or in combination with the legal malpractice and lawyer discipline regimes, provide sufficient incentive for lawyers to be proactive in assuring client compliance in those situations where persons other than the client—e.g. creditors and the financial system as a whole—are most likely to be harmed. Unlike these fault-based regimes, the conditional fee that we propose focuses on lawyer compensation and compensates the attorney based on an important component of the results obtained for the client,[34] which is the client's compliance with the law, at least in those situations where the client is at risk of insolvency. If the client does not comply and becomes insolvent, the lawyer does not get paid.

The conditional fee we propose is principally an incentive mechanism, not a way to compensate creditors (an issuer's legal fees are likely to be a small percentage of creditors' overall losses in a situation such as the Lehman Brothers bankruptcy). Nonetheless, disgorgement of conditional fees may be the only recovery creditors get from the issuer's lawyers. As discussed above, private securities fraud suits cannot be brought under federal law against aiders and abettors of securities fraud, or even co-conspirators, and the definition of the primary violator is exceedingly narrow. [35] In some states, lawyers sued by a bankruptcy trustee can raise the defense of *in pari delicto*, claiming that the conduct of the defunct debtor's officers and directors are attributable to the bankruptcy estate, thereby blocking most suits for malpractice and breach of fiduciary duty against professional service providers.[36] Finally, the SEC has to date not used the SOX rules or any other securities laws to require disgorgement of fees or other payments by lawyers except in situations where the lawyers themselves are found to have violated the securities laws.

This conditional fee disgorgement rule, like our proposed personal

---

[33] The SEC's rules should require that lawyers opining on large transactions report basic facts about those transactions to issuer boards of directors, unless the chief legal officer or outside securities counsel has reviewed the transaction and affirmatively opined that the issuer is in compliance with US securities laws. The SEC should also clarify that these and other SOX Section 307 rules apply to any lawyer providing an opinion or other work product to be relied upon by the issuer's auditors. Finally, lawyers providing opinions should have affirmative duties to investigate transactions to satisfy themselves that they are not assisting a client in committing a fraud. The extent of required investigation should depend on the nature of the transaction.

[34] *See* MODEL RULES OF PROF'L CONDUCT R. 1.5 (2009) (listing factors to be used in determining the reasonableness of legal fees, including the results obtained).

[35] *See* Janus Capital Grp. v. First Derivative Traders, 131 S. Ct. 2296, 2301-02 (2011); Stoneridge Inv. Partners v. Scientific Atlanta, 552 U.S. 148, 153, 166-67 (2008); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177-80 (1994); *supra* text accompanying notes 3-5.

[36] *See* Kirschner v. KPMG LLP, 938 N.E.2d 941, 950, 955-57 (N.Y. 2010).

liability rule for investment bankers discussed briefly above,[37] would impose strict liability, unrelated to a showing of the lawyers' culpability. Lawyers would be required to accept responsibility for the outcome of their legal representation in those situations where bad outcomes are particularly likely. Because only fees would be lost and personal liability would not be imposed on lawyers absent a finding of fault, this proposal is not as onerous as our personal liability proposal for investment bankers. There is, however, a common theme: in this regime of personal and professional responsibility the "it's not my fault" argument would be irrelevant.

Will a conditional fee discourage lawyers from taking on some financial services firms and other issuers of securities as clients? Perhaps, unless lawyers are compensated for the fact that the fee is conditional. Legal representation in securities and banking matters would probably be of higher quality under the conditional fee regime, but it would be more expensive, especially for clients that take bigger risks.[38]

What if, in the course of a representation, the client increases its risky behavior or otherwise comes closer to insolvency? Will lawyers respond to increased risk of client noncompliance and insolvency in the middle of a representation by raising the conditional fee rather than addressing the underlying problem? Perhaps clients should be required to report material changes in their fee arrangements with their lawyers during the course of a representation on a Form 8-K (this is the same SEC form used to report developments such as resignation of accountants and the reasons behind them in Item 401; the same form could require reporting changes in fee arrangements with lawyers and the reasons behind them).[39]

V. CONCLUSION

We may no longer be in the midst of a full-blown financial crisis, but our economy is scarcely healthy. Indeed, we risk entering into a second "dip"

---

[37] *See* Hill & Painter, *supra* note 10.

[38] Perhaps a rule requiring the conditional fee should contain an exception for smaller clients whose legal fees are already large compared with their market capitalization (unlike Lehman Brothers these smaller institutions are also unlikely to pose a systemic risk to the economy). For larger financial institutions, however, more effective and more conservative–if marginally more expensive–legal representation is worth it.

[39] Even if the specifics of the legal representation are not disclosed under client confidentiality rules, investors as well as regulators should be entitled to see the conditional fee increase reflected in the client's securities filings. *See* MODEL RULES OF PROF'L CONDUCT R. 1.6 (2009) (describing confidentiality as well as common law governing the attorney-client privilege); *see also*, U.S. v. Amerada Hess Corp., 619 F.2d 9080, 985-96 (1980) (discussing federal common law attorney client privilege). Information about lawyers' fees generally is not considered to be privileged (although the nature of the legal services sometimes is privileged), and basic information about legal fees probably should not be kept confidential when the client is a public company.

or recession. Unemployment remains very high, and the housing market is deeply depressed. The stock market remains volatile. Many laws and regulations have been adopted in response to the crisis; there have been other changes as well, including some changes in norms and behavior. There are debates as to how well the law changes will work, and how much we have learned about what to do and what not to do; few if any observers, though, think that we have solved the problem. Indeed, many commentators are suggesting that the next crisis is not far off; some are suggesting it will be even worse than the crisis just past.

Banker behavior was a significant cause of the crisis. We have argued elsewhere that existing law, including the law as changed in response to the crisis, does not sufficiently address banker behavior; we have argued that bankers should bear more liability for their banks' excessive risk-taking.[40]

Here, we briefly consider lawyer behavior. Lawyers designed many of the exotic financial instruments that caused the crisis, and provided securities and other compliance work to large financial institutions that in some cases were not complying with the law. Lawyers blessed transactions such as Repo 105 that helped conceal these problems from investors. Lawyers should accept responsibility for the consequences of their actions, not only in a fault based liability or disciplinary regime, but also by sometimes not getting paid for the work they do when that work does not accomplish its objective—i.e. when compliance work does not cause the client to comply with the law—and the client also becomes insolvent.

Our conditional fee proposal will not prevent all loophole lawyering. The client may be close to the line, but remain on the "right side"—our proposal only addresses violations of law, not aggressive interpretations. Our proposal also does not address violations of law that cause dramatic losses for shareholders or other parties such as customers, counterparties and investors, but do not result in the client's insolvency. For these reasons the conditional fee is only part of the solution to the problem of loophole lawyering and lax compliance oversight by lawyers. An effective legal malpractice liability regime, a more diligent lawyer disciplinary regime, and more assertive oversight of lawyers by the SEC and bank regulators, will also be necessary. In a limited range of circumstances, however, the conditional fee could realign lawyer incentives toward more conservative assessment of risk than their clients' assessment. Conditional fees thus should help some banking lawyers and securities lawyers do a better job representing their clients.

We think our proposal can play an important role in preventing, or at least limiting the effect of, future financial crises. Problematic transactions

---

[40] Hill & Painter, *Berle's Vision Beyond Shareholder Interests*, *supra* note 10.

should become more difficult to do because lawyers will be less willing to help, particularly if a transaction poses a risk of both legal violation and future insolvency. Lawyers who fear loss of conditional legal fees under a no-fault regime in addition to their existing exposure to malpractice liability and other sanctions when fault can be shown, would presumably conduct more due diligence, and might refuse to participate in transactions unless problematic elements were eliminated. Lawyers would be encouraged to err on the side of caution. The benefits of our proposal come at a cost: fewer transactions and higher legal fees. But on balance, this cost seems worthwhile.

This proposal is less ambitious and hence perhaps more likely to be effectively implemented than our proposal regarding bankers' personal liability. While we hope that a conditional fee regime, whether implemented by financial regulators, state bar ethics committees or by private parties themselves, could motivate lawyers to limit or even eliminate their involvement in problematic client behavior, much more needs to be done. Our broader conclusion is that the ethos that prioritizes and rewards financial and legal risk taking needs to change. Our hope, with this proposal, our proposal regarding bankers, and other reforms we are suggesting elsewhere,[41] is that such an ethos will begin to change in the financial services industry, and be supplanted by an ethos of professional and personal responsibility.

---

[41] In a book tentatively titled THE PERSONAL AND PROFESSIONAL RESPONSIBILITIES OF INVESTMENT BANKERS, we will discuss several suggested reforms, including personal liability of investment bankers for firm debts, limiting compensation for investment bankers on the premise that investment banking plays a facilitating rather than a primary role in economic development and is *not* the place for either excessive innovation or big risk—big reward business decisions, promoting regional investment banking to reinforce social and economic ties with clients and other economic actors affected by bankers' actions, and promoting specialized investment banking that focuses on services such as underwriting securities or retail brokerage to increase the value of reputation for high quality services rather than the current emphasis on propriety trading in an investment bank's own account.

REGULATING INFORMATIONAL INTERMEDIATION

ONNIG H. DOMBALAGIAN†

INTRODUCTION

Informational intermediaries—intermediaries who process information (an opinion, a price, a rating, an index, or other certification) out of raw data or other informational inputs—occupy a curious role in financial regulation. Federal laws governing financial transactions seek to regulate the information generated by such intermediaries with a view toward encouraging public use, if not reliance—be they underwriters,[1] auditors,[2] or other gatekeepers assessing the adequacy of issuer disclosures in securities offerings,[3] stock exchanges or other securities information processors compiling market quotations and prices,[4] or credit rating

---

†Professor, Tulane University Law School. Prior to joining the Tulane law faculty in 2003, Professor Dombalagian served as an attorney fellow at the U.S. Securities and Exchange Commission and practiced in the field of broker-dealer and financial market regulation for five years as an associate in the Washington D.C. office of Cleary, Gottlieb, Steen & Hamilton. He was publishing editor of the Harvard Law Review while in law school and clerked for the Honorable J. Edward Lumbard on the U.S. Court of Appeals for the Second Circuit upon graduation. In 2007, he received the Felix Frankfurter Distinguished Teaching Award from the graduating class, and in 2009, he was named to the George Denègre Endowed Professorship.

[1] *See* 15 U.S.C. § 77k(a)(5) (2006) (establishing underwriter liability for untrue or misleading statements in a registration statement under the Securities Act of 1933); *see also* Municipal Securities Disclosure, 17 C.F.R. § 240.15c2-12 (2010) (establishing disclosure obligations of underwriters in municipal securities offerings).

[2] *See* 15 U.S.C. § 77k(a)(4) (2006) (discussing the liability of accounting firms under the Securities Act of 1933); 15 U.S.C. § 78j-1 (2006) (describing obligations of registered accounting firms with respect to audits required under the Securities Exchange Act of 1934).

[3] *See* 15 U.S.C. § 77k(a)(4) (establishing liability of other professionals).

[4] *See* 15 U.S.C. § 78k-1(a)(1)(C)(iii) (2006) (finding that the availability of quotation and transaction information is in the public interest); 15 U.S.C. § 78k-1(c)(1)(A) (2006) (granting the SEC authority to promulgate rules to prevent fraud and assure prompt, accurate, reliable and fair collection, processing, distribution, and publication of such

agencies rating corporate debt and asset-backed securities.[5] Financial regulators have also relied upon the diligence and judgment of informational intermediaries to feed quantitative and qualitative information into the risk-management formulas that pervade the regulation of financial issuers, products, and services.[6]

Such regulatively mandated or sanctioned use comes at a cost: as regulation allows informational intermediation to become a franchise, regulators must be attuned to the risk that its long-term reputational value will be tarnished, whether from abuse or neglect.[7] In the wake of the Enron scandal and the dot-com bubble of the early 2000s, policymakers and academics called into question the independence and accountability of accountants, attorneys, underwriters, listing exchanges, credit rating agencies, and research analysts in ensuring the completeness and accuracy of the information published by public companies under the reporting requirements of federal securities law.[8] In the wake of the recent financial crisis, it seems fitting to add others to the list of regulated informational intermediaries, including those who participated in the creation of asset-backed securities and related synthetic products (such as mortgage

---

information).

[5] *See* 15 U.S.C. § 78o-7 (2006) (listing the registration requirements for credit rating agencies).

[6] *See, e.g.*, 12 U.S.C. § 24a(a)(3)(A) (2006) (conditioning a national bank's authorization to conduct financial services through a subsidiary upon the credit rating of its debt); 15 U.S.C. § 78c(a)(41) (2006) (adding a credit rating requirement to the statutory definition of "mortgage related security"); *see also* Net Capital Requirements for Brokers or Dealers, 17 C.F.R. § 240.15c3-1e(b)(3), (c)(4)(vi) (2010) (making references to historic market prices and spreads and credit ratings for purposes of computing market risk and credit risk components of net capital); Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure, 12 C.F.R. pt. 208 app. A (2010) (making references to market value and credit ratings for purposes of risk-based capital measures for Federal Reserve state member banks).

[7] *See, e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L. Q. 619, 681–90 (1999) (discussing "regulatory license" view of credit rating agencies); *see generally* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1409-19 (2002) (discussing the risks associated with using auditors and attorneys as gatekeepers).

[8] *See, e.g.*, S. REP. No. 107–205, at 1-2 (2002) (referencing Senate Banking Committee hearings on, among other topics, the importance of auditor independence for the quality of audits, conflicts of interest and the compromise to auditor independence raised by accounting firms' provision of consulting services to audit clients, and conflicts of interest among securities underwriters and affiliated stock analysts); Coffee, *supra* note 7, at 1406-08 (describing the failure of auditors and analysts as "gatekeepers" during the late 1990s); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 403–07 (2004) (questioning the independence of analysts and credit rating agencies in light of Enron's collapse).

originators, SPV sponsors, and collateral managers) and perhaps even government-sponsored enterprises (such as Freddie Mac and Fannie Mae).[9]

Regulators take a variety of approaches to regulating information products. In some cases, informational intermediation has been (and in parts, still is) regulated as an industry utility. More frequently, the preferred approach to regulating informational intermediaries is to impose (or, once imposed, heighten) regulatory obligations akin to those of other professionals or fiduciaries. Commentators have exhaustively studied the quasi-public "gatekeeping" role that attorneys and accountants play in securities disclosure, and the traditional reliance on the reputational interests of such firms in discharging their due diligence obligations notwithstanding the manner of compensation and other significant conflicts of interest to which they are subject.[10] The Sarbanes-Oxley Act of 2002 ("SOX"), for example, tightened requirements for the regulation of accountants, attorneys, and research analysts, with a particular focus on assuring auditor independence and heightening diligence.[11] In 2006, Congress adopted similar professional obligations and conflict-of-interest rules for credit rating agencies.[12] In the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") , Congress likewise recognized the role of issuers of asset-backed securities as informational intermediaries by imposing a duty on such intermediaries to conduct due diligence with respect to the assets underlying asset-backed securities.[13]

---

[9] FIN. CRISIS INQUIRY COMM'N, THE FIN. CRISIS INQUIRY REPORT 226-30 (2010).

[10] *See generally* Coffee, *supra* note 7 (discussing gatekeeper liability as an incentive to catch wrongdoing); Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 418–20 (2004) (noting that "[a]part from the considerable epistemological challenges auditors face in vouching for managerial assertions," there are various "structural limits" to quality assurance, including conflicting incentives, capture, and independence); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003) (discussing gatekeeper liability as an incentive to catch wrongdoing); Peter B. Oh, *Gatekeeping*, 29 J. CORP. L. 735, 747–55 (2004) (distinguishing "reputational intermediaries" from "corporate gatekeepers" primarily in terms of the gatekeeper's ability to "disrupt misconduct by withholding support" from the corporate issuer and its concomitant "monitoring duties that govern the decision to grant or deny support").

[11] *See* 15 U.S.C. § 78j-1(g)(l) (2006) (prohibiting accounting firms from providing non-audit services to audit clients and from performing an audit in the presence of certain conflicts of interest); 15 U.S.C. §78j-1(j) (requiring an audit partner rotation); 15 U.S.C. §§ 78j-1(i), (k) (2006) (requiring an accounting firm to seek preapprovals from, and submit audit reports to, an independent audit committee); 15 U.S.C. § 7245 (2006) (requiring the SEC to adopt rules of professional responsibility for attorneys); 15 U.S.C. § 78o-6 (2006) (requiring the SEC to adopt rules regarding research analyst conflicts of interest).

[12] 15 U.S.C. § 78o-7 (2006) (adding § 15E to the Securities Exchange Act of 1934).

[13] Dodd-Frank Wall Street Reform and Consumer Protection Act § 945, 15 U.S.C. § 77g(d)(1) (Supp. IV. 2011) (instructing the SEC to promulgate rules requiring issuers

At the same time, the alternative approach of weaning regulation away from express reliance on informational intermediaries has received significant attention. In the wake of the ongoing financial crisis, the SEC proposed to scale back reliance on credit ratings, *inter alia*, for purposes of assigning risk weightings or haircuts in computing net capital or expediting securities offerings.[14] As instructed by Dodd-Frank,[15] other financial regulators have similarly combed through their rules and regulations to find ways to eliminate unnecessary reliance on credit ratings.[16] Dodd-Frank has also given the SEC the authority to impose on issuers of asset-backed securities the obligation to disclose certain asset-level or loan-level data as necessary for investors to perform their own due diligence,[17] and to compel credit rating agencies to provide investors with more information about the nature of the representations and warranties made in connection with such

---

of asset-backed securities "to perform a review of the assets underlying the asset-backed security"); S. REP. NO. 111-176, at 133 (discussing the need for such diligence).

[14] *See, e.g.*, Securities Ratings, Securities Act Release No. 8940, 73 Fed. Reg. 40,106, 40,107-09 (proposed July 11, 2008) (proposing, *inter alia*, greater reliance on minimum denomination requirements, eligibility requirements for purchasers, and reporting experience of issuers in lieu of credit ratings); References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58,070, 73 Fed. Reg. 40,088, 40,093 (proposed July 11, 2008) (proposing, *inter alia*, greater reliance on broker-dealers to make certain credit risk and liquidity determinations for purposes of net capital and customer protection rules); References to Ratings of Nationally Recognized Statistical Ratings Organizations, Investment Company Act Release No. 28,327, Investment Advisers Act Release No. 2751, 73 Fed. Reg. 40,124, 40,125-26 (proposed July 11, 2008) (proposing, *inter alia*, greater reliance on mutual fund directors and investment advisers to make certain credit risk and liquidity determinations).

[15] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939(a)-(e), 124 Stat. 1376, 1885-86 (2010) (to be codified as amended in scattered sections of 26 U.S.C.) (replacing references to ratings and related terms, such as "investment grade," in various statutes governing financial institutions with delegation of authority to individual agencies to develop "standards of credit-worthiness"); § 939A (requiring federal agencies to review and, as necessary, modify any regulations that require assessments of credit-worthiness or refer to or require reliance on credit ratings).

[16] *See, e.g.*, Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings, 76 Fed. Reg. 44,262 (proposed July 25, 2011) (to be codified at 17 C.F.R. pts. 1, 4) (implementing the CFTC's removal of references to and reliance on credit ratings); SEC, REPORT ON REVIEW OF RELIANCE ON CREDIT RATINGS (2011) (summarizing proposed rule changes); BOARD OF GOVERNORS OF THE FED. RESERVE, REPORT TO THE CONGRESS ON CREDIT RATINGS 3-7 (July 2011) (listing references to credit ratings in Board regulations and discussing consideration of alternatives to the use of such ratings for regulatory purposes).

[17] *See* 15 U.S.C. § 77g(c) (2006) (instructing the SEC to prescribe rules requiring issuers of asset-backed securities "at a minimum, to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence").

securities.[18] Finally, some academic commentators have encouraged regulators to allow institutional and professional investors to use alternative approaches (e.g., credit-default swap spreads) when assessing credit risk for investment management purposes.[19]

In this contribution, I would like to explore the extent to which we can survive in a world without regulatively privileged informational intermediaries, and to the extent that we cannot, whether there are ways to regulate their conduct with a view to improving the utility of their output. I discuss in Part I the reasons why I do not think we can completely kick the habit of relying on informational intermediaries for essential regulatory tasks. I turn to the problems with the models most frequently invoked to regulate informational intermediaries in Part II, as well as the concerns raised by the compensation models regulators and commentators have proposed in Part III. In Part IV, I offer some thoughts as to whether an "outcome-based" approach to regulating informational intermediaries might not, in tandem with the other approaches, rehabilitate the fallen angels among informational intermediaries.

I. WHY DO WE NEED INFORMATIONAL INTERMEDIARIES?

Informational intermediaries, as I refer to them, process raw data (or other informational inputs) into information. The information produced can take the form of a disclosure document, a professional opinion, a price or range of prices, a rating, an index, or other certification. Like every commodity, there is a market for information products; information producers, all things being equal in an efficient market, should generate information up to the point where the marginal cost exceeds the marginal value of the information to consumers.[20] As economists have debated,

---

[18] *See* 15 U.S.C. 78o-7 (2006) (instructing the SEC to prescribe rules requiring each credit rating agency to describe "the representations, warranties, and enforcement mechanisms" available to investors in asset-backed securities).

[19] Mark J. Flannery et al., *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085, 2089 (2010).

[20] The process by which this equilibrium is achieved in the market for financial information and the efficient allocation of the resulting equilibrium has been the subject of significant scholarly attention. *See, e.g.*, Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 786-796 (1985) (describing market models that attempt to reconcile the claim that "informed participants (except for corporate insiders who possess unique access to certain information) cannot outperform other market participants" in efficient markets, and that investors should therefore lack the incentive to change their portfolios or information acquisition strategies, with the claim that efficient markets nevertheless "afford investors the opportunity to earn competitive, positive returns from securities research").

however, regulatory intervention may be appropriate in some circumstances to correct for the underproduction of information, either because insiders have an incentive to withhold it or because individual market participants have no incentive to produce it. For example, the fact that corporate insiders or other traders can profit from privileged access to information may significantly affect the willingness of other market participants to trade against such counterparties and may thus impair the efficiency of information markets.[21] Conversely, to the extent that the non-excludable, non-rivalrous use of information encourages better pricing, broader public investment, and hence greater liquidity in associated financial instruments,[22] the inability of any single market participant fully to internalize those benefits may lead to suboptimal production.[23] For these reasons, policymakers and scholars have long debated the wisdom of mandatory disclosure of corporate information, mandatory publication of quotations and trading prices, restrictions on insider trading and selective disclosure, and the bundle of rights and privileges associated with other basic financial data.[24]

The focus of this contribution is somewhat tangential to this debate, although it is invariably intertwined with the larger issues of information regulation. As I refer to them, informational intermediaries add value by transforming one set of data into another more meaningful or more usable

---

[21] The economic argument is that market makers stand to lose when they trade against informed traders and must pass the resulting costs onto uninformed traders in the form of wider spreads, which in turn diminish liquidity as fewer people trade in the face of increased transaction costs. *See* Lawrence M. Ausubel, *Insider Trading in a Rational Expectations Economy*, 80 AM. ECON. REV. 1022, 1025 (1990); Mark Klock, *Mainstream Economics and the Case for Prohibiting Inside Trading*, 10 GA. ST. U. L. REV. 297, 329-33 (1994) (summarizing the economic argument).

[22] *See, e.g.*, Robert Ahdieh, *Beyond Individualism in Law and Economics*, 91 B.U. L. REV. 43, 78-79(2011) (asserting that "[i]nformation is non-rival and non-excludable, like other public goods" and that regulation should invite "more collective modes of analysis" rather than limit the "network qualities" of such information and "the pattern of positive feedback that arises where 'exposure to information shapes demand for additional information,'" for the purpose of advancing private interests); Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371, 383 (1977) (describing the "public good" aspect of information as the ability of purchasers of information to be able to sell or resell such information without diminishing its usefulness to themselves).

[23] Leland et al., *supra* note 22 (postulating that financial intermediaries that act as investment conduits exist because they capture part of the value of the information they produce through the increased value of the portfolio they have assembled based on such information).

[24] *See generally* Onnig H. Dombalagian, *Licensing the Word on the Street: The SEC's Role in Regulating Information*, 55 BUFF. L. REV. 1, 31-63 (2007) (discussing policymaker and academics' arguments on these topics).

form of information.[25] This exercise comprises two steps: an informational intermediary must first exercise diligence to compile inputs, and then employ a methodology for compiling or processing the inputs into the desired output. Testing the reliability of inputs is the classic gatekeeping function[26]—law firms and underwriters maintain diligence checklists, accounting firms apply auditing standards, exchanges employ order entry parameters and monitor trading data for anomalies, and comptrollers use internal controls in an effort to provide "reasonable assurance" that the output is not tainted by errors, omissions, or other deficiencies that would reduce its value to consumers.[27] To the extent that some informational intermediaries have privileged access to inside information, all of the policy concerns relating to the opportunity to profit from selective access remain pertinent to such informational intermediaries.

In this paper, I focus on the social utility of the second step: employing a sound methodology for processing inputs into the desired output. This transformation can take a variety of forms. To the extent that the intermediary's output is a narrative presentation of information, the intermediary's role may simply be to attest to the sufficiency and accuracy of the presentation of the information it has received or discovered in accordance with objective procedures prescribed by law or the profession. The creative aspect of the intermediary's work is interpretive, in that it makes the information more usable, but should not transform the inputs in a material way. To the extent that much of the preparatory work is done by the issuer itself, the value added by external intermediaries is, moreover, largely a binary certification. Thus, when an auditor opines that financial statements "present fairly, in all material respects, an entity's financial

---

[25] *Cf.* ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 66 (2007) (describing investment banks as informational intermediaries).

[26] *See generally* Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK. J. CORP., FIN. & COM. L. 119, 123 (2006) (defining "gatekeeper" as "a person or firm that provides verification or certification services or that engages in monitoring activities to cabin illegal or inappropriate conduct in the capital markets").

[27] *See, e.g.*, 15 U.S.C. § 78j-1(a)(1) (2006) (requiring audits under § 10A of the Exchange Act to include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts"); 15 U.S.C. § 78m(b)(2)(B) (2006) (requiring Exchange Act reporting companies to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that transactions are properly executed and recorded); *see also* 15 U.S.C. § 77k(b)(3)(A) (2006) (requiring underwriters and other non-expert statutory defendants under § 11 to prove that after "reasonable investigation" they had "reasonable ground to believe" the truth and completeness of the statements in a registration statement to qualify for due diligence defense).

position, results of operations, and cash flows in conformity with generally accepted accounting principles,"[28] or when a law firm states that "nothing came to our attention that caused us to believe [that a document] contained any untrue statement of a material fact or omitted to state any material fact required to be stated therein or necessary to make the statements therein not misleading,"[29] the value added by the second step could be perceived as a formality of accountability.

In other cases, the financial intermediary adds significant judgment—whether in the form of deterministic algorithms or formulae, subjective assessments of merit, or a combination of both. Underwriters in security offerings and research analysts following a publicly traded company, for example, use narrative disclosures, financial statements, and other endogenous information about the company, as well as exogenous information such as industry and macroeconomic trends and the demand for the company's securities, to produce a price or price target, based on a combination of valuation techniques and subjective judgment.[30] Specialists or market makers on an exchange apply their subjective judgment to the information gleaned from privileged access to centralized order flow—the stream of incoming limit and market orders in a particular security routed through a specialist post or limit order book—to generate quotations, which then become the basis for further trading both on and off the exchange.[31] Credit rating agencies map financial disclosures to specific categories of credit quality.[32]

---

[28] CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Reports on Audited Financial Statements, § 508.07 (AM. INST. OF CERTIFIED PUB. ACCOUNTANTS 2010).

[29] Report of the Subcommittee on Securities Law Opinions, Committee on Federal Regulation of Securities, ABA Section of Business Law, *Negative Assurance in Securities Offerings (2008 Revision)*, 64 BUS. LAW. 395, 408 (2009) (including sample language).

[30] *See, e.g.*, MORRISON & WILHELM, *supra* note 25, at 25-26, 240-42 (stressing the importance of "relationships and tacit human capital" in the valuation and placing of new issues, particularly when information is "closely held by a few insiders" and where "investment banker networks and investment banker reputation" are both particularly valuable); DAVID P. STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY: THE NEW PARADIGM 119-24 (2010) (describing the range of inputs and methodologies investment bank research analysts use to determine, among other information products, a company's forecasted value).

[31] *See, e.g.*, MAUREEN O'HARA, MARKET MICROSTRUCTURE THEORY 53-75 (1995) (describing various models of market maker and specialist price adjustment responding to informed and uninformed trading).

[32] For example, Standard & Poor's summarizes its credit rating opinions as follows:

'AAA'—Extremely strong capacity to meet financial commitments. Highest Rating.

'AA'—Very strong capacity to meet financial commitments.

'A'—Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.

Unlike the basic gatekeeping function, one can question the utility of regulatory interference or reliance on this second step of the intermediation process. First, granting particular credence to a limited set of intermediaries may be unnecessary. If the inputs on which an informational intermediary relies have otherwise been disclosed, the intermediary's own assessment of that information might arguably have no special value beyond that which others are willing to pay to have it generated (if they cannot generate it themselves).[33] It is not difficult to imagine that some sophisticated institutions could take the same financial and nonfinancial disclosures received by an underwriter or rating agency and generate estimates of the value of a security or the creditworthiness of an issuer either based on their own proprietary models or on independent third-party research that they pay for out of pocket.[34] Moreover, while the cost of duplicating the gatekeeper's diligence may be prohibitively expensive, the valuation or risk-assessment exercise for such institutions may not, particularly if the

---

'BBB'—Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.

'BBB-'—Considered lowest investment grade by market participants.

'BB+'—Considered highest speculative grade by market participants.

'BB'—Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.

'B'—More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.

'CCC'—Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments.

'CC'—Currently highly vulnerable.

'C'—Currently highly vulnerable obligations and other defined circumstances.

'D'—Payment default on financial commitments.

Credit Ratings Definitions & FAQs, STANDARD & POOR'S, http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us#def_1 (last visited Aug. 17, 2010).

[33] *See* Thomas J. Fitzpatrick, IV & Chris Sagers, *Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations*, 61 ADMIN. L. REV. 557, 581-85 (2009) (questioning the value of credit ratings).

[34] *See, e.g.*, 17 C.F.R. § 240.15c3-1e (2010) (allowing a broker or dealer to use an alternative approach to computing net capital deductions); Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, 76 Fed. Reg. 26,550, 26,552-53 (proposed May 6, 2011) (to be codified at 17 C.F.R. § 240.15c3-1) (permitting broker-dealer, for purposes of computing net capital, to apply haircut of less than 15 percent to commercial paper, nonconvertible debt, or preferred stock if it has a process for determining creditworthiness that considers the following factors: credit spreads, securities-related research, internal or external credit risk assessments, default statistics, inclusion on an index, priorities and enhancements, price, yield, volume and asset-specific factors). As the release notes, broker-dealers that rely on Rule 15c3-1e to compute net capital using proprietary value-at-risk models have long been permitted to rely on internal ratings. *Id.* at 26,555.

institutions possess proprietary models that can generate uniquely tailored or simply better information than the information generated by informational intermediaries for their broader clientele.

Second, to the extent that informational intermediaries have a broad range of discretion in performing this second transformative step, giving them regulatory privileges creates the potential for abuse of competitors, customers, and the public. For example, Congress has expressed significant concern about the consistency with which ratings methodologies are employed,[35] particularly to the extent that allegations have been made that favorable ratings have been conditioned on the purchase of additional services, the rating of additional securities, or the refusal to obtain ratings from certain competitors.[36] Nearly a decade earlier, the SEC published a report uncovering collusion among NASD market makers to keep public bid-asked quotations artificially wide (while trading at much narrower spreads in private alternative trading systems) with a view to maximizing the profitability of handling retail market orders.[37]

Nevertheless, there are several reasons why reliance by regulators on certain informational intermediaries remains popular.[38] First, not all institutions possess equal sophistication or the means (or will) to expend resources on processing the thicket of information necessary to adequately evaluate financial investments, particularly those that trade in a market that does not efficiently incorporate public disclosures;[39] if a "critical mass" of

---

[35] *See, e.g.* 15 U.S.C. § 78o-7(r) (2006) (instructing the SEC to promulgate rules to ensure, among other things, that credit ratings are determined using approved procedures and methodologies and that changes to such procedures and methodologies are publicly disclosed and applied consistently).

[36] *See, e.g.*, 15 U.S.C. § 78o-7(i) (2006) (instructing the SEC to promulgate rules to prohibit such "unfair, coercive, or abusive" practices).

[37] *See* SEC, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET 23 (Aug. 8, 1996) http://www.sec.gov/litigation/investreport/nd21a-report.txt (describing implicit collusion among Nasdaq market makers); *see also* Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256, 71,262 (Dec. 8, 2004) (describing self-regulatory organization's' ("SRO") "tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow").

[38] In a parallel vein, Claire Hill makes a strong case for why issuers and investors have continued to rely on certain established nationally recognized statistical rating organizations ("NRSROs")—such as Standard & Poor's, Moody's, and Fitch—despite their track record with respect to mortgage-backed securities in recent years. *See* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L. Q. 43, 61-62 (2004).

[39] Robert P. Bartlett, III, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During The Financial Crisis*, 36 J. CORP. L. 1, 55-56 (2010) (discussing, among other obstacles to processing disclosure about complex instruments faced even by "highly-motivated, sophisticated investors," the logistic complexity entailed in "the rapid processing of hundreds and even thousands of interconnected

such institutions does not exist, markets may not efficiently price such securities.[40] Access plays a significant role: if the cost of sharing the underlying input with multiple intermediaries is prohibitive or entails the provision of material nonpublic information, a privileged intermediary with public responsibilities might be appropriate.[41] Third, regulators strapped for staff may find it unmanageable, for example, to maintain the costly iterative supervisory process[42] used to determine whether all financial institutions maintain the necessary internal processes for assessing creditworthiness as part of their compliance with net capital ratios or prudential management obligations.[43] Finally, regulators may well prefer that an objective benchmark be available for investment products—whether that be a consistent set of publicly reported prices for purposes of producing account statements and other financial documents,[44] well-

---

underlying securities" and "investor inattention" to low-level information until it is "rebroadcast in a more salient fashion").

[40] *See* Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, U. ILL. L. REV. 1, 19 (2004) (observing that a market for complex instruments or transactions may not "reach a fully informed price equilibrium, and hence will not be efficient," if "less than a critical mass of investors can understand them in a reasonable time period").

[41] *See, e.g.*, Regulation FD, 17 C.F.R. § 243.100(b)(2)(i) (2010) (permitting disclosure of material nonpublic information to "an attorney, investment banker, or accountant" to take place without simultaneous public disclosure). The express exemption from Regulation FD for credit rating agencies in Rule 100(b)(2)(iii) was legislatively eliminated by Section 939B of the Dodd-Frank Act. *See* Removal from Regulation FD of the Exemption for Credit Rating Agencies, Securities Act Release No. 9146, 75 Fed. Reg. 61,050 (Oct. 4, 2010) (to be codified at 17 C.F.R. pt. 243). The SEC had revised the exemption in 2009 to limit its scope to statutorily defined NRSROs and credit rating agencies that make their credit ratings "publicly available." *See* Amendments to Rules for Nationally Recognized Statistical Rating Organization, Exchange Act Release No. 61,050, 74 Fed. Reg. 63,832, 63,834 (Dec. 4, 2009) (to be codified at 17 C.F.R. 240.17g-2).

[42] *See, e.g.*, Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 267 (2007) (noting that regulation of depository institutions constituted an estimated 45.1 percent of the total budget and required an estimated 42.7 percent of the total staff for U.S. financial regulation in 2004).

[43] *See, e.g.*, Exchange Act Release No. 64,352, 76 Fed. Reg. at 26,554 (requesting comment on the "appropriate level of regulatory oversight of a broker-dealer's credit determination processes," and more specifically whether the SEC should describe in more detail how examiners will examine these processes, whether the SEC should require "securities industry self-regulatory organizations to set appropriate standards," "require broker-dealers to create and maintain records of creditworthiness determinations," adopt rules that "reference a single or limited set of factors," and seeking recommendations for "alternate and more reliable means of establishing creditworthiness for purposes of the Net Capital Rule").

[44] *See, e.g.*, 15 U.S.C. § 78k-1(a)(1)(C)(iii) (2006) (finding it "in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . the availability to brokers, dealers, and investors of information

defined indexes to facilitate use of index-based mutual funds or exchange contracts,[45] or standard definitions of credit risk to facilitate the marketing of certain types of instrument (e.g., "money market" mutual funds)[46] that otherwise have the potential to mislead investors.[47]

II. REGULATING INFORMATIONAL INTERMEDIARIES

An informational intermediary's work product is only as useful as the diligence and acumen of its associated persons. The goal of regulation is to create an atmosphere that encourages the exercise of such talents and discourages abuse of the intermediary's privileged access to inputs or regulatory imprimatur to sell informational products. The framework for regulating informational intermediaries varies with the need to restrict access to inputs or facilitate coordination of outputs. For the most sensitive informational products, policymakers may subject informational intermediaries to regulation as a public utility, though the desirability of this policy option has waned as multiple sources of information have emerged and the need for regulatory coordination has declined. For less sensitive information products, regulators might, for example, employ professional standards of care and loyalty or disclosure standards that ensure sufficiency and comparability of information.

A. Informational Intermediaries as Utility

One model for regulating informational intermediaries is to treat them as a public utility. Under this model, regulators confer a regulatory franchise (de jure or de facto) on informational intermediaries in exchange for which the regulators exercise significant authority over the conduct of the utility and its members with a view to ensuring that they do not exploit the

---

with respect to quotations for and transactions in securities").

[45] *See, e.g.*, 17 C.F.R. § 240.15c3-1a(b)(1)(i)(D) (2010) (defining "qualified stock basket" by reference to the capitalization of certain indices for purposes of facilitating offsetting of long and short positions across product groups under a theoretical options pricing model).

[46] *See* 17 C.F.R. § 270.2a-7(a)(12) (2010) (permitting investment company boards to use NRSRO credit ratings to determine whether a security is an "Eligible Security" for purposes of satisfying the portfolio composition requirements for money market mutual funds).

[47] *See* HARVEY E. BINES & STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION § 8.02[A][2] (2d ed. 2004) (observing that courts reviewing the prudence of investment management decisions have tended to "marginalize" the evidentiary value of the rating agencies, particularly for debt with equity-like features the value of which as an investment is less dependent on creditworthiness, in favor of the investment manager's own analysis of a security).

regulatory franchise.[48] The rationale for adopting this approach may vary based on the type of information. For example, in the case of exchanges, regulators historically viewed the centralization of order flow as a natural monopoly,[49] while in the case of rating agencies, regulators may have expressed concern about the corrosive effects of competition on the quality of service provided.[50] Among other aspects of the regulatory framework for such intermediaries, regulators might approve the utility's access to inputs, oversee the rules or methodology by which the utility transforms its inputs into new information, the manner in which it is disseminated, restrictions on levels of access, and how the utility is compensated. All of this is done with a view to ensuring that the intermediary operates in the public interest.

Examples of the utility model in financial markets are not difficult to identify. The incentives for securities and commodity exchanges to provide a given quantity or quality of information, for example, may depend in no small part on their ability to monopolize the processing and dissemination of quotation and trading information.[51] Underwriting syndicates managed by bulge bracket firms could be cajoled into bearing the significant cost of diligence traditionally required by the Securities Act, in part because the syndicate underwriting system protected the investment banking industry from competitive pressure on underwriting spreads.[52]

---

[48] *Cf.* STEPHEN BREYER, REGULATION AND ITS REFORM 15-35 (1982) (discussing and critiquing the traditional rationale for regulatory intervention in certain industries, including the existence of "natural monopolies," positive or negative "spillovers" or "externalities," the cost of producing adequate information relative to the benefit that can be extracted from such efforts, and the destructive effects of "excessive competition" on quality or consistency).

[49] *See generally Stock Exchange Practices: Hearings Before the Committee on Banking and Currency on S. Res. 84 and S. Res. 56*, 73d Cong. pt. 1, (1933) (testimony from members of J.P. Morgan, Co.) (investigating stock exchange practices and their effect); *Stock Exchange Practices: Hearings Before the Committee on Banking and Currency on S. Res. 84 and S. Res. 56 and S. Res. 97*, 73d Cong., pt. 16, 7703-47 (1944) (statement of Samuel Untermyer) (arguing for stronger regulation of securities exchanges); Craig Pirrong, *Securities Market Macrostructure: Property Rights and the Efficiency of Securities Trading*, 18 J.L. ECON. & ORG. 385, 403 (2002) (concluding that "the optimal security market involves the creation of an open access central limit order facility and the simultaneous elimination of any cream-skimming markets").

[50] *See, e.g.*, JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 289 (2006) (discussing rating agencies' "race to the bottom" mentality).

[51] *See, e.g.*, RUBEN LEE, WHAT IS AN EXCHANGE? 97-104, 121-28 (1998) (contrasting the economic incentives for strategic dissemination of information by exchanges with the framework established by the SEC's national market system initiatives under Section 11A of the Exchange Act).

[52] *See, e.g.*, Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 627–28 n.206 (1984) (observing that "both the objection to shrinking underwriting spreads and Commissioner Thomas' concern with

Until relatively recently, the SEC's process of recognizing "nationally recognized statistical rating organizations" ("NRSROs") through an "opaque no-action process" created sufficient uncertainty about the possibility of new entrants that commentators viewed their recognition as an effective regulatory franchise.[53] SOX further codified the SEC's power to expressly "recognize, as 'generally accepted' for purposes of the securities laws," the accounting principles established by a private standard setting body, such as the Financial Accounting Standards Board.[54]

The downside of treating informational intermediaries as utilities is that immunity from competition and regulatively mandated exclusive access to marketwide information may breed corruption and discourage innovation. Stock exchanges, for example, came under significant pressure to abandon the most anticompetitive of their rules—such as fixed commissions,[55] prohibitions on off-board trading,[56] and access to quotation displays[57]—in part because they were prone to evasion by sophisticated investors and did

---

the due diligence role of the underwriter" as a result of the SEC's self-registration rules "are best evaluated from the perspective of the role of the underwriter as a reputational intermediary" and that "[i]dentifying the settings in which reputational services are not needed may not only explain why underwriting spreads are lower in these offerings, but may also provide the best approach to determining the appropriate breadth of the Rule's application"); *see also* Delayed or Continuous Offering and Sale of Securities, Securities Act Release No. 6423, 47 Fed. Reg. 39,799, 39,807 (Sept. 10, 1982) (to be codified at 17 C.F.R. pts. 229 and 230) (dissent of Commissioner Thomas) (noting that "[t]he competitive bidding environment will also surely create pressures for underwriters to complete deals rapidly, irrespective of the adequacy of their due diligence investigation.").

[53] *See, e.g.*, Roberta S. Karmel & Claire R. Kelly, *The Hardening of Soft Law in Securities Regulation*, 34 BROOK. J. INT'L L. 883, 924-29 (2009) (observing that the SEC's pre-2007 policy of regulating credit rating agencies through no-action letters designating select agencies as NRSROs was criticized because of the "highly concentrated number of NRSROs" and the resulting belief that the NRSRO designation was "a barrier to competition in the credit rating business").

[54] 15 U.S.C. § 77s(b) (2006).

[55] *See* 15 U.S.C. § 78f(e) (2006) (prohibiting national securities exchanges "[o]n and after June 4, 1975" from imposing "any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members" unless approved by the Commission).

[56] *E.g.*, 17 C.F.R. § 240.19c-4 (2010).

[57] The SEC's efforts in this regard began with rules requiring "electronic communications networks" to publish their top-of-book market maker orders into the consolidated quotation system, and culminated in a rule requiring all "alternative trading systems" to publish their best priced bids and offers into the consolidated quotation system. *See* 17 C.F.R. § 240.11Ac1-1(c)(5) (2000) (imposing a display requirement for market maker quotes entered into an "electronic communications network"); 17 C.F.R. § 240.11Ac1-4(b) (2000) (imposing customer order display requirements for market makers); 17 C.F.R. § 242.301(b)(3) (2010) (imposing customer order display requirements for alternative trading systems).

not keep pace with technological innovations by third-party competitors.[58] The SEC was thus thrust into the awkward position of both defending dominant market participants while creating incentives for their competitors to experiment with new technologies in a long-term effort to induce its franchisees to make similar changes (or co-opt the competitors).[59] Similar observations may be made about other anticompetitive arrangements created by federal securities law. For example, whether one considers questionable underwriting practices in initial public offerings to be "collusion"[60] or the product of "efficient contracting,"[61] the Department of Justice, the SEC, FINRA, and the courts have eschewed heavy-handed application of antitrust law in favor of detailed regulation of the arrangements among issuers, underwriters, and investors so as not to upset the traditional "book-building" process essential to formulating and maintaining a stable offering price for equity securities.[62] And the SEC's solution to alleged collusion among NASDAQ market makers in maintaining public quotation spreads wider than privately quoted spreads through electronic communications networks was to promulgate rules advancing its long-standing ambition of centralizing and consolidating quotation display and access (culminating in a central limit

---

[58] Notice Approving Proposed Change to Rescind Exchange Rule 390, 65 Fed. Reg. 30,175, 30,175 (May 10, 2000) (observing that New York Stock Exchange Rule 390 created "an artificial incentive for trades to be routed to foreign markets" after hours to avoid its off-board trading prohibition and "effectively restrict[ed] the competitive opportunities of electronic communications networks ('ECNs'), which use innovative technology to operate agency markets that offer investors a high degree of order interaction"); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 473-86 (1982) (describing evasion of fixed commissions by institutional investors through strategies such as regional exchange memberships, "give-up" arrangements, and soft brokerage).

[59] *See* Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. RICH. L. REV. 1069, 1148-49 (2005).

[60] *See* Hsuan Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1124 (2000) (concluding seven percent underwriting spread in equity IPOs is the product of "collusion").

[61] *See* Robert S. Hansen, *Do Investment Banks Compete in IPOs?: The Advent of the "7% Plus Contract"*, 59 J. FIN. ECON. 313, 344 (2001) (concluding that the seven percent underwriting spread in equity IPOs is supported by "efficient contract" theory).

[62] *See, e.g.*, Credit Suisse Sec. (USA) v. Billing, 551 U.S. 264, 283 (2007) (concluding that "where conduct at the core of the marketing of new securities is at issue; where securities regulators proceed with great care to distinguish the encouraged and permissible from the forbidden; where the threat of antitrust lawsuits, through error and disincentive, could seriously alter underwriter conduct in undesirable ways, to allow an antitrust lawsuit would threaten serious harm to the efficient functioning of the securities markets"); Randall Smith, *U.S. Ends Probe Into Underwriting Fees Charged by Securities Firms for IPOs*, WALL ST. J., Apr. 9, 2001, at C11 (announcing the end of the Department of Justice's probe into possible price fixing by underwriters).

order book) for NASDAQ securities.[63]

B. *Informational Intermediaries as Professionals with Public Duties*

A second approach is to treat informational intermediaries as professionals with public duties to assure the quality of the service they provide.[64] While such intermediaries owe no direct fiduciary duty to the individuals who use the information they create, they may assume regulatory responsibilities or obligations analogous to those observed by professionals.[65] Such obligations may take a variety of forms, but typically include qualification, examination, registration or licensure by a regulatory agency or self-regulatory body;[66] a duty of diligence when collecting and testing information and performing other professional obligations;[67] and an obligation to report illegal activity or uncover negative information in

---

[63] *See* Dale A. Oesterle, *Regulation NMS: Has The SEC Exceeded Its Congressional Mandate To Facilitate A "National Market System" In Securities Trading?*, 1 N.Y.U. J. L. & BUS. 613, 654-58 (2005) (describing the SEC's involvement in furthering the centralized publication and accessibility of quotations as a "cascade of SEC rules tweaking and tinkering with the NASD automated execution system [that] continues unabated").

[64] *See, e.g.*, U.S. v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) ("By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."); Mishkin v. Peat, Marwick, Mitchell & Co., 658 F. Supp. 271, 275 (1987) ("When such a licensed professional undertakes a statutorily mandated audit of a client, and where the statute and the regulations promulgated thereunder require the accountant to submit certifications of his client's financial statements to public agencies who, based upon such information are empowered to decide whether or not the client may continue to sell securities to the public, the accountant is acting, in a sense, as a quasi-public official.").

[65] *See, e.g.*, TAMAR FRANKEL, FIDUCIARY LAW 43-45 (2011) (noting the competing obligations of such professionals to the public and their fiduciary duty to clients).

[66] *See, e.g.*, 17 C.F.R. § 240.15b7-1 (2010) (requiring associated persons of brokers or dealers to meet standards of training, experience, competence, and other qualification standards, including required examinations). Lawyers and accountants are of course admitted to practice through examinations (including character and fitness examinations) administered by state bar associations and the American Institute of CPAs, respectively.

[67] *See, e.g.*, 15 U.S.C. § 77k(b) (2006) (creating due diligence defense for experts such as auditors and non-experts such as underwriters in connection with civil liability for material misrepresentations or misleading omissions in a registration statement under the Securities Act); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 687 (1968) (referencing duty of reasonable investigation); John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1310-11 (2003) (discussing a due diligence obligation for attorneys under federal securities law).

connection with their information gathering function (whether or not they owe a fiduciary duty to the source of the information).[68] With respect to the duty of diligence, for example, regulators may either define the processes that informational intermediaries must employ or require firms to develop their own internal controls and procedures, the adequacy of which can be tested in accordance with industry norms.[69] For informational intermediaries that are deemed "independent" of the source of their information inputs, such as auditing firms, securities analysts, or rating agencies, regulators would further specify the conditions under which professionals would be required to avoid or disclose conflicts.[70]

The approach of heightening standards of professional behavior for intermediaries in financial markets was a core element of both SOX and Dodd-Frank. SOX imposed heightened duties on a range of professional actors, including accountants, attorneys, officers, directors (particularly independent directors), and research analysts, and called for studies with respect to rating agencies that subsequently led Congress to impose statutory duties on credit rating agencies in 2006.[71] With respect to auditors in particular, SOX imposed fairly strict prohibitions against cross-provision of services,[72] which were perceived to compromise the integrity of accounting firms providing a variety of more lucrative services,[73] and

---

[68] *See, e.g.*, 15 U.S.C. § 78j-1 (2006) (describing the requirements for audits); 17 C.F.R. § 205.3 (2010) (explaining the role of attorneys representing issuers).

[69] *See, e.g.*, American Institute of Certified Public Accountants, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards: AU Section 161*, *available at* http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00161.pdf; American Institute of Certified Public Accountants, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice: QC Section 10*, *available at* http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/QC-00010.pdf.

[70] *See* Laby, *supra* note 26, at 154-60 (examining the role of auditors and securities analysts).

[71] *See* Securities Exchange Act § 15E(f)(2) and (i), 15 U.S.C. §§ 78o-7(f)(2), (i) (2006) (requiring registration of NRSROs, accountability for rating procedures and establishment of related internal controls, prevention of misuse of nonpublic information, management of conflicts of interest, and prohibition against unfair, coercive, or abusive tactics). Dodd-Frank amended § 15E of the Exchange Act to impose additional duties on credit rating agencies. *See, e.g.*, 15 U.S.C. §§ 78o-7(h)(3), (t) (2006 & Supp. IV 2011) (additional rules regarding management of additional conflicts); 15 U.S.C. §§ 78o-7(h)(3), (q)-(s) (2006 & Supp. IV 2011) (requiring greater transparency of ratings performance and credit ratings methodologies).

[72] *See* 15 U.S.C. § 78j-1(g) (2006) (prohibiting nine specific non-audit services).

[73] *See, e.g.*, S. REP. NO. 107-205, at 15-19 (2002) (summarizing testimony to the effect that "the growth in the non-audit consulting business done by the large accounting firms for their audit clients has so compromised the independence of the

created a statutory self-regulatory organization to replace the auditing profession's peer oversight mechanisms.[74] Dodd-Frank has taken this approach further, by extending professional obligations to loan originators[75] and granting the SEC the authority to impose the same fiduciary standard of conduct applicable to investment advisers on brokers and dealers, when they recommend securities to retail customers.[76]

Professional obligations—whether cast as fiduciary duties or industry norms enforced by self-regulation—may nevertheless be unsatisfactory devices for encouraging informational intermediaries to improve the quality of their output. In the case of some professionals, courts and regulators may be reluctant to second-guess business decisions and focus on process, rather than substance, when assessing liability for breach of professional or fiduciary norms relating to business decisions[77]—particularly in private actions, where the specter of strike suits and vexatious litigation maintains a particularly strong hold over the judicial imagination. The U.S. Supreme Court's decision in *Jones v. Harris Associates*[78] illustrates the judicial reluctance to peer beyond process when evaluating issues that touch on a professional's judgment, rather than simply her bona fides or competence. In considering whether an investment adviser's compensation was in breach of its fiduciary duty, the Court observed that, "[w]here a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process."[79]

Moreover, to the extent that professional duties are focused on ensuring the production of information that meets industry standards, they provide

---

audits").

[74] *See* 15 U.S.C. § 7211 (2006) (creating the Public Company Accounting Oversight Board).

[75] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 1402(a)(2), 15 U.S.C. § 1639b(a)(2)-(b)(2) (Supp. IV 2011) (imposing a "duty of care" on mortgage originators and associated qualification, registration and licensing requirements to "assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive or abusive").

[76] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 913(g), 15 U.S.C. § 78o(k)(1)-(2) (Supp. IV 2011).

[77] *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 262-64 (Del. 2000) (rejecting "substantive due care" and holding that the business judgment rule requires only "process due care"); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 117-24 (2004) (making the argument for judicial abstention from substantive review of board decisions on the grounds that "judges are not business experts").

[78] Jones v. Harris Assocs., 130 S. Ct. 1418 (2010).

[79] *Id.* at 1429.

little incentive for intermediaries to assume the costs or take the risks necessary to produce information that consistently exceeds those thresholds.[80] Courts have long recognized that "[a]spirational ideals . . . that go beyond the minimal legal requirements . . . do not define standards of liability."[81] The informational aspect of an informational intermediary's function—whether it be a rating, a price, a decision to list or include in an index—necessarily entails a level of discretion that professional duties cannot hope to regulate.[82] Moreover, they tread into the realm of opinion, where regulatory powers may themselves be limited, absent evidence of misrepresentation or bad faith.[83] As a result, such obligations may be effective at weeding out tortious or unethical conduct—and are thus a vital component of a regulatory framework—but cannot in themselves maximize the quality of information in the pipeline.

C. Informational Intermediaries and Disclosure-Based Regulation

A third approach is to standardize disclosures relating to the intermediary's performance. This approach seeks to empower market participants to make informed decisions when relying on a particular informational intermediary—whether in absolute terms or relative to its peers—based on past performance. For some types of information, such as narrative disclosures or binary certifications, qualitative measures of performance are not particularly helpful. While underwriters, lawyers and accountants, for example, may seek to rank themselves based on the size,

---

[80] *Cf.* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 29 (1986) (summarizing literature postulating that managers, as fiduciaries, "do not profit-maximize, but rather 'profit-satisfice'—that is, they seek that level of profits that will suffice to prevent external interventions by dissatisfied creditors or stockholders," in light of the lack of perfect information and the need for "satisfactory answers to immediate problems").

[81] *Eisner*, 746 A.2d at 256 (distinguishing aspirational ideals of corporate governance and the standard of directorial liability for breach of fiduciary duty under Delaware law).

[82] *See* FRANKEL, *supra* note 65, at 171 (explaining that "[m]easuring, let alone controlling, the quality of expert performance is difficult [because it] contradicts the very reason for entrusting fiduciaries with discretionary power").

[83] *See* Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 175 (S.D.N.Y. 2009) (describing First Amendment protections for credit ratings as "matters of public concern"); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 511 F. Supp. 2d 742, 817 (S.D. Tex. 2005) (observing that, even in the absence of categorical protection for rating agencies under the First Amendment, "the courts generally have shielded them from liability for allegedly negligent ratings for various reasons"); *see also* Compuware Corp. v. Moody's Investors Services., Inc., 499 F.3d 520, 531, 534 (6th Cir. 2007) (affirming the dismissal of claims against rating agencies brought on the basis of credit ratings by invoking the protections of the First Amendment).

prestige, and complexity of the deals in which they participate, such indicia may only serve as indirect proxies of the quality of the service they provide—namely, how accurately an offering of securities is priced.[84]

For other types of information—such as the value of quotation data or credit ratings—performance standards may be useful, as long as industry members cooperate or regulators compel standardized disclosures about performance quality to facilitate comparisons.[85] The SEC has required, for example, consolidated presentation of quotation information from exchanges and over-the-counter market makers into quotation montages in order to enable subscribers to compare performance.[86] The Commission has also taken the initiative in requiring disclosure of the quality of exchange and brokerage executions through various metrics that are ostensibly designed to help investors determine the nature of an exchange's order flow (orders that move prices versus passive orders) and how well a particular exchange or broker performs.[87] As discussed below, Congress has instructed the SEC to develop performance metrics for credit rating agencies as well.[88]

Disclosure by itself is no guarantee, however, that market participants will be able to use such information in a meaningful way. Retail investors, of course, have no obligation to find or read such information and may in any event lack the sophistication to use it effectively.[89] Regulators may

---

[84] *See, e.g.*, Randolph P. Beatty & Ivo Welch, *Issuer Expenses and Legal Liability in Initial Public Offerings*, 39 J.L. & ECON. 545 (1996) (examining, inter alia, how IPO underpricing and IPO underpricing uncertainty are related to perceived rankings of expert quality).

[85] *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act § 942, 15 U.S.C. § 77g(c)(2)(A) (Supp. IV 2011) (instructing the SEC to "set standards for the format of the data provided by issuers of an asset-backed security, which shall, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes"); *id.* § 932, 15 U.S.C. § 78o-7(q) (instructing the SEC to adopt rules requiring each credit rating agency to "publicly disclose information on the initial credit ratings . . . and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different [agencies]"); *see also* Lynn Bai, *Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?*, 7 N.Y.U. J. L. & BUS. 47, 59-66 (2010) (describing the SEC's performance disclosure rules for NRSROs and observing that the SEC's failure to impose consistency on the disclosures NRSROs provide has resulted in reported data that are "substantially inconsistent" and make "the industry-wide comparison of credit rating agencies' performance measurements a difficult and tedious task").

[86] 17 C.F.R. § 242.605 (2011).

[87] *See id.* § 242.606.

[88] 15 U.S.C. § 78o-7(q).

[89] *See* Barbara Black, *Are Retail Investors Better Off Today?*, 2 BROOK. J. CORP. FIN. & COM. L. 303, 334-36 (2008) (noting that disclosure-based regulation "presupposes investors who are capable of understanding the information" and that dedicated

impose fiduciary duties on institutional investors, such as pension and mutual funds, insurance companies, and other financial institutions, to require asset managers to periodically review performance disclosures as part of their compliance obligations, though such duties may effectively constitute a mandate to purchase whatever information products are necessary to satisfy regulatory scrutiny.[90] It is difficult to monitor how fiduciaries use such information: insofar as no fiduciary should exclusively rely on a single source of information, investment decisions cannot always be traced to the use of a particular informational intermediary. Moreover, to the extent that informational services are bundled with other services, such as execution services as permitted by Section 28(e) of the Exchange Act,[91] it may be difficult to hold fiduciaries responsible for failure to apply information from performance metrics in their operations.

III. COMPENSATING INFORMATIONAL INTERMEDIARIES

To the extent that regulatory muscle alone is insufficient to create incentives to improve the performance of informational intermediaries, a complementary approach is to experiment with their compensation model. Market participants, for example, frequently argue that the amount or quality of information available for public use could be improved if more financial incentives were available to informational intermediaries, and that regulators are responsible for structuring the market for such information to ensure that such financial incentives exist.[92] Such intervention may include not only creating a market need for information (through compulsion or otherwise) but also prohibiting collateral forms of compensation that might detract from the quality of the information created. The three basic sources of compensation—end users, issuers, and markets—are discussed in turn.

---

investor-education efforts are necessary to make disclosure-based regulation meaningful).

[90] *See* Roger D. Blanc, *Intermarket Competition and Monopoly Power in the U.S. Stock Markets*, 1 BROOK. J. CORP. FIN. & COM. L. 273, 290-91 (2007) (arguing that "[b]y federalizing a duty of best execution" based on the quality metrics market centers and broker/dealers must publish under Rules 605 and 606, "the Commission deprived exchange members and their fiduciary customers of the ability to control market data prices").

[91] 15 U.S.C. § 78bb(e) (2006).

[92] *See, e.g.*, Joel Seligman, *Rethinking Securities Markets: The SEC Advisory Committee on Market Information and the Future of the National Market System*, 57 BUS. LAW. 637, 654-58 (2002) (discussing the competing consolidator model advanced for processing of equity data).

A. Compensation by End Users of Information

To the extent that access to information can be restricted, through contract or otherwise, informational intermediaries can charge end users a fee for their information products; the virtue of this model is that the amount and quality of information produced can be set by market forces rather than regulatory fiat.[93] Institutional investors, for example, can purchase research about individual issuers.[94] Exchanges and alternative trading systems sell depth-of-book information to professional traders without regulatory compulsion.[95] Proxy advisory services provide analysis and recommendations for institutional proxy voting committees.[96] The public indirectly benefits from the private sale of such information to the extent that institutions convert such information into trading and voting activity. For products that only have value if published, informational intermediaries may lack the incentive to improve the quality of their information products because they cannot charge users for access. For example, the value of financial indexes and credit ratings derives largely from their established public recognition as benchmarks; without public disclosure, their value would be substantially diminished.[97] In such cases,

---

[93] How equilibrium is achieved in the market for financial information and whether it is allocatively efficient has been the subject of significant scholarly attention. *See, e.g.*, Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 786-796 (1985).

[94] One can debate whether investment managers have sufficient incentive to purchase the optimal amount of information in connection with their investment activity, particularly if the cost of such research must be funded from the managers' management fee. To encourage the purchase of such research, Section 28(e) of the Exchange Act permits investment managers to purchase research with "soft dollars"—i.e., commissions on securities transactions paid to broker-dealers in excess of the prevailing cost of execution—if such commissions are "reasonable in relation to the value of the brokerage and research services" provided by the broker-dealer to the manager. 15 U.S.C. § 78bb(e); *see also* D. Bruce Johnsen, *Using Bond Trades to Pay for Third Party Research*, 5 VA. L. & BUS. REV. 481, 482 (2011) (arguing that "managers' use of client commissions on fixed income trades to pay for investment research is both legally permissible and in their account holders' best interest," despite prevailing hesitation about the applicability of Section 28(e) to fixed-income securities).

[95] *See, e.g.*, Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Offer an Optional Derived Data Fee for NASDAQ Basic, Exchange Act Release No. 64994, 76 Fed. Reg. 47,621, 47,622 (proposed Aug. 5, 2011) (describing the variety of non-"core" data Nasdaq sells under various pricing schemes, subject to SEC approval of its fee structure).

[96] *See, e.g.*, Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 896-906 (2007) (describing the market for the corporate governance industry and the major firms participating in that market).

[97] In a similar vein, the role of the *New York Times* as a national paper of record would be diminished if it aggressively prevented others from reprinting its articles

policymakers may seek alternative tools to ensure the accountability of informational intermediaries to end users. Congress subscribes to this approach by requiring a credit rating agency to obtain "certifications" from qualified institutional buyers, as a condition of recognition as a "nationally recognized statistical rating organization."[98]

Some commentators have proposed compensation models that attempt to overcome the collective action problem faced by users in the selection of informational intermediaries. Professors Choi and Fisch, for example, would allow users of financial information to direct compensation to financial intermediaries through vouchers financed by issuers.[99] Under their model, regulators would impose a mandatory annual fee on issuers of publicly traded securities,[100] which the issuer's shareholders would then allocate (based on their proportionate ownership interest) to eligible intermediaries (including auditors, analysts, proxy insurgents, and presumably credit rating agencies as well) either through the existing proxy voting process or through a centralized voucher system managed by the SEC or a third-party utility.[101] Intermediaries would be required to register with the SEC and periodically provide data to the SEC on their activities, "the amount of voucher dollars they receive annually, other sources of funding (if any), and how they use the voucher dollars."[102]

While the Choi-Fisch proposal provides significant leverage for major institutional investors to seek improvements in the quality of informational intermediation, it is unclear whether such investors possess the incentive to use that leverage in the absence of a mechanism to facilitate collective action. For example, voucher models may not lead to an optimal outcome to the extent that individual institutional investors seek to exchange vouchers for discounts on other services (as with soft dollars)[103] or to the

---

or otherwise sharply limited public access to nonpaying readers. Arthur Ochs Sulzberger, Jr., *A Letter to Our Readers about Digital Subscriptions*, N.Y. TIMES, Mar. 18, 2011, at A28.

[98] *See* 15 U.S.C. § 78c(a)(62) (definition of "nationally recognized statistical rating organization"); *see also* 15 U.S.C. § 78o-7(a)(1)(C)-(D) (imposing a certification requirement as part of registration as an NRSRO for credit rating agencies that have not received, or been the subject of, a no-action letter from the SEC staff before August 2, 2006).

[99] Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 314-28 (2003).

[100] *Id.* at 317-18.

[101] *Id.* at 321-23.

[102] *Id.* at 323-27.

[103] *Id.* at 333-36 (describing the potential for "intermediary corruption" if intermediaries are able to channel rebates or kickbacks to shareholders voting to direct the allocation of vouchers).

extent that voucher holders cannot act collectively to bargain terms with informational intermediaries.[104] Another variant of the user-compensation model would interpose the SEC in the selection process, by requiring rating agencies to bid for the opportunity to perform the rating pursuant to specified conditions while collecting user fees from purchasers to pay the rating agencies and the SEC administrative costs in operating the program.[105]

Moreover, inadequately funded user-driven compensation models are prone to the risk of hidden conflicts of interest. End users may think they are paying an information producer for unbiased information when in fact the intermediary's products are subsidized by issuers or third parties that have an interest in distorting the product to advance diverging interests. One recent study notes, for example, how the decline in profitability of traditional news outlets has made them more susceptible to public relations firms that can offer "ready-made" articles, exclusives, and other benefits to help sell their clients' point of view as news.[106] Some commentators argue that sophisticated investors are able to take such conflicts into account when assessing the reliability of stock recommendations.[107] For example, in response to perceived conflicts of interest involving research analysts that contributed to the dot-com bubble, the rules adopted under SOX require securities analysts, who publish or provide research reports to U.S. clients, to disclose any compensation that "was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in the research report."[108] Regulators have nevertheless remained skeptical that such conflicts can be sanitized through disclosure alone; for example, the New York Attorney General's Office, the SEC, and various other regulatory or self-regulatory bodies campaigned to promote the availability of independent sources of research analysis, going so far as to earmark $432.5 million of the $1.4 billion settlement with ten major investment banks over deceptive research reports to fund

---

[104] *See id.* at 328-31 (describing the problem of coordinating shareholder allocations of vouchers and the resulting inefficient dispersion of vouchers across intermediaries).

[105] *See* Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1062 (2009).

[106] *See generally Slime-slinging*, ECONOMIST, May 19, 2011, *available at* http://www.economist.com/node/18712755 (explaining the downfall and rise of modern American journalism and the influence of business and public relations).

[107] *See* Anup Agrawal & Mark A. Chen, *Do Analyst Conflicts Matter? Evidence from Stock Recommendations*, 51 J.L. & ECON. 503, 531 (2008) (concluding that "while analysts do respond to [investment bank] and brokerage conflicts by inflating their stock recommendations, the market discounts these recommendations after taking analysts' conflicts into account").

[108] 17 C.F.R. § 242.501(a)(2)(i) (2011).

independent, third-party research.[109]

B. Compensation by Issuers of Financial Products

Some forms of information must be distributed to the public without an opportunity to recoup the cost of preparing the information from all recipients—for example, when the information is provided to induce offerees to enter into a transaction or to provide ongoing assurances to prospective and former security holders about the value of transactions into which they have entered. In theory, compensation by the issuer relieves information producers of the need to negotiate a price with diffuse end users of information (including both shareholders and public investors generally).[110] Because of the inherent conflict of interest in an issuer-compensation model, commentators have sought to devise structures in which issuers' discretion to select or compensate informational intermediaries is limited. One could, for example, restrict issuers' discretion by randomly assigning intermediaries to issuers (as suggested in Dodd-Frank for credit-rating agencies),[111] by requiring periodic rotation (as was proposed, but ultimately rejected in SOX, with respect to accounting firms),[112] or by regulating (or permitting intermediaries to collude in the setting of) fees.[113] Each of these solutions appears to

---

[109] Press Release, SEC, Ten of Nation's Top Inv. Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Inv. Banking (Apr. 28, 2003), http:// www.sec.gov/news/press/2003-54.htm.

[110] *See, e.g.*, Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L. J. 45, 48-50 (2004) (describing the "well-known collective action problems" faced by investors in financing research into issuers); Choi & Fisch, *supra* note 99, at 307-09 (describing issuer subsidies for exchange listing, audit services, and proxy solicitation as examples of issuer payments required by regulation to overcome the financing problem).

[111] 15 U.S.C. § 78o-9(b)(2) (Supp. IV 2011) (directing the Commission to study the feasibility of establishing, and granting the Commission the authority to establish, "a system in which a public or private utility or self-regulatory organization assigns [NRSRO]s to determine the credit ratings of structured finance products").

[112] Sarbanes-Oxley Act § 207, 15 U.S.C. § 7232 (2006) (instructing the Comptroller General to study and review "the potential effects of requiring the mandatory rotation of registered public accounting firms"); S. REP. NO. 107-205, at 21 (2002) (discussing the impact of such rotation on the cost and quality of audits).

[113] *See, e.g.*, 15 U.S.C. §§ 78f(b)(4), 78o-3(b)(5) (requiring national securities exchanges and associations to provide, by rule, "for the equitable allocation of reasonable dues, fees, and other charges among members and issuers"); FIN. INDUS. REGULATORY AUTH., FINRA MANUAL: FINRA RULES r. 5110(c)(2) (2009), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6831 (prohibiting members from receiving an amount of underwriting compensation in connection with a public offering that is "unfair or unreasonable"); Chen & Ritter, *supra* note 60, at 1124 (providing arguments against near-identical underwriting

contemplate an oligopolistic arrangement among informational intermediaries, together with all the benefits and abuses of the "utility" model discussed above.

C. Compensation from Other Sources

A third approach is to compensate informational intermediaries from some other source of revenue. The Financial Accounting Standards Board (FASB), for example, is funded through fees paid by Exchange Act reporting companies.[114] The SEC staff and SROs have experimented with allocation formulae under inter-market plans that attempt to direct revenue from the sale of consolidated market data to those exchanges or brokers who reveal the most aggressive price information—thus compensating those market participants that contribute most to identifying the "top-of-book" quotation by giving them a greater share of tape revenue.[115]

Such approaches, of course, leave much discretion in the hands of regulators to decide what information is important. Moreover, they create their own problems—specifically, the need to find a dedicated source of revenue. It could be politically difficult to impose new transaction fees (or increase existing transaction fees) dedicated to subsidizing reputational intermediaries, particularly to the extent that regulators and other commentators generally favor using such fees to fund regulation or a variety of competing public goods.[116] One might also consider the

---

spreads across initial public offerings); Hansen, *supra* note 61, at 344 (providing arguments in defense of near-identical underwriting spreads across initial public offerings).

[114] 15 U.S.C. § 77s(b); 15 U.S.C. § 7219; Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 47743, 68 Fed. Reg. 23,333 (May 1, 2003).

[115] The formula for the allocation of market data revenues by SRO exclusive processors under NMS Plans essentially allocates income first to individual "eligible securities" reported under a Plan based on a relative measure of total transaction volume ("security income allocation"), and then distributes the security income allocation to individual Plan participants based on the proportionate dollar volume of transaction reports reported by the participant in such security (adjusted to minimize the impact of "qualified" transactions over $5000) and the relative percentage of time the participant published an automated quote equal to the national best bid and offer (weighted by the dollar size of the quote) in such security. Regulation NMS, Exchange Act Release No. 51808, 70 Fed. Reg. 37,496, 37,610 (June 29, 2005).

[116] *See, e.g.*, HM TREASURY, RISK, REWARD AND RESPONSIBILITY: THE FINANCIAL SECTOR AND SOCIETY 33-39 (2009) (considering the merits of a financial transaction tax with the coordinated "commitment of all the major international financial centres" for the purpose of dampening speculation and "to ensure the [financial services] sector makes a fair contribution to society and broader social objectives"); DIV. OF MKT. REG., SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS VI-7-8 (1994) (describing Section 31 fees as de minimis fees designed "in part to compensate the federal government for the cost of regulating and overseeing

distributional efficiency of such taxes. Proposals to impose taxes on derivatives or securities trading markets must often calibrate the tax base to balance the desire for revenue against the desire to avoid driving transactions offshore or raising trading fees for favored constituencies, such as pension and mutual funds.[117] Moreover, to the extent that fees such as transaction fees or tape revenue are used to subsidize informational intermediaries, regulators will routinely face pressure to reduce the cost of trading rather than preside over the allocation of the resulting revenues.[118]

IV. CAN OUTCOME-BASED PERFORMANCE CRITERIA IMPROVE INFORMATIONAL INTERMEDIATION?

An alternative approach to regulating informational intermediation would tie regulatory benefits and sanctions to after-the-fact measures of performance, as opposed to merely overseeing the process of information production or eliminating conflicting interests. The most effective reward permits greater deference to the judgment of those intermediaries whose past performance justifies it. More specifically, regulators could relax rules limiting deference to intermediaries who accurately predict the risks associated with specific financial instruments (be they credit ratings, estimated default rates on a pool of mortgages or ability to maintain listing criteria, etc.), while limiting deference to those who are unable to make such predictions. In such a system, regulators (or, preferably, self-regulators) would assess the performance of each category of informational intermediary based on objective criteria established in advance of the

---

the securities markets"); *see also* Kern Alexander, *International Regulatory Reform and Financial Taxes*, 13 J. INT'L ECON. L. 893, 910 (2010) (advocating bank balance sheet taxes, currency transaction taxes, and financial transaction taxes "to assist governments in paying for the social costs of financial crises and providing global public goods"); Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 241 (2007) (proposing that such fees be used to fund an investor compensation fund for victims of securities fraud).

[117] *See, e.g.*, Adam H. Rosenzweig, *Imperfect Financial Markets and the Hidden Costs of a Modern Income Tax*, 62 SMU L. REV. 239, 279-287(2009) (contrasting securities transaction excise taxes and derivative trading taxes in terms of who bears the burden of taxation, the ease of collection, and ease of evasion through offshore trading); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 699-700 (1995) (noting the need to balance the impact of any transaction tax on both value-adding trading that facilitates price discovery and welfare-reducing trading based on speculation).

[118] *See, e.g.*, *The Effects of the Excessive Fees Collected Under Federal Securities Laws and Their Impact on the Financial Markets and on the Economy as a Whole: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., and Urban Affairs*, 106th Cong. 1 (1999) (statement of Sen. Rod Grams) (characterizing Section 31 fees on securities transactions—which more than fully funded the SEC's operations in the 1990s—as a "backdoor tax on capital formation and investment").

specified assessment period. A variety of regulatory schemes have incorporated outcome-based performance criteria, such as in the area of education,[119] health care,[120] and executive compensation.[121] Such approaches are often portrayed as a more enlightened form of regulation because they enable regulators to create incentives to achieve particular social goals while giving market participants the freedom to decide how to meet those goals.[122] Outcome-based approaches are also routinely resisted by market participants, among other reasons, because particular outcome measures are too narrow (resulting in an inefficient allocation of resources to achieve a particular quantifiable end)[123] or unpredictable, however rationally modeled.[124]

In the context I propose, an outcome-based approach to regulating

---

[119] *See, e.g.*, 20 U.S.C. §§ 6311-6320 (2006) (requiring states to adopt plans that, inter alia, define "adequate yearly progress" by reference to measurable indicators and triggering certain remedies if schools fail to achieve such progress).

[120] *See, e.g.*, 42 U.S.C.A. § 1395ww(o) (West 2010) (establishing a "Value-Based purchasing program" under which "value-based incentive payments" are made to hospitals that meet certain performance standards).

[121] *See, e.g.*, 26 U.S.C. § 162(m) (2006).

[122] *See* Cary Coglianese et al., *Performance-Based Regulation: Prospects and Limitations in Health, Safety, and Environmental Protection*, 55 ADMIN. L. REV. 705, 708-11 (2003) (defining performance-based regulation as a regulatory system in which performance is used as "the basis for the legal commands found in regulatory standards," "a criterion for allocating enforcement and compliance resources," "a trigger for the application of differentiated (or tiered) regulatory standards," and "a basis for evaluating regulatory programs and agencies"); *see, e.g.*, Tomiko Brown-Nagin, *Toward a Pragmatic Understanding of Status-Consciousness: The Case of Deregulated Education*, 50 DUKE L.J. 753, 767-68 (2000) (describing the threat of charter revocation as an incentive to meet or surpass state achievement goals based on "empirical data or outcome-based performance measures"); Sidney D. Watson, *Discharges to the Streets: Hospitals and Homelessness*, 19 ST. LOUIS U. PUB. L. REV. 357, 383 (2000) (asserting that an "outcome-based performance standard provides a financial incentive for the managed care entity to reduce the number or percentage of patients discharged to streets and shelters" by sending "a clear and unequivocal message about the goal" and "leaving the details to those who run the institution").

[123] Garry W. Jenkins, *Who's Afraid of Philanthrocapitalism?*, 61 CASE. W. RES. L. REV. 753, 787-92 (2010) (noting that performance measurement "makes people preoccupied with achieving specific goals" that can also "cause people to narrow their focus in ways that may be harmful to larger objectives or values"); Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 18-21 (2004) (noting that institutional investors, "[i]n their competition with one another . . . seek quarter-to-quarter and year-to-year performance statistics that are better than those of their peers," with the result that managers of corporations were focused on short-term stock prices instead of other measures of long-term corporate performance).

[124] Coglianese, *supra* note 122, at 715 (noting that performance-based standards may create "considerably uncertainty" when actual performance cannot be "measured, evaluated, and verified," for example, when the limitations of predictive models are not well understood and performance cannot be measured reliably).

information is worth considering only for narrow categories of information that can verifiably be graded on a spectrum of effectiveness and for which reliance can fairly be calibrated based on effectiveness. Binary certifications of compliance with federal securities law, GAAP or narrative disclosures, for example, cannot be measured by sufficiently granular quantitative criteria to permit a measured, but significant, regulatory response. To the extent that stock prices, firm performance or other informational products are inherently forward looking, the gradations of regulatory response must be sufficiently fine so as not to unduly penalize firms that through no fault of their own cannot foresee the future. But to the extent that reliance can be tiered, regulators may be able to create incentives to improve the quality of information products in the face of the various obstacles described above.

A. Developing Criteria for Measuring Performance

To implement such principles, there needs to be a way to measure performance. The legitimacy of any system of reputational ranking or quality assurance rests on the metrics used for assessment, including, among other things, the extent to which such metrics are discretionary or objective, verifiable based on public information or certified by a regulator or third party, and probative of future performance or simply the result of random processes.[125] Indeed, Dodd-Frank has called for more specific metrics for credit ratings in an effort to educate the public as to what credit ratings are intended to mean,[126] while the SEC has sought to explore the possibility of alternative rankings to measure different kinds of credit risk.[127] Such criteria should ideally be designed in a manner that does not create opportunities or incentives for manipulation, and must be revised by a publicly accountable body to ensure that they reflect changes in business models and the introduction of new financial products.

There is no shortage of raw data to base the performance assessment of informational intermediaries, either on a current or retrospective basis. The SEC borrowed a variety of measures of execution performance from the finance literature, for example, to measure the quality of exchange and

---

[125] *Id.* (observing the consensus view of roundtable participants that "performance-based standards work well when actual performance can be measured, evaluated, and verified").

[126] 15 U.S.C. § 78o-7(q)(1) (Supp. IV 2011).

[127] *See, e.g.*, Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57967, 73 Fed. Reg. 36,212, 36,235-36 (proposed June 25, 2008) (seeking comment on the use of different rating symbols for structured products to differentiate such ratings from conventional debt securities).

broker-dealer trading.[128] The observed yield on transactions in securities or from credit default swaps can be used to assess the accuracy of ratings in hindsight.[129] Similar to the back-testing of Value-at-Risk ("VaR") models contemplated by prudential regulators,[130] the goal of such exercises is not to suggest that certain models or processes are wrong, but rather to advise the public as to whether certain models outperform others and to encourage firms, whose models appear to be underperforming, to contemplate adjustments on an ongoing basis in order to bring them into line with observed data.

B. Defining the Scope of Reliance through Regulatory Policy

The purpose of grading reputational performance is to encourage the production of better information, not to deter or restrict informational intermediaries from selling information. Financial regulation by its nature entails an elaborate system of subtle rewards and sanctions, which can be adapted to the context of informational intermediation. Even disregarding the reliance on credit ratings by financial regulators now disfavored by Congress, in many areas of financial regulation, regulators must make decisions in reliance upon quantitative and qualitative models. Bank regulators have the authority to permit or restrict the expansion of a bank holding company's activities depending on the degree to which it is "well capitalized" and "well managed" under their supervisory procedures.[131] Both the SEC and bank regulators have permitted firms to rely on proprietary VaR models to compute net capital so long as such models are appropriately back-tested to ensure that risks fall within an arbitrary range

---

[128] *See, e.g.*, Disclosure of Order Routing and Execution Practices, Exchange Act Release No. 43084, 65 Fed. Reg. 48,406, 48,409 (Aug. 8, 2000) (proposing rules requiring certain market centers to make available monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis).

[129] Mark J. Flannery et al., *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085, 2113 (2010) (concluding that "CDS spreads reflect available information, which makes them useful for regulatory and risk-management purposes, even if they are not necessarily suitable for forecasting" and that a process for "gathering and publishing CDS-spread data is a promising model for both regulators and private institutions to implement for monitoring purposes").

[130] *See* 17 C.F.R. § 240.15c3-1e(d)(1)(iii)(A) (2011) (providing that a broker-dealer using a VaR model to calculate market risk must "conduct backtesting of the model by comparing its actual daily net trading profit or loss with the corresponding VaR measure generated by the VaR model, using a 99 percent, one-tailed confidence level with price changes equivalent to a one business-day movement in rates and prices, for each of the past 250 business days, or other period as may be appropriate for the first year of its use").

[131] 12 U.S.C. § 1843(*l*)(1) (2006).

determined by regulators;[132] the failure to perform within the parameters established by regulators triggers net capital increases pursuant to a regulatory formula.[133]

I do not advocate a draconian "rank and yank" system of quality control (for example, one that rewards the top 20% and punishes the bottom 10%, in the style of former GE CEO Jack Welch).[134] Unlike the sanctions applicable to "gatekeeping" activities, the "carrots and sticks" should be largely definitional or procedural rather than fines, sanctions, and restrictions on business. The easiest to administer, of course, are reduced paperwork requirements, less frequent compliance examinations, and other ministerial conveniences. The judicious use of safe harbors and evidentiary presumptions may also signal a record of good faith. For opinions on which fiduciaries seek to rely in good faith or that may be challenged as libelous, evidentiary presumptions based on a demonstrated record of success may be a particularly valuable benefit,[135] without exposing underperforming informational intermediaries to an increased risk of liability.

Safe harbors dependent upon achieving a particular level of reputational performance might be more adventurous. Consider a world in which an "investment grade rating" was defined to mean any of the top x ratings of a specific credit rating agency, where x is a variable within a specified range (e.g., between three and five) and is dependent on the accuracy of an agency's rating system over a rolling period.[136] Such a rule might arguably

---

[132] *See* 17 C.F.R. § 240.15c3-1e(d)(1)(iii)(A).

[133] *See id.* §§ 240.15c3-1e(d)(1)(iii)(C), 240.15c3-1g(a)(2) (linking the "multiplier" used to convert modeled losses into a market risk deduction from net capital to the number of back-testing exceptions observed in the prior quarter).

[134] *See, e.g.*, Alan Murray, *Should I Rank My Employees?*, WALL ST. J., http://guides.wsj.com/management/recruiting-hiring-and-firing/should-i-rank-my-employees/ (last visited Oct. 18, 2011) (describing former General Electric CEO Jack Welch's philosophy of ranking employees each year, showering the top 20% with "praise, affection and various and generous financial rewards," giving the middle 70% "coaching, training, and thoughtful goal-setting," and terminating the bottom 10%).

[135] *See* BINES, *supra* note 47, at 370 n.32 (suggesting that reliance on ratings is "a point of evidence more than a point of law," and that "ratings for straight debt generally should receive only that weight that is customary among investment managers for the particular investment at issue"); *cf.* Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43590, 65 Fed. Reg. 75,414, 75,432 (Dec. 1, 2000) (observing that mandatory market center performance statistics are "by no means determinative of best execution," but nevertheless expecting that such measures "will provide broker-dealers with a clearer sense of execution quality among market centers, and will be helpful to broker-dealers in seeking to fulfill their duty of best execution").

[136] Given the actual granularity with which credit rating agencies publish ratings, finer gradations may be possible. To the extent that upgrades or downgrades across categories (e.g., AAA– to AA+) are of much greater import than upticks or downticks

improve the quality of ratings because pressure from conscientious issuers to maintain standards (and from institutional investors anxious not to liquidate securities automatically downgraded under such a regulatory scheme) would counterbalance pressure from less conscientious issuers to erode them. Alternatively, consider Dodd-Frank's safe harbor for qualified mortgages from the intermediary's duty of care.[137] The Board could use its authority to define qualified mortgages[138] to give an individual loan originator' more or less latitude (e.g., with respect to the minimum interest charges ratio) based upon its track record with respect to accurately modeling default rates.

C. *Would Grading Informational Intermediaries Be Fair?*

Several objections immediately come to mind. First, as the SEC instructs mutual fund companies to routinely remind us,[139] past performance is no guarantee of future performance: To the extent that an informational intermediary cannot guarantee the performance of the issuers, assets, or instruments with respect to which it conducts diligence, can rewards or sanctions follow fairly, if constitutionally, from the vicissitudes of financial cycles? Conversely, if regulators are wary of imposing harsh performance standards for this very reason, won't the proposed framework enable regulators to conclude (or allow self-regulatory bodies to conclude) that all informational intermediaries, like the mythic children of Lake Wobegon, are above average?[140] In such case, we are no

---

within a particular rating (AAA to AAA–), a hypothetical financial regulator in my proposal may prefer to require credit rating agencies to take bolder action as a condition of maintaining the integrity of their rating scheme.

[137] Dodd-Frank Wall Street Reform and Consumer Protection Act § 1411, 15 U.S.C. § 1639c(a)(1) (Supp. IV 2011) (prohibiting a creditor from "mak[ing] a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments").

[138] 15 U.S.C. §§ 1639c(b)(3)(A) & (B) (Supp. IV 2011) (conferring authority on the Federal Reserve Board to "prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage" entitled to a presumption of an ability to repay).

[139] *See, e.g.*, 17 C.F.R. § 230.482(b)(3)(i) (requiring mutual fund advertisements to include "a legend disclosing that the performance data quoted represents past performance" and "that the investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost").

[140] *See* Garrison Keillor, *A Prairie Home Companion*, AMERICAN PUBLIC MEDIA, (Nov. 2, 2007) http://www.publicradio.org/columns/prairiehome/posthost/2007/11/02/dear_mr_keillor

better off than the "gatekeeper" system which only imposes minimal procedural standards. Only the ability to create and maintain "soft" signals—through an integrated compliance, inspections, and enforcement policy—would make such a system effective: if regulators cannot be trusted to do so, we are better off with a world of imperfect market incentives.

The ability to enjoy safe harbors based on performance history may pose more problems for regulators, to the extent that it may be difficult to establish a sufficient record to conclude that historical performance is a valid criterion for granting regulatory relief or imposing additional regulatory burdens across the board. Of course, the manner in which ratings and ratios are used in federal securities and banking regulation are themselves, to a degree, arbitrary. Dodd-Frank's imposition of a 15:1 risk-weighted capital ratio for large bank holding companies and systemically significant nonbank financial companies[141] undermines in many respects attempts to refine the capital models established by the Basel Committee;[142] yet rigid quantitative metrics may be the only legislative tool available to prod regulators and regulated entities to engage in the ongoing, more nuanced, and resource-intensive balancing of qualitative and quantitative risk management that actually stands a chance at preventing crises.[143] If procrustean metrics have a role to play in financial regulation,

---

_as_a_1.php (recognizing, and perhaps lamenting, the repeated invocation of the phrase as an "anti-test-score joke"); Timothy De Lizza, *The Incoherency of American Corporate Governance and the Need for Federal Standards*, 34 FORDHAM URB. L.J. 1111, 1118 (2007) (illustrating application of the "Lake Wobegon Syndrome" to executive compensation, where benchmarking practices lock in ever-escalating compensation).

[141] Dodd-Frank Wall Street Reform and Consumer Protection Act § 165(j), 12 U.S.C. § 5365(j)(1) (Supp. IV 2011).

[142] *Regulatory Developments 2010*, 66 BUS. LAW. 665, 666 (2011) (noting that Dodd-Frank "limits regulatory discretion in adopting Basel III requirements in the United States").

[143] *See* James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731, 745-49 (2009) (discussing the relative culpability of financial regulators in failing to "question critically the data used in the quantitative risk assessments, the adequacy of the models, the seriousness of the scenarios that firms used to stress test the firm's operations and assets, or the role of risk management in the firm's governance" and the lessons learned from those experiences); *see also* Damian Paletta, *Treasury, Fed Work to Kill Capital Provision in Senate Bill*, WALL. ST. J. (May 19, 2010) (describing the role of the Collins Amendment, which requires federal bank regulators to establish minimum leverage capital and risk-based capital requirements for bank holding companies based on the generally applicable leverage capital and risk-based capital requirements for insured depository institutions, in the negotiations among federal and international financial regulators as to minimum capital requirements for bank holding companies).

as long as there is a relationship between the purpose of the regulatory benefit (essentially, reducing the cost of diligence) and the metric (measure of diligence failures), I believe such a rule should survive scrutiny.[144]

A second, perhaps more intractable problem, is that objective measures of performance (even outcome-based rankings) are too narrow in their focus to capture fully the quality of work product.[145] Would this framework create the incentive to avoid taking risks—such as experimenting with new financial products, evaluation methodologies, or even expanding their business to rate a larger number of issuers—for fear that a pristine "grade" might be undermined by a few bad experiences? In the longer term, would we discourage the involvement of third-party informational intermediaries in new business models if they feared they would become subject to performance-based regulation—preferring instead to remain "advisors" than actual transactional middlemen?

One answer to this problem is that regulatory impediments will pale in comparison to commercial incentives. More diligence by intermediaries and less reliance by end users would seem to be quite logical when dealing with new products or methodologies, and some new products may well be deterred, but it is important to keep in mind that the likely effect of these requirements would be to incrementally raise the cost of participation, rather than block participation. The nature of participation, however, is an important concern; one does not necessarily want to encourage a realm of caveat emptor, in which no intermediary is responsible for acting at least in part in the investor's interest. Even here, the alternatives being considered (eliminating reliance on ratings altogether) would seem to undercut the role of the informational intermediary in a much more damaging way—i.e., by reducing the value of their work product to zero.

---

[144] Of course, any commentator advocating major regulatory initiatives must be mindful that the D.C. Circuit in recent years has vacated a number of SEC rules as "arbitrary and capricious" because of the agency's failure to conduct adequate diligence and serious evaluation of costs in formulating the rule proposal. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148-49 (D.C. Cir 2011) (proxy access rule); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166, 177, 179 (D.C. Cir. 2010) (rule regarding fixed-income annuities); Chamber of Commerce v. SEC, 412 F.3d 133, 143-45 (D.C. Cir. 2005) (rule regarding independence of mutual fund boards).

[145] *See* Jenkins, *supra* note 123. As we are acutely aware, for example, *U.S. News* rankings are a poor measure of the quality of a law school. *See, e.g.*, Brian Leiter, The U.S. News Law School Rankings: A Guide for the Perplexed (May 2003), LEITER RANKINGS http://www.leiterrankings.com/usnews/guide.shtml (stating that the factors considered by the *US News* rankings "are *highly manipulable* and, as a result, the overall ranking results are meaningless. . . .") (emphasis in the original).

CONCLUSION

To the extent that we need intermediaries who add to the public good by transforming financial data into useful information, we might well seek to craft a regulatory regime that does more than give away regulatory franchises or set minimal standards of performance. Such approaches may be the best that regulators can do for the basic diligence that officers, directors, attorneys, accountants, underwriters and other gatekeepers perform to assess the fair presentation of data. But if the transformative role of informational intermediaries has value, which cannot be captured in a commercial marketplace because of its public importance, better regulatory tools are needed.

LIVING WILLS AND PRE-COMMITMENT

ADAM FEIBELMAN†

INTRODUCTION

Among many other things, the Dodd-Frank Act of 2010 requires large bank holding companies and systemically important non-bank financial institutions to prepare plans "for rapid and orderly resolution in the event of material financial distress or failure. . . ."[1] Firms subject to this requirement must submit their resolution plans—living wills—to the Federal Reserve Board, the newly created Financial Stability Oversight Council, and the Federal Deposit Insurance Corporation. This provision is part of a global movement among financial regulators and international institutions to embrace living wills, a movement that began to gather steam after the outbreak of the financial crisis in 2008.[2] According to advocates of the new policy, it will help financial regulators identify systemic risks and resolve failing financial firms without escalating those risks.[3]

Despite the enthusiasm for living wills among international financial regulators and policymakers across the globe, the regulatory tool itself is still largely conceptual at this stage, and the concept is not well defined.

---

†Sumter Davis Marks Professor of Corporate and Business Law, Tulane University. Thanks to Douglas Baird, Melissa Jacoby, Kim Krawiec, David Skeel, Christoph Thole, and participants in the American University Business Law Review symposium, *Law, Finance, and Legitimacy after Financial Reform*, the University of Munich conference on *Regulatory Competition in Contract Law And Dispute Resolution*, and the Tulane Law School faculty workshop series.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5365(d)(1) (Supp. IV 2011).

[2] *See infra* notes 18-21 and accompanying text.

[3] *See infra* note 15 and accompanying text. There is also a good deal of skepticism about this innovation. *See, e.g.*, Adam Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 468-69 (2011) ("While living will proposals are an academically intriguing idea, they suffer, like many regulatory proposals, from a serious disconnect with institutional realities. Living wills are unlikely to actually prevent the failure of [too-big-to-fail] institutions or assist in their resolution."); Alan Sloan, *Wall Street Living Wills Doomed to Fail*, WASH. POST, June 14, 2011, *available at* http://www.washingtonpost.com/business/economy/wall-street-living-wills-doomed-to-fail/2011/06/14/AGHjs7UH_story.html ("These 'wills' . . . are a weak, pathetic substitute for what Washington really should have done . . . .").

Thus far, only a few jurisdictions or regulatory institutions have formally required financial firms to prepare living wills or resolution plans.[4] Within those jurisdictions the regulatory framework is still under design. The provisions in the Dodd-Frank Act creating the regime, for example, are skeletal and vague, mostly delegating to the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board (Federal Reserve) the job of creating a framework for the regime. The Federal Reserve and the FDIC promulgated a final rule implementing the living wills regime in October 2011,[5] and this rule clarifies the skeletal shape to some extent. It defines some of the key terms of the statute, describes what information and analysis must be included in the resolution plans, and addresses the scope of confidentiality of information in the plans.[6] But the rule is still a broad and general document, and it will take some experience with regulatory practice to establish precisely what a resolution plan is, how such plans are created, and how they will be utilized. Perhaps because of this uncertainty about the ultimate content and operation of the regime, living wills are generally overlooked in the otherwise voluminous discussions of the Dodd-Frank Act and post-crisis financial regulation.

Living wills deserve much more attention. This new scheme could represent an important change in the regulatory treatment of financial institutions and perhaps a profound one. This will depend largely on whether living wills are intended to play a meaningful role when firms actually experience financial distress.[7] If such plans are not expected to reflect a commitment to particular actions, the regime would represent a relatively minor operational change in regulatory approach, but one that could still have significant benefits as an information-forcing device.[8] If, instead, such plans are intended to meaningfully guide or determine the action of firms and regulators in the event of a firm's financial distress, the regime could represent one of the major innovations among recent reforms to financial regulation around the world. There is at least some early indication that lawmakers and regulators expect or intend the scheme to operate in this fashion. Sheila Bair, the recent Chair of the FDIC, has been quoted as saying of living wills, "It is critically important that they not be viewed simply as a 'paper exercise'; they must be actionable."[9]

---

[4] *See infra* notes 20-21 and accompanying text.

[5] Regulation QQ, 76 Fed. Reg. 67,323 (Nov. 1, 2011) (to be codified at 12 C.F.R. pts. 243, 381).

[6] *See infra* notes 28-31 and accompanying text.

[7] *See infra* notes 32-35 and accompanying text.

[8] *See infra* note 15 and accompanying text.

[9] Bill McConnell, *Resolving Resolution*, THE DEAL MAGAZINE, Oct. 29, 2010, http://www.thedeal.com/magazine/ID/037182/insights/resolving-resolution.php.

To the extent that living wills schemes lean in the direction of pre-commitment, they echo proposals to allow or require commercial firms to pre-commit to their treatment in bankruptcy.[10] The topic of pre-commitment to bankruptcy treatment attracted a good deal of attention among bankruptcy scholars during the 1990s.[11] Various writers proposed, among other things, allowing firms to pre-commit to a particular bankruptcy treatment by contract or by designation in the firm's corporate charter.[12] For proponents, the primary benefits of allowing firms to commit to a particular bankruptcy treatment include improving the accuracy of the price of credit and, ideally, reducing it by increasing creditors' insolvency state returns. As critics have pointed out, however, allowing firms to pre-commit to bankruptcy treatment could cause *ex post* inefficiency if firms commit to a treatment that ends up reducing insolvency-state returns and could lead to transfer of value from some creditors to others or to firms' shareholders.[13]

This Essay examines living wills through the lens of the literature on pre-commitment to bankruptcy treatment. Part I describes the living wills scheme in more detail. Part II summarizes the literature on pre-commitment in the bankruptcy context. It describes leading proposals for bankruptcy pre-commitment arrangements and notes some similarities and differences between those arrangements and living wills. There is a fundamental underlying similarity: both schemes contemplate the possibility that firms will identify and, at least provisionally, pre-commit to a course of action in the event of financial distress. Pre-commitment in the bankruptcy context is generally understood to involve the question of whether a firm will be reorganized or liquidated in the case of financial distress. Similarly, a living wills program appears to require firms to anticipate, among other things, whether and how some portion of the firm could be reorganized as well as the likely fate of particular assets that might be liquidated or otherwise alienated.

On the other hand, whatever the ultimate design of living wills regimes, there are some fundamental differences between them and proposals to allow firms to pre-commit to bankruptcy treatment. Most obviously, a living wills scheme is mandatory, not voluntary, and it is part of a process controlled by federal financial regulators. On a programmatic level, living wills or resolution plans will be changeable, perhaps frequently; most of

---

[10] Adam Levitin makes this observation as well. *See* Levitin, *supra* note 3, at 468 (citing Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992)).

[11] *See infra* note 41 and accompanying text.

[12] *See infra* note 42 and accompanying text.

[13] *See infra* notes 53-56 and accompanying text.

the proposals for bankruptcy pre-commitment are generally premised on much more stability in a firm's commitment. Finally, some of the content of resolution plans will be confidential, and the financial services industry is pushing hard to increase the scope of such confidentiality. The bankruptcy pre-commitment proposals are premised on full disclosure.

Part III identifies some important implications for the design of a living wills program from the bankruptcy literature. The primary lesson from that literature is that if living wills provide creditors with credible information about the firm's insolvency–state treatment, they will likely influence creditors' transactions with firms *ex ante*. Ideally, for example, living wills might promote more efficient pricing of credit for participating firms. In any event, it is important for policymakers to understand the potential effects of purporting to create a scheme that features meaningful pre-commitment.

In sum, this Essay aims to illuminate some of the consequential choices of regulatory design that financial regulators across the globe face in creating living wills regimes. More generally, it aims to help fuel scholarly interest in living wills as a regulatory tool.

I. LIVING WILLS, EMERGING CONCEPT

A living will or resolution plan for a commercial firm is a relatively new, immediately popular, regulatory concept. At the most general level, it is a requirement to "stipulate[] in advance the steps government and firms will take to produce an orderly resolution at a fatally weak financial institution."[14] Although the precise form and function of living wills remain largely undetermined, there appears to be a growing consensus that a firm's living will should provide a detailed description of the firm's assets, liabilities, counter-parties, and "develop scenarios under which certain . . . parts can be sold, or put into liquidation [and, perhaps] . . . systemically important parts may . . . be rescued."[15]

As this description suggests, a primary impetus for the growing appeal of living wills is the dissatisfaction of widespread bailouts of financial firms during the recent global financial crisis. Thus, the living wills provision should be understood as part of the fabric of the Dodd-Frank Act, which

---

[14] Ron Feldman, *Forcing Financial Institution Change Through Credible Recovery/Resolution Plans: An Alternative to Plan-Now/Implement-Later Living Wills*, *in* ECONOMIC POLICY PAPERS, *at* 1 (2010), *available at* http://www.minneapolisfed.org/pubs/eppapers/10-2/eppaper10-2_wills.pdf.

[15] Emilios Avgouleas, et al., *Living Wills as a Catalyst for Action* 4 (Duisenberg School of Finance, Working Paper No. 4, 2010), *available at* http://www.dsf.nl/assets/cms/File/Research/DSF%20policy%20Paper%20No%204%20Living%20wills%20as%20a%20Catalyst%20for%20Action%20Update%20May%2010.pdf.

has the interrelated goals of avoiding future crises, reducing the likelihood or scope of future bailouts, and ensuring that no firms continue to be "too big to fail."[16] In theory, living wills have the potential to promote such goals in various ways. If designed and employed effectively, they might, among other things, help avoid crises by alerting regulators to lurking institutional and systemic risks; help avoid failures and crises by identifying sources of capital in times of stress; and, reduce the amount of public support needed by systemically important firms in financial distress by providing an actionable plan for their resolution.[17]

Whether and how living wills serve these functions remains to be seen and depends on how they are designed and implemented. This is very much a work in progress. In 2009, the G20 embraced living wills and charged the Financial Stability Board to help ensure that "[s]ystemically important financial firms . . . develop internationally-consistent firm-specific contingency and resolution plans."[18] The Financial Stability Board, the Basel Committee, and the European Committee of Banking Commissioners are currently preparing policies that will effectively require living wills for many large financial institutions.[19] The UK adopted a

---

[16] *See* Feldman, *supra* note 14, at 1 ("Orderly resolutions obviate the need for bailouts."); Avgouleas, *supra* note 15, at 1-4 ("Amongst the proposals to curtail the too-big-to-fail practice, we believe that the concept of Living Wills is a promising beginning; [it] . . . might allow systemically important banks to fail or, at least, to be unwound in an orderly manner without imposing disproportionate costs on the taxpayer."); Richard Herring, *Wind-Down Plans as an Alternative to Bailouts: The Cross-Border Challenges*, *in* KENNETH SCOTT, ET AL. (EDS.), ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM, (2010), *available at* http://fic.wharton.upenn.edu/fic/papers/10/10-08.pdf (proposing that well-designed wind-down plans for financial firms could reduce the need for bailouts).

[17] *See* Avgouleas, *supra* note 15, at 4-5. The literature on living wills acknowledges that some financial institutions, or portions of institutions, will continue to pose systemic risk under any likely regulatory reforms. Living wills, then, can help policymakers determine "which parts [of firms] they need to keep alive for systemic purposes." *Id.* at 6.

[18] Grp. of Twenty Fin. Ministers & Cent. Bank Governors [G-20], *Leaders' Statement at the Pittsburgh Summit*, at 9 (Sept. 24-25, 2009), *available at* http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

[19] *See, e.g.*, Fin. Stability Bd., Consultative Document, *Effective resolution of Systemically Important Financial Institutions: Recommendations and Timelines*, 17-19 (July, 19, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110719.pdf (proposing a framework for mandatory resolution plans for globally significant financial institutions expected to be adopted by the G20 in November 2011); Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-border Resolution Group*, 31-34 (Mar. 2010), *available at* http://www.bis.org/publ/bcbs169.pdf (recommending resolution plans); Communication from Comm'n to the European Parliament, the Council, the European Economic and Social Committee, the European Court of Justice and the European Central Bank: An EU Framework for Cross-Border Crisis Management in the Banking Sector 5 (2009), *available at* http://ec.europa.eu/internal_market/bank/docs/crisis-

scheme for living wills in the summer of 2010 and required a handful of the country's largest banks to submit plans as part of a pilot program.[20] The UK Financial Services Authority published a proposed framework for a final rule on resolution plans in August 2011.[21]

The new U.S. scheme for living wills is also taking shape slowly. The Dodd-Frank Act sets the basic structure of the regime in place. The new law requires that large bank holding companies and systemically significant non-bank financial companies[22] "report *periodically* to the Board of Governors, the [Financial Stability Oversight Council], and the [FDIC] the plan of such company for rapid and orderly resolution in the event of material financial distress or failure . . . ."[23] The Act specifically requires that these plans describe: (1) how an insured bank within the corporate family "is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company"; (2) "the ownership structure, assets, liabilities, and contractual obligations of the company"; and (3) any "cross-guarantees tied to different securities, identification of major counter parties, and a process for determining to whom the collateral of the company is pledged . . . ."[24]

If the Federal Reserve and the FDIC determine that a firm's plan "is not credible or would not facilitate an orderly resolution of the company . . . " then the firm can resubmit the plan "including any proposed changes in business operations and corporate structure to facilitate implementation of the plan."[25] If a firm ultimately fails to submit a credible plan, the Federal Reserve and the FDIC "may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities,

---

management/091020_communication_en.pdf.

[20] *See* Financial Services Act, 2010, c. 28 § 7 (U.K.); Financial Services Authority, *Recovery and Resolution Plans*, Consultation Paper No. CP11/16, (Aug. 2011), *available at* http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf (noting the pilot program). The movement toward living wills started a bit earlier in the UK than in the US. *See* Financial Services Authority, Turner Review Conference Discussion Paper: *A Regulatory Response to the Global Banking Crisis: Systemically Important Banks and Assessing Cumulative Impact*, Financial Services Authority, DP09/4 (2009), *available at* http://www.fsa.gov.uk/pubs/discussion/dp09_04.pdf.

[21] *See Recovery and Resolution Plans*, *supra* note 20 (articulating, among other things, the goals of resolution plans and proposing information and analysis that should be included in the plans). The FSA expects a final rule to be adopted in early 2012. *Id.* at 11.

[22] The Dodd-Frank Act authorizes the newly created Financial Stability Oversight Council to designate systemically significant non-bank financial firms, which will be subject to heightened regulatory attention. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5323 (Supp. IV 2011).

[23] 12 U.S.C. § 5365(d) (emphasis added).

[24] 12 U.S.C. § 5365(d)(1)(A)-(C).

[25] 12 U.S.C. § 5365(d)(4)(B).

or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies."[26] Furthermore, if a firm has been subjected to requirements to resolve deficiencies and then fails to resubmit a credible plan within two years, the Federal Reserve and the FDIC may require the firm "to divest certain assets or operations . . . to facilitate an orderly resolution of such company . . . in the event of the failure" of the firm.[27]

These agencies adopted a final rule in October 2011, elaborating to some extent the required content of living wills, the process for reviewing the plans, the definitions of key statutory terms and phrases, and the timeline for firms to submit initial plans.[28] A plan must include, *inter alia*, an executive summary, information about the firm's organizational structure and the relationships among its material entities, and "a strategic analysis of the plan's components."[29] The rule provides that the strategic analysis shall:

> [i]nclude detailed descriptions of the (i) [k]ey assumptions and supporting analysis underlying the covered company's resolution plan, including any assumptions made concerning the economic or financial conditions that would be present at the time the covered company sought to implement such plan; (ii) [r]ange of specific actions to be taken by the covered company to facilitate a rapid and orderly resolution of the covered company, its material entities, and its critical operations and core business lines in the event of material financial distress or failure of the covered company; (iii) [f]unding, liquidity and capital needs of, and resources available to, the covered company and its material entities, which shall be mapped to its critical operations and core business lines in the ordinary course of business and in the event of material financial distress at or failure of the covered company; (iv) [c]overed company's strategy for maintaining operations of, and funding for, the covered company and its material entities, which shall be mapped to its critical operations and core business lines . . . .[30]

The rule also requires that plans be resubmitted each year with relevant updates.[31]

---

[26] 12 U.S.C. § 5365(d)(5)(A).

[27] 12 U.S.C. § 5365(d)(5)(B).

[28] *See* Regulation QQ, 76 Fed. Reg. 67,323 (Nov. 1, 2011) (to be codified at 12 C.F.R. pts. 243, 381). The final rules provides that covered companies with $250 billion or more in assets must submit their initial resolution plans by July 1, 2012. *Id.* at 67,330. The FDIC has also promulgated an interim rule requiring insured depository institutions with $50 billion or more in assets to submit resolution plans to it. *See id.* at 67,333.

[29] *See* Regulation QQ, 76 Fed. Reg. at 67,327.

[30] *See id.* at 67,337.

[31] *Id.* at 67,335. Firms must notify the regulators within 45 days after any event that

As one comment letter noted during the rule-making process, a strategic analysis is not necessarily the same as an actionable plan.[32] So the language of the rule begs the question of whether or how much the living wills or resolution plans will guide—and are intended to guide—federal regulators and firms in the case of financial distress. While the Act itself provides that a living will "shall not be binding on a bankruptcy court, a receiver . . . , or any other authority that is authorized or required to resolve [the firm],"[33] the plans "should detail how, in practice, the covered company could be resolved under the Bankruptcy Code."[34] As noted above, at least some federal regulators appear to intend that living wills be actionable and not simply informational.[35] Ultimately, this question of design and function can only be resolved by regulatory practice and will remain uncertain to some extent until the first firm covered by the regime experiences financial distress.

As discussed below, the scope and the magnitude of the effect of the living wills program could turn in large part on whether the information in resolution plans will be available to private counterparties. As initially proposed, the rule implementing the living wills scheme provided that a company submitting a plan "that desires confidential treatment of the information submitted would be required to file a request for confidential treatment."[36] Many comment letters from the financial industry during the rule-making process urged that the content of the plans be presumptively confidential.[37] The final rule provides that the plans will include public and confidential sections, with the former including the general information about the firm's material entities, core business lines, assets, liabilities, capital and funding sources, derivative and hedging activities, and most notably "a description, at a high level, of the covered company's resolution strategy covering such items as the range of potential purchasers and the covered company, its material entities and core business lines."[38] Regulators will presumably determine through practice the amount of

---

has, or could foreseeably have, a "material effect" on the firm's plan. *Id.* at 67,335-36.

[32] *See* letter from Charles Taylor, Dir., Pew Fin. Reform Project to Jennifer Johnson, Sec'y, Bd. of Governors of the Fed. Reserve Sys. & Robert E. Feldman, Exec. Sec'y, Fed. Deposit Ins. Corp. (June 9, 2011), *available at* http://www.federalreserve.gov/SECRS/2011/June/20110614/R-1414/R-1414_060911_81215_302027193104_1.pdf.

[33] *See* 12 U.S.C.A. § 5365(d)(6).

[34] Reg. QQ, 76 Fed. Reg. at 67,327.

[35] *See supra* note 9 and accompanying text.

[36] Resolution Plans and Credit Exposure Reports Required, 76 Fed. Reg. 22,648, 22,653 (proposed April 22, 2011) (to be codified at 12 C.F.R. pt. 381).

[37] Reg. QQ, 76 Fed. Reg. at 67,326.

[38] *Id.* at 67,332.

information necessary to provide this description.

In sum, because the main purposes of a living wills scheme (i.e., avoid crises and bailouts) are regulatory in nature, such a scheme will necessarily be operated and closely controlled by regulatory actors. It may lean heavily on the preferences and plans of regulated firms, but financial regulators will have broad authority to effectively impose some mandatory aspects of the scheme. It is possible that the regulatory goals of the living wills regime will be served simply by forcing firms to prepare and submit the plans rather than setting in place an actionable plan for resolution. The plans will likely be subject to amendment, perhaps frequently,[39] but any changes *ex ante* (before financial distress) could still be a form of pre-commitment. As such changes increase in frequency, however, the strength and predictive value of any particular plan would presumably decline.

II. COMMITMENT REGARDING BANKRUPTCY

The new living wills schemes echo proposals to allow firms to commit themselves *ex ante* to a particular treatment in bankruptcy if they experience financial distress.[40] These proposals stem from a literature that gained prominence in the late-1980s and early 1990s that criticized practice under Chapter 11 of the US Bankruptcy Code as too costly and for providing managers and shareholders with too much leverage to avoid efficient liquidations.[41]

---

[39] *See supra* note 31 and accompanying text.

[40] *See generally* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992) [hereinafter *Debtor's Choice*] (proposing that firms be able to choose their bankruptcy treatment from a menu of options in their charters); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998) [hereinafter *Contract Theory*] (arguing generally that parties could contract to follow the bankruptcy approach "that is optimal in their particular circumstances" and setting forth a formal model to support this claim, *articulated in* Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127 (1997)); Robert K. Rasmussen, *Resolving Transnational Insolvencies Through Private Ordering*, 98 MICH. L. REV. 2252 (2000) [hereinafter *Private Ordering*](arguing that firms should be able to select ex ante which jurisdiction's bankruptcy laws will apply if they experience financial distress). *See* Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1238-58 (2005) [hereinafter *Normative Theory*] (arguing that "capital costs would be reduced were firms permitted to agree in lending contracts to use a particular procedure in the failure state").

[41] *See, e.g.*, Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1045-46, n.11 (1992) (discussing criticism of bankruptcy law that "reorganization may permit managers to effect wealth transfers from creditors (and perhaps other stakeholders) to equity holders"); Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1110 (1994) ("[N]o legal provisions favorable to managers or shareholders would likely be efficient, even as a mere set of default rules in the event firms do not

Responding to such concerns, a number of writers proposed various contractual strategies that would enable firms in financial distress to avoid the need for a formal bankruptcy regime or that would enable creditors to effectively avoid the effects of their debtor filing under Chapter 11. Elizabeth Warren and Jay Westbrook provide a useful taxonomy of these proposals, describing them as "automated bankruptcy," "menu," and "evergreen."[42] The first, and largest, category of such proposals aimed to make bankruptcy law unnecessary by designing a capital structure that could automatically facilitate efficient resolution if a firm became insolvent.[43] The "menu" category included one main proposal, discussed below, that would give firms a set of bankruptcy procedures to choose from.[44] The "evergreen" category included proposals that aimed to increase the scope of contracting over particular aspects of bankruptcy law and procedure.[45]

In one of the earliest and most systematically developed iterations of an approach to pre-commitment in bankruptcy, Robert Rasmussen proposed that firms be able to select at the time of incorporation the bankruptcy

---

explicitly contract for an insolvency process.").

[42] Elizabeth Warren & Jay Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1204 (2005).

[43] *See, e.g.*, Bradley & Rosenzweig, *supra* note 41, at 1078 (proposing the repeal of Chapter 11 and automatic cancellation of residual claims against a defaulting firm); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323-33 (1993) (proposing that firms could issue tiers of fixed-obligation equity, avoiding debt, and the residual unsatisfied class of interest holders could decide the fate of insolvent firms more efficiently than a bankruptcy process); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992) (arguing that firms and creditors can effectively avoid the "common pool" problem and other collective action problems by allocating rights and interests in the firms by contract, obviating a primary justification for bankruptcy law); *see also* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM L. REV. 527, 530 (1983); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 785-88 (1988); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); William H. Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 L. & CONTEMP. PROBS. 13, 37-38 (1977).

[44] *See* Rasmussen, *Debtor's Choice*, *supra* note 40, at 100.

[45] *See generally* Schwartz, *Contract Theory*, *supra* note 40. *See also* Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 354-55 (1997) (proposing that agreements to waive the automatic stay be presumably enforceable); Steven L. Schwarcz, Rethinking Freedom of Contract: A Bankruptcy Paradigm, 77 Tex. L. Rev. 515, 524-34 (1999) (discussing doctrinal and scholarly debate over the enforcement of contracting with respect to bankruptcy, especially agreements to waiving the automatic stay). Schwarcz proposed that parties should be allowed to contract with respect to bankruptcy-specific rights in certain circumstances, but only if it does not "create troublesome externalities," *see id.* at 552, or "significantly impair" the ability of the debtor to be rehabilitated, *see id.* at 579-84.

regime that would apply to them if they experience financial distress.[46] As Rasmussen observed, bankruptcy law is effectively "part of the bargain between the investors of a firm and its creditors . . . ."[47] Thus, if a firm selects an applicable set of bankruptcy rules from a menu of approaches at its inception, then all voluntary creditors will be lending into that particular bankruptcy regime.[48] Treatment of nonconsensual creditors (e.g., tort victims), however, would be determined by a mandatory rule supplied by the state.[49] In subsequent work, Rasmussen extended his proposal, arguing that bankruptcy choice of law provisions in the transnational context should be upheld.[50]

According to Rasmussen, the primary potential benefit of allowing firms to choose a bankruptcy option *ex ante* is that it enables creditors to more accurately price credit they might extend to the firm. If the firm can commit to a bankruptcy regime that increases the insolvency-state return to its creditors, then the creditors will charge less for credit.[51] Because firms have unique borrowing needs, they and their various creditors will have particular combinations of interests; thus, the optimal arrangement for each firm *ex ante* will likely differ across institutions.[52] Even if firms do not pick the optimal arrangement, it follows from this logic that pre-commitment may allow for more accurate pricing of credit, which would also reduce uncompensated transfers of wealth among creditors and shareholders.

As Rasmussen noted, however, a pre-commitment scheme should not be completely inflexible, and some room should be allowed for firms to change their original choices.[53] Commitment to a bankruptcy option may be optimal or efficient *ex ante* and yet become less so over time due to changed circumstances. Yet, "later amendments of the corporate charter must be constrained so as to eliminate the potential for future expropriation of wealth from creditors to shareholders."[54] He proposed that some

---

[46] *See* Rasmussen, *Debtor's Choice*, *supra* note 40, at 121. One option Rasmussen proposes for the menu would be "no–bankruptcy," which would allow for the contingent equity-type arrangements. *See id.* at 100-02.

[47] *Id.* at 53.

[48] *Id.* at 57-59, 61-65.

[49] *Id.* at 53.

[50] Rasmussen, *Private Ordering*, *supra* note 40, at 2275.

[51] Rasmussen, *Debtor's Choice*, *supra* note 40, at 57.

[52] *See Id.* at 54, 65 ("[D]iversity among firms ... implies that firms should be offered a choice of bankruptcy options. . . ." and "[a]ny impediment to the optimal arrangement will ultimately be borne by the firm.").

[53] *Id.* at 116-21 ("Locking firms into their original choice will undoubtedly lead to inefficient results.").

[54] *Id.* at 55.

changes from the original choice (e.g., from Chapter 11 to Chapter 7) would not raise this concern.[55] Changing from Chapter 7 to Chapter 11 or changing away from a no-bankruptcy option, however, should perhaps require unanimous creditor consent or a charter amendment coupled with a waiting period.[56]

Alan Schwartz has argued as well that firms and their lenders might prefer a range of contractual approaches to pre-commitment regarding bankruptcy treatment. He proposed that firms be allowed to contract with their creditors to effectively constrain the firm's discretion regarding crucial aspects of bankruptcy.[57] In an initial paper, Schwartz explained how, if allowed, firms could contract with their creditors to subsequently select the bankruptcy treatment—liquidation or reorganization—that maximizes the value of the firm if it experiences financial distress.[58] Firms could offer "renegotiation-proof" contracts that "bribe[] the firm by permitting it to keep [some percentage] of the insolvency monetary return no matter which bankruptcy system the firm chooses."[59] This model is thus designed to allow parties to bind the firm to make the bankruptcy decision that is efficient *ex post*, balancing *ex ante* and *ex post* tensions.[60] Yet, it introduces a practical problem of coordination with various creditors across time.[61] In another study, Schwartz also proposed that firms could efficiently commit in their lending agreements with creditors to the particular bankruptcy procedure that would apply to them.[62]

Significant for present purposes, Schwartz argued that firms and creditors would be willing to adopt an "updating term," i.e., a provision that the pre-commitment to bankruptcy procedure could change under the lending contracts if a different procedure became "optimal in light of current circumstances."[63] He offered two reasons to be optimistic that

---

[55] *Id.* at 117.

[56] *Id.* at 117-20.

[57] Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127 (1997).

[58] *See id.* at 134. Schwarz posits that there are two broad strategies for contracting in this regard: contracts that contemplate renegotiation ex post in the insolvency state and contracts that aim to "induce the insolvent firm always to choose the optimal bankruptcy procedure."

[59] Schwartz, *Contract Theory*, *supra* note 40, at 1827. A "partially renegotiation-proof contract" would bind the firm to opt for whichever bankruptcy regime correlates to some meaningful external signal. *Id.* at 1830-31.

[60] For example, a creditor may generally prefer its debtor to commit to liquidation but have the ability to reorganize if that would increase the creditor's return.

[61] *See* Schwartz, *supra* note 57, at 140 ("[T]he economic variables that determine which contract is optimal . . . can vary over time.").

[62] Schwartz, *Normative Theory*, *supra* note 40, at 1238-48.

[63] *Id.* at 1257. In his proposal for the renegotiation-proof contracts, Schwartz similarly argued that parties would be willing to include conversion terms in their

creditors would agree to such a term. First, he proposed that it is unlikely that circumstances would change such that a different procedure would become optimal. And second, he argued that, if an update were warranted by changed circumstances, creditors would actually prefer the firm to commit to the newly efficient procedure.[64]

Acknowledging the challenge of conflicting creditor interests for contractual approaches, Schwartz proposed that firms adopt a majority voting rule for creditors—"a bankruptcy contract would bind all creditors if a majority in amount of creditors have signed it."[65] Creditors may be willing to adopt such a provision because "there is less creditor conflict *ex ante* than after insolvency."[66] Schwartz has also argued that the problem of potentially divergent contracting preferences among creditors lending at different times could be solved by insisting that priorities among creditors be strictly respected, thereby significantly reducing the likelihood that creditor interests with respect to bankruptcy treatment will diverge. Assuming that they do not diverge, Schwartz finds that creditors will uniformly prefer the firm to choose a bankruptcy procedure that is *ex post* efficient, i.e., that maximizes the insolvency state return for all creditors, who will share according to their priorities.[67]

The literature on contractarian approaches to bankruptcy has drawn a lively body of critical responses.[68] One critique, for example, is that proponents focus on the costs of the bankruptcy regime, but do not consider the comparable costs of a contractual arrangement.[69] These costs include *ex ante* negotiating costs and *ex post* enforcement costs.[70] Such costs presumably increase significantly as a firm has larger numbers of creditors

---

contracts to ensure that the "bribes" paid by the firm would be consistent across contracts. Schwartz, *Contract Theory*, *supra* note 40, at 1834-35.

[64] Schwartz, *Normative Theory*, *supra* note 40, at 1257.

[65] *Id.* at 1256.

[66] *Id.*

[67] Schwartz, *supra* note 57, at 141-43.

[68] *See* Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, 515-18 (2001) (cataloging some of the most direct criticism of the contractarian approaches to bankruptcy); s*ee also* Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669 (1993); David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465 (1993); Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992); Warren & Westbrook, *supra* note 42.

[69] *See, e.g.*, Block-Lieb, *supra* note 68, at 505-07.

[70] *See id.* at 510 ("Both private- and public-law mechanisms for resolving a firm's financial distress would engender substantial litigation as, under both, incentives exists for strategic interpretation of the governing rules."); *see also* Korobkin *supra* note 68, at 720-21; Warren, *supra* note 68, at 476-77; Skeel *supra* note 68, at 482.

who conduct transactions with the firm at different times.[71] It is possible that the multiplicity of creditors could simply make pre-commitment to *ex post* bankruptcy treatment impossible.[72] A number of writers argue that contract approaches might "impose distributive costs" on unsophisticated parties and creditors who cannot adjust, especially tort victims and employees.[73] It is possible that a particular *ex post* approach in bankruptcy could increase the expected insolvency-state returns of some creditors but reduce the expected returns of others. The former should charge the debtor less for credit and the later should charge more; if the latter cannot adjust to this information, then it may effectively transfer value to the debtor and other creditors.

Pre-commitment to bankruptcy treatment is generally not available under current law.[74] It is a common feature[75] of bankruptcy regimes in advanced economies that firms are not allowed to pre-commit, to not seek relief under available bankruptcy laws, or to not select a generally available option under bankruptcy law. As a result, any direct test of the benefits or dangers of allowing such pre-commitment would require changes in the existing framework of bankruptcy law, and the proposals described above continue to be debated in the abstract. This fact alone might support arguments against pre-commitment in bankruptcy; if it is a good idea, it is fair to ask why no economically significant jurisdiction has allowed parties to do so. It is entirely possible, however, that some combination of path dependency, risk aversion, and political calculation among policymakers constrain countries from allowing pre-commitment approaches to bankruptcy even if it were a desirable policy.[76]

---

[71] Warren & Westbrook, *supra* note 42, at 1202 (2005); Rasmussen, *Debtor's Choice*, *supra* note 40, at 100, 114-16.

[72] Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317, 332-333 (1999).

[73] Warren & Westbrook, *supra* note 42, at 1203 ("Our data ... tend[s] to confirm the hypothesis that there would be substantial redistributive implications from any private bankruptcy system that gave strongly adjusting creditors additional opportunities to shift losses to maladjusting creditors."); *see, e.g.*, LoPucki *supra* note 72, at 339.

[74] *See* Schwartz, *Contract Theory*, *supra* note 40, at 1808 ("Western countries . . . restrict the ability of parties to alter certain outcomes that the state [bankruptcy] system directs."); Warren & Westbrook, *supra* note 42, at 1999 ("[M]ost courts will not enforce prebankruptcy contractual agreements not to file, nor will they permit the parties to vary the applicable rules"). *But see* Tracht, *supra* note 46, at 306 (noting that this prohibition, while generally assumed to be true, has not been clearly articulated by courts). As Tracht and Lopucki observe, moreover, there are various practical contracting strategies that can achieve similar results. *See id.* at 309-11; Lopucki, *supra* note 73, at 334-39.

[75] *See, e.g.*, Schwartz, *Contract Theory*, *supra* note 40, at 1808 ("Western countries require the debtor . . . to participate in the state-supplied bankruptcy system and restrict the ability of parties to alter certain outcomes that the state system directs.").

[76] In a similar vein, it is difficult to evaluate the significance of the lack of evidence

To be clear, though, the purpose of this discussion is not to weigh in on debates about contractarian approaches to bankruptcy. Rather it is to propose that these debates about bankruptcy law have some important relevance for the design and operation of a living wills program. But this is only true to the extent that these are analogous or comparable approaches, a threshold question. And the differences between Rasmussen's menu-option approach and Schwartz's contractual scheme reflect that pre-commitment to bankruptcy treatment can, theoretically, occur in a number of ways.

This variety in bankruptcy pre-commitment approaches notwithstanding, they appear to be fundamentally analogous or comparable in many respects to the broad framework for living wills in the Dodd-Frank Act, at least as that framework has been conceived thus far. Both are intended to allow (or require) firms, while they are financially sound, to articulate a plan for how they would respond to financial distress. More specifically, both schemes purport to force or enable firms to actually resolve themselves according to that plan, with particular focus on liquidating some or all of these firms' assets in the event of financial distress when the firms might otherwise try to avoid doing so.

The underlying goals of pre-commitment in the living wills scheme and in proposals to allow pre-commitment with respect to bankruptcy are meaningfully different. The overriding goals of the former are to promote systemic stability and to avoid bailouts.[77] Pre-commitment to bankruptcy treatment is designed to promote accurate pricing of the cost of credit, ideally downward.[78] At a broad level of generality, however, this difference in underlying aims is reconcilable: both schemes aim to increase the predictability of firms' insolvency-state fate and both rely on the firms themselves to participate in determining the substance of their insolvency-state plan.

That said, these differing goals will inevitably lead to some differences in institutional design. The living wills scheme is a mandatory program conducted by regulatory entities charged with preserving systemic stability and protecting the public fisc. The scheme is largely (perhaps primarily) concerned with forcing comprehensive and timely information from

---

that firms privately adopt living wills and resolution plans. If the proponents of living wills are correct in describing their various functions, it stands to reason that such insolvency-related plans would be valuable to firms even if they were not legally binding or operative. It is possible, however, that firms do such explicit planning and do not disclose it. Furthermore, they arguably conduct such planning indirectly through capital structure or through loan covenants.

[77] *See* Levitin, *supra* note 3, at 468-69.

[78] *See* Rasmussen, *Private Ordering*, *supra* note 40, at 2257.

regulated firms. This information-forcing aspect of living wills could end up driving regulatory design more than the pre-commitment aspect of the living wills. Regulatory concerns about systemic risks and bailouts also increase the need to for the living wills to be revised with some regularity.

In contrast, proposals to allow pre-commitment to bankruptcy do not involve regulatory action beyond the design stage, if at all;[79] they are premised on extending freedom of contract or choice to firms where it does not currently exist. They are not explicitly intended as information-forcing devices, and some proposals do not envision that firms will provide any information to outsiders other than their choice of bankruptcy treatment. Finally, proposals for pre-commitment to bankruptcy treatment generally envision that the commitment will be durable if not permanent.[80]

In sum, this Part argues that there is a fundamental similarity between contractarian approaches to bankruptcy and living wills schemes to the extent that these schemes purport to provide for pre-commitment to insolvency-state treatment. The scope of overlap is not complete, especially because living wills schemes have central functions other than ensuring pre-commitment. The next Part explores implications of this similarity and draws lessons from the bankruptcy literature for policymakers involved in designing and employing living wills regimes.

III. IMPLICATIONS FOR REGULATORY DESIGN

Considering the living wills regime in light of the literature on bankruptcy pre-commitment proposals yields a number of insights that could inform the institutional design of the regime. The most important insight in this regard is the possibility that living wills will affect the behavior of stakeholders, especially creditors, at the transaction stage and could affect the cost of credit for firms subject to the scheme. Policymakers should be especially attentive to the possibility that this will occur as they consider the intended binding effect of living wills and assess the likelihood that resolution plans will actually guide regulators when a firm experiences financial distress.

Living wills regimes will likely influence the behavior of counter-parties to regulated firms if those counter-parties believe that the regimes will affect their relationships with the firms. And the regimes could affect those firms' counter-parties in various ways. In theory, for example, living wills could commit firms to resolution plans that creditors believe are likely to improve their insolvency-state returns from regulated firms. Creditors

---

[79] The regulatory component of those proposals would primarily consist of removing existing barriers to commitment.

[80] *See supra* note 9 and accompanying text.

could determine, for example, that a particular plan, if followed, would make a wasteful reorganization and/or bailout less likely[81] or that it would lead to a more efficient liquidation. If so, the regime could reduce regulated firms' cost of credit.

More modestly, creditors might perceive that a debtor's living will, if followed, would make their insolvency-state returns more predictable if not increase them. Given the policy goals of limiting bailouts, the living wills regime might make liquidations more likely even where reorganization would yield a greater return for creditors. If so, the regime could give creditors reason to believe that their insolvency-state returns from a regulated debtor would decrease under the scheme, which might increase the cost of credit.[82] Presumably, this would be a justifiable cost of the regulatory goals of helping avoid crises and limiting the need for bailouts. Furthermore, if the living wills made this regulatory treatment more predictable, creditors could price transactions more accurately, avoiding a transfer of wealth from (some) creditors to firms and investors.

But, again, these effects are premised on counter-parties perceiving that the living wills reflect a pre-commitment, increasing predictability. And this will depend largely on how the financial regulators intend to treat the living wills and how they actually treat them when regulated firms experience financial distress. Regulators may express their intention to treat living wills as a pre-commitment, but doing so will likely be difficult and perhaps controversial *ex post*. This is a challenge for both living wills regimes and pre-commitment to bankruptcy.[83] Tension between *ex ante* and *ex post* efficiency will inevitably arise in both contexts. Imagine a firm committing to a form of resolution that turns out to involve much higher costs and yield less value than available alternatives that the firm committed not to pursue. For example, a firm might commit to liquidate certain assets if it experiences a specified type of financial distress but, *ex post*, those assets appear to be appreciably more valuable if the firm retains them as a going concern or liquidation might raise concerns about systemic stability. In such a case, policymakers or courts would be forced to choose

---

[81] This, of course, will be a challenge for the scheme. As Feldman notes, firms "have no incentive to draw up credible plans." *See* Feldman, *supra* note 14, at 1. "[C]reditors will not view living wills drawn up in private as real threats to future bailouts. Thus, creditor discipline will remain too weak." *Id.* Feldman argues that for the scheme to allow for "orderly resolution without bailouts," it must change institutions ex ante, be "driven by supervisors," and have "transparent outcomes." *Id.*

[82] It is possible, however, that the overall function of the regime would improve the health of firms such that they would be less likely to fail in the first place, which would presumably reduce the cost of credit.

[83] *See* Levitin, *supra* note 3, at 468 ("A binding living will is not a workable system. If a living will is not binding . . . its functional value as a resolution plan is limited. . . .").

between taking an action with a significant *ex post* loss or declining to enforce the commitment to promote predictability. There are reasons to believe that financial regulators will be more likely to choose the latter course—i.e. not follow the plan—than would courts faced with a pre-commitment to bankruptcy. Regulators faced with genuine concerns about systemic stability are notoriously willing to deviate from formal and informal expectations.

All of the foregoing assumes that a firm's potential creditors will know the content of a firm's plan or pre-commitment and have some confidence in it. In fact, the bankruptcy pre-commitment proposals depend expressly on firms being able to communicate their pre-commitments to potential creditors and investors. This suggests that determining the transparency of living wills may be one of the most consequential design choices for the regime. If living wills are to be actionable yet secret, this would seem to ensure that credit to firms subject to the regime would not be priced accurately. It could unnecessarily increase the cost of credit; without evidence to the contrary, creditors might have to assume the most pessimistic prediction of their insolvency-state returns.

Not surprisingly, the question of disclosure and confidentiality of information in living wills has been a hotly debated issue.[84] The FDIC and the Federal Reserve's final rule on living wills ensures that at least some general information will be made available to counter-parties, although it remains to be seen if the public section of the plans will provide sufficient information to affect transactions with the firms.[85] In any event, it is possible that firms could voluntarily disclose some or all of the contents of their living wills. While firms may prefer not to do so, creditors might require confidential disclosure of significant information about the wills before they lend.[86]

The literature on pre-commitment to bankruptcy treatment should also raise some concerns about the effect of allowing changes to firms' living wills over time.[87] If creditors lend to a firm based on commitments made

---

[84] *See* Regulation QQ, 76 Fed. Reg. 67,323, 67,326 (Nov. 1, 2011) (to be codified at 12 C.F.R. pts. 243, 381).

[85] *See id.* at 67,332.

[86] Even if the details of the plan are not actively disclosed, voluntarily or otherwise, it seems desirable that the FDIC would adopt a relatively consistent approach to its review of firms' living wills. If so, creditors could safely make basic assumptions about how various assets might be treated under a firm's living will. This would look more like a regulatory rule than a voluntary, optional commitment by firms, but if it is reliable, and especially if it approaches the optimal voluntary plan (given a background no-bailout policy), then this should improve pricing of credit.

[87] *But see* Avgouleas, *supra* note 15, at 6 ("A constant updating of the recovery and resolution plans and the maintenance of a data-room on the bank's assets, liabilities, activities, counterparties and contracts . . . allow the authorities to make a swift

in a living will about how the firm will be resolved, then a change in the commitment to resolution might undermine the *ex ante* pricing decisions, leading to a wealth transfer from one party to the other. This is not to say that living wills should not be changeable. If changed circumstances make it desirable to amend a living will, the amendment could be beneficial to all creditors. They might prefer the change in plan so long as it does not meaningfully alter the priorities among them. Furthermore, creditors may be able to anticipate to some extent the scope of possible circumstances or the factors that would make various changes more or less likely; if so, they might also be able to price the risks of changes to firms' living wills *ex ante*.

Presumably, creditors who lend for longer terms would be more susceptible to changes in firms' living wills than those who lend for shorter terms. Much lending to financial firms is for relatively short terms, which may obviate some of possible concerns about allowing firms to amend their wills. It is also possible that the prospect of amendment would cause firms to be even more inclined to borrow on shorter maturities. If so, that could be either a neutral or a costly consequence of the living wills regime, depending on the collateral effects of nudging firms toward borrowing more on shorter terms.

Finally, the literature on pre-commitment in bankruptcy suggests that it will be important to enforce commitments in living wills if the plans have been represented as a meaningful commitment. Put another way, it will be important not to represent the wills as binding if policymakers know or have good reason to believe that they will not be given that effect. The potential effect of pre-commitment on the cost and availability of credit is a function of creditors' expectations that a stated commitment or plan effectively binds the firm. If the treatment or action actually undertaken is inconsistent with the plan, then any action taken in response to the plan *ex ante* was misguided; there is certainly no efficiency gain, and creditors could end up charging too much or too little for credit based on misguided expectations.

This concern is heightened in regard to living wills if the new background regulatory norm is going to shift away from bailouts. This background policy will likely reduce creditors' insolvency-state returns and therefore increase the cost of credit. This is because bailouts can help finance efficient restructuring or reorganization; a narrower scope for bailouts could increase the likelihood that regulated firms will be liquidated at a lower value than the firm would have as a going concern. Adding

---

assessment of the situation and also to determine which parts [of a firm] are systemic and which other parts can be hived off.").

uncertainty about how losses will be allocated in a world without bailouts could increase the cost of credit more than necessary if each party has to account for the possibility that they will bear significant losses. This suggests that a living wills scheme that purports to create a binding commitment to a particular course of action but does not enforce the planned treatment could be worse than a scheme that does not purport to create a binding commitment of any sort.

CONCLUSION

Living wills or resolution plans are one of the few innovative aspects of recent financial regulatory reforms, and yet they have attracted relatively little attention and commentary compared to other reforms. Depending on regulatory design and practice, these living wills have the potential to be a significant tool for financial regulators who aim to avoid systemic crises and taxpayer bailouts. This Essay emphasizes some basic similarities between living wills and proposals to allow parties to pre-commit with respect to bankruptcy treatment. Like contracting about bankruptcy, living wills potentially involve firms making some form of commitment or strong prediction regarding their insolvency-state treatment. If living wills do purport to reflect some meaningful degree of commitment in this regard, and if the contents of the wills are disclosed to regulated firms' counter-parties, these counter-parties are likely to adjust to the plans. Thus, financial regulators should be mindful of the potential *ex ante* effects of living wills and clarify to market participants as much as possible how they intend to utilize the wills in the event of a firm's financial distress.

FINANCIAL REGULATION REFORM AND TOO BIG TO FAIL

BRETT H. MCDONNELL†

I. INTRODUCTION

Perhaps the leading critique of the Dodd-Frank Act from the left is that it does too little to address the problem of too big to fail ("TBTF") financial institutions.[1] This critique is not unique to the left—many on the right make similar arguments.[2] The critique of TBTF institutions has two main components, which I shall call the economic argument and the political argument. The economic argument focuses on a major moral hazard problem. TBTF institutions know they are likely to be bailed out if they near failure because the consequences of their failure to the financial system are dire.[3] Knowing this, they take on too much risk, increasing the chances of financial crisis.[4] The political argument focuses on the political clout of TBTF institutions.[5] Their size and centrality to the financial

---

†Professor of Law, *University of Minnesota Law School.* I thank participants at American University Washington College of Law's symposium on Law, Finance and Legitimacy After Financial Reform, especially panel commentators Jose Gabilondo, Lisa Fairfax, and Peter Conti-Brown, for helpful comments.

[1] *See generally* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2010) and JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY (2010) for two of the leading, and best, instances of the sort of critique I have in mind. These are not actually critiques of Dodd-Frank, since they were published before the Act passed. However, the Act clearly falls well short of the actions that both books advocate, and the authors have subsequently made predictable criticisms of the Act, although they are not completely critical. *See also* Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951 (2011), for a discussion of the Dodd-Frank Act's limited effectiveness in solving the TBTF problem and in ending taxpayer bailouts.

[2] *See generally* RAGHURAM G. RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY (2010) (discussing the causes of the economic meltdown and the continuing flaws in the current economic system); GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS (2004) (warning that not enough has been done to reduce problems of the TBTF problem).

[3] Wilmarth, *supra* note 1, at 954.

[4] *See generally* STERN & FELDMAN, *supra* note 2 at 2.

[5] *See infra* Part III.

system gives them immense lobbying power in Washington, both in Congress and among regulatory agencies. The revolving door places many industry insiders at the heart of agency decision-making. The political argument maintains that this revolving door goes a long way towards explaining the excessive deregulation which set the stage for the financial crisis.

There are important truths in both the economic and the political arguments against TBTF institutions. However, there are also important limits to the truth of both arguments. I believe the limits are more central than the truths, and that if anything, Dodd-Frank has gone too far in focusing on TBTF institutions. Part II explores the truths and limits of the economic argument, while Part III does the same for the political argument. Part IV lays out a map for my own preferred approach to the TBTF problem. In the short run, we need relatively modest but firm regulation. Dodd-Frank looks pretty good in many ways, but still needs some important fixes. The longer run is more daunting: we need to find ways to develop alternative financial and other institutions that are smaller and more focused on community and other stakeholder interests.

II. THE ECONOMIC ARGUMENT

The economic argument contains an important truth that almost all analysts have recognized in the wake of the financial crisis. The existence of TBTF financial firms creates a severe moral hazard problem.[6] TBTF firms (many rightly point out that it may be more accurate to speak of firms that are too *inter-connected* to fail),[7] are tied to many other firms in many other financial markets. If they fail, they put stress on many of those firms and markets.[8] Particularly if such a failure occurs at a time when market participants are already nervous about financial troubles, the failure of one TBTF firm may set off a chain reaction that leads to widespread collapse of many financial firms and markets.

The realistic prospect of such a chain reaction collapse creates the moral

---

[6] Viral V. Acharya et al., *Prologue: A Bird's-Eye View, The Dodd-Frank Wall Street Reform and Consumer Protection Act, in* REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 1, 9-10 (2011); RAJAN, *supra* note 2, at 18, 131; NOURIEL ROUBINI & STEPHEN MIHM, CRISIS ECONOMICS: A CRASH COURSE IN THE FUTURE OF FINANCE 68-72 (2010); *see* JOHNSON & KWAK, *supra* note 1, at 166-74 (discussing the restructuring efforts made for economic recovery); *see also* STIGLITZ, *supra* note 1, at 118 (stating that through explicit or implicit governmental guarantees, banks do not bear the risks they take). *See generally* STERN & FELDMAN, *supra* note 2 (arguing that many of the problems inherent in TBTF firms that caused the financial collapse still exist).

[7] Acharya et al., *supra* note 6, at 2-6; ROUBINI & MIHM, *supra* note 6, at 200.

[8] Acharya et al., *supra* note 6, at 2-5.

hazard problem. History[9] and political common sense strongly suggest that the government and central bank will not stand back and face the threat of such a collapse. Rather, they will step in and rescue the TBTF firm. But, those running such a firm know this. It gives them incentive to take on too much risk.[10] If that risk pays off, they are sitting pretty. If it doesn't, then taxpayers will bail them out.[11] Moreover, TBTF firms will face a lower cost of raising capital,[12] as investors also anticipate a bailout if things go wrong. Thus, more resources flow to TBTF firms which are taking on high risk, which will tend to drive the financial system towards the very crises which regulators hope to avert. Clearly the experience of the many bailouts in the latest crisis should make persons in the financial markets anticipate bailouts the next time around.

This economic critique comes from all sides of the political spectrum. Economists of all stripes can easily spot the moral hazard threat.[13] And for politicians of the left and right, TBTF institutions make tempting targets—on the left, because bailouts help rich financiers while doing nothing (directly) for common folk, and on the right because they represent Big Government distorting private markets. So politicians from Al Franken[14] to Michele Bachmann,[15] just to focus on my own state, can gleefully take aim at the bailouts.

But those on the left and right tend to disagree on how to solve the moral hazard problem. Many on the left would like to cap the size, and maybe also the complexity, of financial institutions, so that companies are not allowed to become too big (or too inter-connected) in the first place.[16]

---

[9] *E.g.* CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES (5th ed. 2005); CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009).

[10] STERN & FELDMAN, *supra* note 2.

[11] *See* STIGLITZ, *supra* note 1, at 118.

[12] *See* Brett H. McDonnell, *Don't Panic! Defending Cowardly Interventions During and After a Financial Crisis*, 116 PENN. ST. L. REV. (forthcoming 2011) (manuscript at 9) (on file with author), *available at* http://ssrn.com/abstract=1753760 (discussing the under-pricing of risk with a government bailout, like with Fannie Mae and Freddie Mac).

[13] *See supra* notes 6–8 and accompanying text (discussing the origins and effects of moral hazard).

[14] Al Franken, *To Be Blunt!*, C-SPAN 2 (Mar. 23, 2010), http://videocafe.crooksandliars.com/taxonomy/term/2981,3312.

[15] Catalina Camia, *GOP Moves to Repeal IRS, Wall Street Rules*, USA TODAY ON POLITICS (last updated Jan. 6, 2011, 2:10 PM), http://content.usatoday.com/communities/onpolitics/post/2011/01/gop-moves-to-repeal-irs-bank-bailouts-/1.

[16] JOHNSON & KWAK, *supra* note 1, at 208-13; ROUBINI & MIHM, *supra* note 6, at 226-30; STIGLITZ, *supra* note 1, at 164-68.

Analysts on the right tend to be skeptical of that degree of regulation. They believe it is likely either to have unintended consequences or to be evaded (or both).[17] Instead, they either call for lighter regulation that limits the risk TBTF institutions can take on,[18] or else call for limits on the ability of the government to intervene in failing companies. Those on the left think that lighter regulation (such as Dodd-Frank) is unlikely to solve the problem and they are skeptical that we can credibly commit to limit intervention in a crisis.[19]

But there are reasons to doubt the strong emphasis of many on TBTF as the main cause of the crisis. For one thing, it is not clear that large and complex financial institutions are, on balance a bad thing.[20] Size and diversity of institutions can arguably increase stability. Larger, more diverse financial institutions may be better able to weather economic storms.[21] That indeed would seem to be one of the lessons of the Great Depression, where the banking system was highly decentralized and quite unstable.[22] The more concentrated Canadian system weathered the recent storm better.[23]

Furthermore, other problems besides TBTF may have played at least as great a role in the financial crisis. In my opinion,[24] the true core lesson from our latest crisis should not be the problem of TBTF institutions, but rather the problem of the shadow banking world, where unregulated institutions and markets are economically very similar to banks, and similarly subject to contagious panics, but they are not regulated like banks.[25] Panics can occur in these markets as many mid to small sized institutions following similar strategies face similar stresses. Key examples during the latest crisis included the panics in the money market fund and

---

[17] RAJAN, *supra* note 2, at 171-72.

[18] *Id.* at 168-69, 171-76.

[19] JOHNSON & KWAK, *supra* note 1, at 208-13.

[20] *Id.* at 211; RAJAN, *supra* note 2, at 172.

[21] *See, e.g.*, RAJAN, *supra* note 2, at 172 ("[l]arger banks may be better at diversifying and attracting managerial talent (including risk managers).").

[22] *See* Elizabeth Dunne Schmitt, Professor, Oswego State Univ. of N.Y., Lecture Notes on *Chapter 13: Financial Industry Structure*, (2003), http://www.oswego.edu/~edunne/340ch13.htm (last visited Oct. 12, 2011).

[23] Tony Porter, *Canadian Banks in the Financial and Economic Crisis*, (Sept. 01, 2011, 11:35 p.m.), *available at* http://www.nsi-ins.ca/english/pdf/Canadian%20Banks%20(tony%20porter).pdf.

[24] *See* McDonnell, *supra* note 12, at 8.

[25] Viral V. Acharya & T. Sabri Oncu, *The Repurchase Agreement (Repo) Market, in* REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 319, 319 (2011); ZOLTAN POZSAR ET AL., FED. RES. BANK OF N.Y., STAFF REPORT NO. 458, SHADOW BANKING (2010).

commercial paper markets.[26] And the Great Depression remains the leading example of panics caused by a series of failures in relatively small, lightly regulated financial institutions.[27] We have now regulated institutions we label "banks," but not many similar ones. These shadow banks need greater regulation to reduce the chances of future panics.

Moreover, there are many causes of financial firms taking on too much risk and leverage beyond the moral hazard problem on which the economic argument focuses. These include corporate governance failures (including compensation schemes that encourage too much risk-taking), herd behavior, and a tendency towards over-optimism caused by short memories after economies recover from a crisis.[28] Human beings seem quite able to convince themselves that this time things will be different, and that they do not need to protect themselves against the chance of a financial crisis.[29] Other problems revealed by the crisis include various incentive failures within the mortgage-backed securitization chain[30] and governmental policies that encouraged a housing bubble as a way of avoiding coming to grips with the pain of economic stagnation for the middle class.[31]

In its focus on new regulations for TBTF institutions, Dodd-Frank does too little to regulate smaller shadow banking institutions. The two most crucial sections of the Act are its first two titles.[32] Title I extends capital requirements and other regulatory controls to systemically significant financial companies.[33] Such extended regulation is needed for shadow banking generally, but Title I's language would seem to include only TBTF institutions.[34] Title II creates a new resolution authority, whereby the FDIC can quickly dispose of systemically significant non-banks that are

---

[26] *See* Acharya et al., *supra* note 6, at 25-27; GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007, 106-07 (2010).

[27] *See* Schmitt *supra* note 22 and accompanying text.

[28] *See* McDonnell, *supra* note 12, at 9-10 nn. 24-34 and accompanying text.

[29] *See* REINHARDT & ROGOFF, *supra* note 9, at 208-13.

[30] McDonnell, *supra* note 12, at 8-9. See also GORTON, *supra* note 26, at 39-41, 138-41 for a discussion on problems with mortgage-backed securitization chains.

[31] *See* RAJAN, *supra* note 2, at 85 (stating that the government and Federal Reserve encouraged the housing bubble "[i]n an attempt to induce recalcitrant firms into creating jobs.").

[32] *See* McDonnell, *supra* note 12, at 38-42.

[33] Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5323 (Supp. IV 2011).

[34] *Id.* I have suggested that creative interpretation might extend this language. McDonnell, *supra* note 12, at n. 183. However, initial rulemaking does not suggest regulators are inclined to such creativity. *E.g.*, Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4,555 (proposed Jan. 26, 2011) (to be codified at 12 C.F.R. pt. 1310).

financially troubled and pose a threat to the financial system.[35] If well-used, this authority can help stop contagious panics while still punishing the main decisionmakers in a way that reduces the moral hazard problem. The resolution authority created by Title II is thus an important mechanism for reducing the TBTF economic problem. But, it could also have provided a tool for dealing with panics in smaller shadow banking institutions. However, here again the language appears limited to TBTF companies.[36]

Indeed, Dodd-Frank may channel more resources into smaller unregulated shadow banks as investors find ways to avoid the new regulations by moving money to more lightly-regulated entities.[37] Because it buys into the economic argument against TBTF, Dodd-Frank may actually increase the risk of future crises, precisely because it focuses mainly on a few large institutions that on their own create large systemic risk.

More likely than not, though, TBTF institutions do on the whole pose a greater risk than others in the shadow banking world. Thus, tougher regulations for TBTF institutions, as contemplated in Dodd-Frank, do make sense. However, the ambiguity as to this point, combined with the difficulty of drafting blanket prohibitions that would not be evadable, suggests something short of the complete assault on the existence of TBTF institutions that some suggest. Rather, we should have stricter regulations, and/or possibly a tax for TBTF firms, whose level depends on the degree of risk posed, while extending some regulations to a broader class of companies. Part IV will consider this idea further, and assess how well Dodd-Frank fits it.

III. THE POLITICAL ARGUMENT

Like the economic argument, the political argument against TBTF firms expresses some important truths. Large institutions with big pots of cash have some real advantages in political organization. A few large companies can more easily overcome free rider problems than many smaller companies.[38] Large TBTF banks and their executives have much prestige. That prestige can cause politicians and regulators to look to hire them as regulators—consider the flow of Goldman Sachs officers into high levels of government.[39] The prestige and high compensation of jobs at the

---

[35] 12 U.S.C. §§ 5381-5394.

[36] 12 U.S.C. § 5383.

[37] McDonnell, *supra* note 12, at 49; ROUBINI & MIHM, *supra* note 6, at 212-13.

[38] *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (17th prtg. 1998).

[39] Most obviously including Treasury Secretaries under both Presidents Clinton (Robert Rubin), Robert E. Rubin - About, U.S. DEPARTMENT OF THE TREASURY,

large banks also work in the reverse direction, luring regulators into private employment. Prospects of such employment may influence their actions as regulators. Agency problems may also allow the managers of large companies to use resources to their own advantage, including in lobbying for legal rules. Note, though, that this last argument suggests that some rules achieved through lobbying by TBTF executives may not be in the best interests of the firms themselves.

The political argument is interrelated with the economic argument; they support each other. On the one hand, capture of the political process by TBTF institutions makes bailouts more likely, worsening the moral hazard of the economic argument. On the other hand and more subtly, the economic argument points to an inherent power for TBTF institutions. Should they collapse, they threaten genuine calamity for the economy as a whole. That gives them the power to go to politicians asking for help, with the real threat that if they do not get it, the economy could tumble down with them. Indeed, I believe this, more than any sort of corruption or influence peddling, explains most of the bailouts of 2007-08.

The political argument has been around for a long time. American distrust of large financial institutions goes back at least to Andrew Jackson's battle with the Bank of the United States.[40] The argument resonates on both the political left and right. On the left it fits well with concerns about the entrenched power of a wealthy elite.[41] On the right, it fits well with standard public choice stories of capture by concentrated economic interests. The financial industry has many companies with a strong interest in weakening financial regulation, whereas the general public which could be protected by such regulation has no persons or organizations which individually stand to gain a lot from such regulation.[42]

Advocates of the political argument can point to many possible examples of industry capture, both during the long boom leading up to the crisis and during and after the crisis. Industry pressure led to extensive financial deregulation, including removal of limits on interest rates, barriers to entry,

---

http://www.treasury.gov/about/history/Pages/rerubin.aspx (last visited Oct. 22, 2011), and Bush (Hank Paulson), Henry M. Paulson, Jr. - About, U.S. DEPARTMENT OF THE TREASURY, http://www.treasury.gov/about/history/Pages/hmpaulson.aspx (last visited Oct. 22, 2011), as well as a U.S. Senator and New Jersey Governor (Jon Corzine), Jon Stevens Corzine – Biographical Information, BIOGRAPHICAL DIRECTORY OF THE UNITED STATES CONGRESS, http://bioguide.congress.gov/scripts/biodisplay.pl?index=C001042 (last visited Oct. 22, 2011).

[40] *See* JOHNSON & KWAK, *supra* note 1, at 18-22.

[41] *Id.* at 18-22; STIGLITZ, *supra* note 1, at 291.

[42] OLSON, *supra* note 38; George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 11-12 (1971).

limits on new financial products, and the end of the Glass-Steagall Act.[43] During and after the crisis, opposition to new regulation was strong, limiting what was included in Dodd-Frank.[44] Now that Dodd-Frank has passed, industry lobbyists are working hard, and in many cases effectively, to de-fang the new rules that regulators must promulgate.[45]

But, it is far from clear that the political successes of the financial world are due to the size and influence of a few big banks. Smaller financial institutions have some political advantages of their own. They are more widely distributed around the country,[46] and hence may be able to effectively lobby in more congressional districts. They are also seen as more politically legitimate—taking money from Goldman Sachs is quite attractive for politicians in ordinary times, but can become an embarrassment when times get tight. At many periods in U.S. history, big banks have had quite a toxic political reputation—consider the Second Bank of the United States.[47] Small local banks, in contrast, have generally had real clout in both state capitals and D.C. The populism of Andrew Jackson is admittedly distant in the past, but even today we see real echoes of it in the reaction to the recent bailouts. Tea partiers and progressive activists share a deep antipathy to the bailouts, an antipathy which was widely expressed across the political spectrum. Of course, that didn't stop the bailouts from happening.[48]

Two of the strongest proponents of the political argument against TBTF institutions, Simon Johnson and James Kwak, illustrate the past power of many smaller companies in a telling quote concerning the savings and loan debacle of the 1980s:

But at the time, the S & Ls—not the Wall Street investment banks—and their lobbying organization, the United States League of Savings

---

[43] *See* JOHNSON & KWAK, *supra* note 1, at 64-87.

[44] Just three Republican Senators voted in favor of the Act. Brady Dennis, *Congress Passes Financial Reform Bill*, WASH. POST, (Jul. 16, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/07/15/AR2010071500464.html?sid=ST2010071504699. Only three Republicans voted for the Act in the House of Representatives. David Dayen, *Dodd-Frank Passes House*, FDL NEWS DESK (Jun. 30, 2010, 4:02 PM), http://news.firedoglake.com/2010/06/30/dodd-frank-passes-house/.

[45] *See e.g.*, Kimberly D. Krawiec, *Dodd-Frank @1: Volcker Wrap-Up*, THE CONGLOMERATE (July 22, 2011), http://www.theconglomerate.org/2011/07/dodd-frank-1-volcker-wrap-up.html; Kimberly D. Krawiec, *Don't 'Screw Joe the Plummer': The Sausage-Making of Financial Reform* (September 16, 2011), available at http://ssrn.com/abstract=1925431.

[46] JOHNSON & KWAK, *supra* note 1, at 66-67.

[47] JOHNSON & KWAK, *supra* note 1, at 18-22, 33.

[48] That they did happen, of course, in part, reflects the political power of TBTF firms, but I also suspect it reflects the reality recognized in the economic argument: not doing the bailouts would have led to disaster.

Institutions, were a powerful political force with influence on both sides of the political aisle. Although individually small, they had a favorable public image (in a country that professes to live by small-town values), they were located in virtually every congressional district, and they benefited from the disproportionate representation of rural states in the Senate.[49]

It is not clear which set of effects is stronger, and thus it is not clear whether the financial industries really have more clout when they are more or less concentrated. For many areas of financial regulation, it may well not matter very much. For most regulation, the interests of large and small financial firms may be more or less the same, and it is often (though not always) the case that there will be little opposition to the financial industry position because those on the other side (generally consumers) are a very large, ill-organized group where each person has relatively weak interests. Standard public choice arguments suggest likely industry capture of regulation in such circumstances. Where opposition is weak, either the more or less concentrated version of the financial industry will be able to organize well enough to be able to impose its will.[50]

Brute political capture is not the only, and quite possibly not the most important, variant of the political argument against TBTF institutions. A deeper problem may be intellectual or cultural capture. A varied set of economic, political, intellectual, and cultural forces have come together to create a general mindset that private market actors are good and dynamic while regulation is generally bad and stultifying.[51] Here too, though, it is not clear that the issue is TBTF institutions specifically as opposed to private market financial actors generally. Note too that while many left and right commentators may agree on the standard political capture argument, they diverge on the cultural capture argument—what leftists see as illegitimate and misguided cultural capture, conservatives will instead see as sensible intellectual advances. This again points to differing solutions to the political argument, similar to the differing solutions we saw to the economic argument.[52] Strong leftists want to eliminate TBTF institutions in order to eliminate their political influence, while conservatives want to heavily limit the ability of governments to act in order to limit the ability of TBTF institutions to influence governments.

---

[49] JOHNSON & KWAK, *supra* note 1, at 66-67.

[50] OLSON, *supra* note 38; Stigler, *supra* note 42 and accompanying text.

[51] *See e.g.* James Kwak, *Cultural Capture and the Financial Crisis*, *in* PREVENTING CAPTURE: SPECIAL INTEREST INFLUENCE IN REGULATION, AND HOW TO LIMIT IT (Daniel Carpenter, Steven Croley & David Moss eds., forthcoming 2011) (unpublished manuscript) (on file with author).

[52] *See supra* text accompanying notes 16–20; *see also* JOHNSON & KWAK, *supra* note 1, at 208-13; RAJAN, *supra* note 2, at 168-69, 171-76; ROUBINI & MIHM, *supra* note 6, at 226-30; and STIGLITZ, *supra* note 1, at 164-68.

There is also another and deeper problem with the leftist call for regulation as a response to the political argument against TBTF institutions: it rarely offers a plausible political story for how such regulation is supposed to happen. After all, if the political argument is true, we can expect fierce opposition to strong regulation of TBTF institutions. Who will provide the political will to overcome that opposition? Anyone who wants to be more than an ineffectual Cassandra should ponder whether they have any sort of answer to that question. There is a certain naïve moralism to much writing and speaking on the need for reining in TBTF institutions, as if speaking out with the right degree of self-righteous indignation should be enough to get politicians and regulators to see the light and fall in line.[53]

It is true that during the height of a crisis, financial regulation may become a salient issue, and a populist attack on TBTF institutions may be popular. Fear of retribution at the polls may actually prod politicians to listen to the eloquent jeremiads of TBTF critics at such moments. But that populist moment passes quickly, and the TBTF institutions should be able to weather the storm by lobbying for vague legislation which appears to address the problem, but which can be weakened to nothing in the quiet after the storm has passed.[54] Progressive opponents of TBTF institutions must identify counter-forces which are informed and patient enough to win a long war. They must be able to pass meaningful legislation during or soon after a crisis, and then translate that legislation into meaningful regulation as the economy recovers and starts to grow again, and popular attention turns elsewhere. To date, progressives do not seem to have found a winning answer within the contemporary political and regulatory system.[55]

---

[53] *E.g.*, JOHNSON & KWAK, *supra* note 1, at 208-13; Paul Krugman, The CONSCIENCE OF A LIBERAL http://krugman.blogs.nytimes.com/; *see also* STIGLITZ, *supra* note 1.

[54] Scott Baker & Kimberly D. Krawiec, *The Penalty Default Canon*, 72 GEO. WASH. L. REV. 663, 673-75 (2004); DAVID EPSTEIN & SHARYN O'HALLORAN, DELEGATING POWERS: A TRANSACTION COST POLITICS APPROACH TO POLICY MAKING UNDER SEPARATE POWERS 7-9 (1999).

[55] A partial answer is the rulemaking bureaucracy. If it can be motivated to pursue rules that give real teeth to legislation, then it can extend the principles established during a brief populist reform period. But the bureaucracy itself is subject to industry capture. One can try to find ways to prod the bureaucracy to resist capture, and to continue to explore systemic problems within the financial system. Indeed, Dodd-Frank continues a number of mechanisms which may do just that. In another paper with Dan Schwarcz, I explore those mechanisms. *See generally* Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629 (2011). *See infra* note 56.

IV. RESPONDING TO TBTF

I argue for a different sort of response from the left[56] to the TBTF problem, rather than simply forbidding financial institutions above a certain size, as some recommend.[57] My response has two main prongs: implementing modestly stricter regulation of TBTF institutions in the short run, and developing alternative financial, economic, and political institutions in the long run.

A. Modestly Stricter Regulation of TBTF Institutions Should Be Implemented

The first prong is modest but firm regulation. Regulation should cover all shadow banking institutions, but larger, potentially TBTF institutions should face stricter rules. All shadow banking institutions need to be covered because, as we have seen, even smaller companies can collectively cause big trouble.[58] We should not prohibit overly large financial companies altogether both because of the possible advantages of bigger, more diversified companies, and also because such rules are an invitation to evasion. But stricter rules are appropriate for such companies, and they will help reduce the moral hazard problem by forcing TBTF institutions to take on less risk. Dodd-Frank already gets part of this right—TBTF institutions will face stricter rules, although much still depends upon implementing regulations.[59] Prudential standards and disclosure requirements for nonbank financial companies may get stricter as companies get larger, more complex, or riskier.[60] Bank holding companies that "pose a grave threat to the financial stability of the United States" may be restricted in their ability to acquire companies or offer financial products.[61] Financial companies may not merge if the resulting entity

---

[56] But I hope to appeal to some on the right as well. Hardcore libertarians would prefer less regulation combined with stronger commitments to keep the State from intervening in financial markets. I have argued against this elsewhere; laissez faire ignores the real threat to economic stability that comes from leveraged financial institutions, and there appears no good, credible way to commit to keep the government out of financial markets. *See* McDonnell, *supra* note 12. Moderate libertarians and conservatives should find much to like in Dodd-Frank. *See id.* The emphasis in my long-term strategy on market and social institutions outside of the State should also have some appeal for libertarians and conservatives.

[57] *See supra* note 16 and accompanying text; *see also* JOHNSON & KWAK, *supra* note 1, at 208-13; ROUBINI & MIHM, *supra* note 6, at 226-30; and STIGLITZ, *supra* note 1, at 164-68.

[58] *See supra* notes 24-27 and accompanying text.

[59] Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. §§ 5325, 5331, 1852 (Supp. IV 2011).

[60] 12 U.S.C. §§ 5325(a), 5365(a).

[61] 12 U.S.C. § 5331(a).

would have liabilities exceeding ten percent of the aggregate liabilities of all financial companies.[62] Insured depository institutions may be prevented from inter-state merger if the resulting entity would control more than ten percent of the total amount of deposits for such institutions.[63] The Act also requires large, risky institutions to create "living wills" that will direct how to unwind them in the event of failure.[64]

The new resolution authority of Dodd-Frank[65] should also help address the TBTF problem. In the last crisis, regulators confronted with sick but not yet bankrupt companies faced a hard choice. They wanted to stop failures that could prevent a run, but the managers of those companies would naturally fight any interventions that punished them, even though they were often responsible for the mess. Regulators had no stick other than to let the firms fall into bankruptcy, and everyone knows they didn't want that, ruining the credibility of that threat. With the new authority, regulators can step in to a firm that is systemically risky and take it over, throwing out the bums who got the firm into trouble if that is the right thing to do. Throwing the bums out is not only satisfying, it helps reduce the moral hazard problem—if the bums know they may well get thrown out, they have good incentive to avoid risks that may get their company into the resolution process. Title II directs the FDIC to punish the officers, shareholders, and perhaps secured creditors of firms resolved under the new authority.[66] The Act specifies that creditors and shareholders will bear the losses of the company.[67] Management responsible for its condition will not be retained.[68] The Act provides for possible actions for damages, restitution, and recoupment of compensation against those responsible for the losses.[69] The treatment of secured creditors is a more difficult question—if they stand to lose a "haircut" when a company fails, they are more likely to act as important monitors, but they are also more likely to start a run. The Act punts on this point, mandating a study on secured creditor haircuts.[70]

The main gap in Dodd-Frank is that it does not attend to smaller shadow

---

[62] 12 U.S.C. § 1852(b).

[63] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 623(a), 124 Stat. 1634 (2010).

[64] 12 U.S.C. § 5365(d).

[65] 12 U.S.C. §§ 5381-5394.

[66] 12 U.S.C. §§ 5384, 5386.

[67] 12 U.S.C. §§ 5384(a)(1), 5386(2).

[68] 12 U.S.C. §§ 5384(a)(2), 5386(4)–(5).

[69] 12 U.S.C. § 5384(a)(3).

[70] 12 U.S.C. 5394.

banking institutions.[71] Banks of course have faced a strict regulatory regime since the New Deal. Dodd-Frank's Title I extends similar regulation to non-bank financial institutions which pose a systemic risk to the economy. Title II extends resolution authority based on the old authority of the FDIC over banks to such risky non-bank institutions. But, the language in Title I and Title II seems to only contemplate too big (or too interdependent) firms, not smaller companies within the shadow banking world.[72] Yet, as I argue in part II, the mistakes and failure of many smaller firms following similar strategies within a market may be just as big a danger as the failure of a TBTF firm. Dodd-Frank does not seem to recognize that—mesmerized, it would seem, by the TBTF analysis of the crisis. Indeed, as it stands, Dodd-Frank could actually make matters worse by pushing more money into the unregulated smaller shadow banks. Basic safety and soundness regulation and resolution authority need to be extended more broadly, even though the smaller firms should be less strictly regulated than the TBTF firms.[73]

There are, though, some ideas for addressing TBTF firms, short of abolishing them, which are worth considering and not included in Dodd-Frank. The Act does not adopt the interesting and potentially valuable idea of taxing financial institutions for the degree of systemic risk to which they are exposing the economy. A well-priced tax would force firms to internalize that risk.[74] The question, of course, is can and would regulators set the tax at a plausible estimate of the level of risk a firm is creating. Regulators already face a variant of this problem in measuring the riskiness of bank assets in setting capital requirements.[75] They have not been spectacularly successful in solving that problem so far. The tax idea is definitely worth exploring, but even without it, differential levels of capital requirements and leverage limits based on riskiness would accomplish much the same purpose. Dodd-Frank seems to require this, but we shall see how good a job the regulators do. The obstacles are both political (TBTF institutions will fight stricter requirements, of course) and economic or conceptual (measuring the riskiness of a financial firm is truly hard).[76]

---

[71] *See supra* notes 32–37 and accompanying text.

[72] 12 U.S.C. §§ 5323, 5383.

[73] *See generally* McDonnell, *supra* note 12 where I discuss this problem more.

[74] Viral V. Acharya et al., *Taxing Systemic Risk*, *in* REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 121, 125 (2011).

[75] Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127 (2009); Peter Miu, et al., *Can Basel III Work? Examining the New Capital Stability Rules by the Basel Committee: A Theoretical and Empirical Study of Capital Buffers* (Feb. 2010), *available at* http://ssrn.com/sol3/papers.cfm?abstract_id=1556446.

[76] *See Measuring and Managing the Value of Financial Institutions: Integrating*

Another idea is trying to make clear that only certain critical parts of TBTF companies will be bailed out. The UK is considering structural separation within TBTF institutions, so that certain risky activities are conducted by a legally separate entity, and only that part of the company not engaged in those activities would be saved during a crisis.[77]

So Dodd-Frank is missing some worthwhile elements, but does have many good parts, and it basically addresses the TBTF moral hazard problem pretty well. But that will do little good if later on, as memories of the crisis fade, the industry succeeds in having the laws subverted by weak rules or non-enforcement. As noted above,[78] we, as a society, would like to design the regulatory process to help make financial regulation less pro-cyclical and less prone to complete industry capture. Most of the time, when the economy is not in crisis, ordinary people pay little attention to financial regulation and the only parties who do pay attention, namely those within the financial industry, have undue influence in rule setting and enforcement. The public only pays attention when a crisis hits, and that is when it becomes more possible to pass strong regulation. However, given the relative ignorance and short attention span of the public, the resulting legislation is likely to be either pro-consumer on the surface but vague so that later, when things have quieted down, regulators can pass pro-industry rules,[79] or else the laws passed in a crisis may have real bite but be crude and often counter-productive, reflecting the ignorance and haste of legislators and the public.[80]

What we would like to have happen is for the legislature to pass pro-consumer but relatively vague laws which regulators can flesh out later, but then have the regulators really give some teeth to the rules. Better still, we would like to prod the regulators in good times to be monitoring, and responding to, emerging financial risks. To achieve that, society tries to insulate agencies from too much influence by the political process (where industry capture is a danger), and to provide systematic ways in which consumer interests and independent voices can be heard within the

---

External and Internal Valuations, WHARTON FINANCIAL RISK ROUNDTABLE 2003 (May 2003), http://fic.wharton.upenn.edu/fic/0503mow.pdf. Indeed, it may be that the problem with regulation is conceptually inevitable. If regulators attempt to base capital requirements in part on the riskiness of a company's assets, they are likely to underestimate the riskiness of some assets, and the uniformity created by regulations will push all regulated companies to over-invest in those assets, increasing their risk. *See also* Philip Z. Maymin & Zakhar G. Maymin, *Any Regulation of Risk Increases Risk* (Sept. 7, 2011), (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1587043.

[77] Wilmarth, *supra* note 1, at 1050-51.

[78] *See supra* notes 53–554 and accompanying text.

[79] *See supra* note 543 and accompanying text.

[80] *See* Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 78, 81-83 (2003).

rulemaking process. Notice-and-comment rulemaking, conflict of interest rules, independent agencies, consumer representatives, and Inspectors General are some of the longstanding mechanisms we use to help out.

Dodd-Frank contains a variety of new mechanisms which try to prod regulators to consider consumer interests and explore emerging financial risks even during good times.[81] Some examples include:

- Numerous studies and reports to Congress, which at least force agencies to consider the relevant issues;[82]
- A new Office of Financial Research;[83]
- The new Financial Stability Oversight Council, which will bring together the leading financial regulators and force them to periodically at least discuss potential emerging risks to the financial system;[84]
- The new Consumer Financial Protection Bureau; [85]
- A new Investor Advisory Committee[86] and Office of the Investor Advocate within the SEC;[87] and
- A suggestion program for SEC employees.[88]

These are just some of the highlights; there are a variety of other experiments within the Act.[89] I hope that individually and collectively all this will do some good at resisting industry pressure, including pressure from TBTF institutions.

B. Alternative Financial, Economic, and Political Institutions Need to be Developed

But shoring up the regulatory bureaucracy is not enough, not by a long shot. As long as the basic political balance of forces remains as lopsided as it is now, that balance will ultimately be reflected in the rules no matter

---

[81] See McDonnell & Schwarcz, *supra* note 55, at 1670-76 where Dan Schwarcz and I explore some of these mechanisms at more length.

[82] *See* Broc Romanek, *What the Dodd-Frank Act Means for Regulators? 243 Rulemakings and 67 Studies*, THE CORPORATE COUNSEL.NET, (July 13, 2010, 7:38 AM), http://www.thecorporatecounsel.net/Blog/2010/07/see-page-344-hooray-kirkland.html.

[83] Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. §§ 5341–5346 (Supp. IV 2011).

[84] 12 U.S.C. §§ 5321, 5322.

[85] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1001–1100H, 124 Stat. 1955-2113 (2010) (partially codified as amended in scattered sections of 5 U.S.C., 12 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C.).

[86] 15 U.S.C. § 78pp.

[87] Pub. L. No. 111-203 § 915, 124 Stat. 1830.

[88] 15 U.S.C. § 78d-4.

[89] McDonnell & Schwarcz, *supra* note 55, at 1670-76.

how well we design our rulemaking institutions. Ultimately, we need to change the underlying balance of power, and that requires recruiting or creating economic and political institutions outside of the government which can counter the political power of TBTF financial institutions. Where can one find or create such institutions? The second prong in responding to the TBTF problem is a longer term strategy, focused on developing alternative financial institutions that are smaller and more focused on community interests. Progressives for decades have focused too much on regulation and too little on building alternative institutions. Yet ultimately the political clout of TBTF financial institutions can only be countered by alternative institutions with power of their own.

This second prong focuses mainly on the political problem that TBTF institutions pose. However, it also helps address the economic moral hazard problem. The sorts of financial institutions this prong suggests creating are likely to be not too large, and hence less subject to the TBTF moral hazard. Moreover, insofar as they behave and invest rather differently than other kinds of financial institutions, they will create a more diversified financial industry. That should help reduce the spread of contagious panics, and reduce the amount of mimicry that occurs—such mimicry can lead to all companies taking on similar risks, creating problems when that strategy goes bad for everyone.

Traditionally, the main source of power that countervailed the interest of big businesses was unions.[90] These do still matter somewhat as demonstrated by the battle in Wisconsin over the attempts of Governor Scott Walker to neuter public employee unions.[91] But American unions have declined precipitously in unionization rates and political power, and any hopes for a significant revival appear dim.[92] Many factors feed this trend. In part it is a self-reinforcing loop—the political decline of unions allows employers to shape labor laws and enforcement so that they can

---

[90] JOHN KENNETH GALBRAITH, AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER, 144–146 (1952).

[91] *See* Monica Davey & Steven Greenhouse, *Big Budget Cuts Add up to Rage in Wisconsin*, N.Y. TIMES, Feb. 17, 2011, at A1, *available at* http://www.nytimes.com/2011/03/12/us/12wisconsin.html?_r=1; A. G. Sulzberger, *Union Bill is Law, but Debate is Far From Over*, N.Y. TIMES, March 12, 2011, at A14, *available at* http://www.nytimes.com/2011/03/12/us/12wisconsin.html?_r=1, *and* Monica Davey & Steven Greenhouse, *Angry Demonstrations in Wisconsin as Cuts Loom*, N.Y. TIMES, Feb. 16, 2011, *available at* http://www.nytimes.com/2011/02/17/us/17wisconsin.html to witness the battle in Wisconsin over the attempts of Governor Scott Walker to neuter public employee unions.

[92] Brett H. McDonnell, *Strategies for an Employee Role in Corporate Governance*, 46 WAKE FOREST L. REV. 429 (2011).

more easily fight unionization, which reinforces the decline of unions.[93] In part it reflects a change in the nature of employment from manufacturing to service industries which are harder to organize.[94] In part it reflects a change in business organization and labor markets, as workers stay at jobs for shorter and shorter periods.[95] The trend of union decline is longstanding and extreme enough, and the variety of causes is large and deep enough, that it seems implausible to look to unions as a source for much stronger future resistance to TBTF institutions.

A very different existing source for potential support for rules containing TBTF companies is current medium size and community banks. These have an obvious interest in curbing both large TBTF banks and in imposing regulations on a variety of institutions in the shadow banking world. They also have a lot of political legitimacy, and they are spread widely throughout the country.[96] They have much influence over many regional Federal Reserve banks. Thus, they are a rather potent political force whose interests in many ways align with an agenda of limiting the power and scope of TBTF institutions. Progressives looking for as strong a regulatory response as possible in implementing Dodd-Frank may indeed want to explore such an alliance on a variety of measures. However, small town bankers typically have a cultural outlook that may not make them supporters of strengthened regulation, even regulation that applies to competitors. And many of Dodd-Frank's regulations do apply to all banks, including community banks—they do not like that, unsurprisingly.[97]

Progressives thus need to consider helping to create new institutions that can support their preferred rules in the long run. These institutions need to be more attentive to the needs of consumers, employees, and communities than the institutions which currently dominate financial markets. After all, if public choice problems imply that those groups are unlikely to organize

---

[93] John Logan, *The Union Avoidance Industry in the United States*, 44 BRIT. J. INDUS. REL. 651, 651 (2006); McDonnell, *supra* note 92.

[94] Robert Rowthorn & Ramana Ramaswamy, *Deindustrialization—Its Causes and Implications*, INT'L MONETARY FUND, ECON. ISSUES 10, at 1 (1997).

[95] *See* DANIEL H. PINK, FREE AGENT NATION: HOW AMERICA'S NEW INDEPENDENT WORKERS ARE TRANSFORMING THE WAY WE LIVE 47-54 (2001) (discussing the factors involved in the evolution of workers becoming free agents).

[96] JOHNSON & KWAK, *supra* note 1, at 66-67; *see supra* note 48 and accompanying text.

[97] *See, e.g.*, Robert M. Vinton, *The Dodd-Frank Act: Impact on Community Banks*, FAIRFIELD AND WOODS (Sept. 2, 2011), http://www.fwlaw.com/Dodd_Frank_Act_Impact_On_Community_Banks.pdf (emphasizing a variety of ways in which the Act increases regulation for all banks). *See also Community Banks Continue to Criticize Dodd-Frank*, SHESHUNOFF A.S. PRATT (July 29, 2011, 8:16 AM), http://www.sheshunoff.com/news/26/Community-Banks-Continue-to-Criticize-Dodd%252dFrank.html for community bank criticism of the Act.

over financial regulation on their own, so that financial companies will dominate the regulatory process, it will help greatly if those financial companies themselves are internally responsive to a broader set of social needs.[98] Also, as noted above, diversity among financial institutions may reduce the risk of failure spreading among companies that have all taken on similar strategies and risks. Past institutional innovations, such as credit unions,[99] mutual insurance companies,[100] community development banks,[101] and the Caja Laboral Popular bank at the center of the Mondragon group of cooperatives in Spain,[102] suggest the kind of direction one could look. Indeed, some of these past innovations are part of the answer for the future as well. Updated versions more in tune with the realities of the modern economy and markets may be needed. Updates are needed because some of these older institutions have taken a beating recently. Many mutual insurance companies have demutualized.[103] The most famous U.S. community development bank, ShoreBank in Chicago, closed in 2010.[104] The most famous international community bank, Grameen in Bangladesh, has faced strong political controversy amid a variety of scandals.[105] Those interested in creating or expanding alternative financial institutions more in tune with social interests will need to study these past problems as well as successes.

In addition to financial institutions, one could also look to innovations in business forms as another way to increase support for strong regulations, and also to lead to companies and markets which undertake less risky financial practices on their own and feature more diversity in investment

---

[98] McDonnell, *supra* note 92.

[99] J. CARROLL MOODY & GILBERT C. FITE, THE CREDIT UNION MOVEMENT: ORIGINS AND DEVELOPMENT 1850-1980 (2d ed. 1984).

[100] HAROLD W. WALTERS, A CENTURY OF COMMITMENT: A HISTORY OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES (1994).

[101] CMTY. DEV. FIN. INST. FUND, DEP'T OF TREASURY, CDFI CERTIFICATION FREQUENTLY ASKED QUESTIONS (2008) *available at* http://www.cdfifund.gov/docs/certification/cdfi/CDFIcertificationFAQs.pdf.

[102] WILLIAM FOOTE WHYTE & KATHLEEN KING WHYTE, MAKING MONDRAGON: THE GROWTH AND DYNAMICS OF THE WORKER COOPERATIVE COMPLEX (1988).

[103] *See* Glenn S. Daily, *Reorganization Status of Mutual Life Insurance Companies*, GLENNDAILY.COM (July 11, 2007), http://www.glenndaily.com/mhctable.htm (providing examples of mutual insurance companies that have demutualized).

[104] *Failed Bank Information: Information for ShoreBank, Chicago, IL*, FEDERAL DEPOSIT INSURANCE CORPORATION, http://www.fdic.gov/bank/individual/failed/shorebank.html (last updated June 15, 2011).

[105] Allison Dower, *Muhammad Yunus and the Grameen Bank Scandal*, PENN STATE GLOBAL FORUM (Apr. 29, 2011, 10:28 AM), http://psuglobalforum.blogspot.com/2011/04/muhammad-yunus-and-grameen-bank-scandal.html.

strategies. Again there are older forms such as cooperatives[106] and nonprofits[107] as well as newer models of social business enterprises[108] that could prove promising. New institutions in the financial markets and real economy companies should complement each other both politically and economically. Non-traditional companies should find it easier to get financing from non-traditional financial companies that share similar values and business models.[109]

V. CONCLUSION

So, have I set forth a framework that is likely to lead to a solution to the economic and political problems of TBTF financial institutions? Not really, alas. The Dodd-Frank Act does present a potentially useful framework. However, that framework has some gaps—most notably, the lack of a tax on systemically risky companies.[110] Worse, industry pressure to weaken rules and enforcement as memories of the crisis fade is already strong and appears likely to undermine most attempts to impose notably stronger rules on TBTF institutions or to punish them when they get in trouble. I like the various attempts in Dodd-Frank to push regulators in the right direction,[111] and hope they will do some good, but fear that the pressures for complacency and capture are just too strong—the regulatory design experiments may help withstand that pressure to a limited extent, but probably only a quite limited extent.

The call for new economic institutions to provide countervailing economic and political power is at best a very long-term project. It would take quite some time to build an ecosystem of such institutions to the point where they have political power anywhere close to that of today's big banks. There are all sorts of obstacles, economic and political, to ever succeeding in building up such new institutions. The status quo has many ways of reproducing itself.

Perhaps serious change will be possible only with a crisis more severe than the recent one. That seems right at least for large-scale political

---

[106] GREGORY K. DOW, GOVERNING THE FIRM: WORKERS' CONTROL IN THEORY AND PRACTICE (2003).

[107] Peter F. Drucker, *What Business Can Learn from Nonprofits*, HARV. BUS. REV. 88–93 (July-Aug. 1989).

[108] Dana Brakman Reiser, *Benefit Corporation? Evaluating Another Hybrid Model for Social Enterprises*, WAKE FOREST L. REV. (forthcoming 2011); Linda O. Smiddy, Symposium, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3 (2010).

[109] *See* Brett McDonnell, Labor-Managed Firms and Banks (1995) (unpublished Ph.D. dissertation, Stanford University) (on file with author).

[110] *See* Acharya et al., *supra* note 74, at 121-40 and accompanying text.

[111] *See supra* text accompanying notes 81–898.

changes—the last set of truly major political changes in the U.S. came with the Great Depression and the New Deal. Major evolutions in economic institutions, though, may not require such a crisis. Or the most plausible path may lie somewhere in between, with a gradual growth of some alternative economic institutions, followed by a large financial crisis that then makes possible further large political and economic changes, supported by the new institutions that have slowly grown to pose an alternative to today's financial behemoths. The last time when crisis hit in 2007-08, progressives were not ready with a menu of either legal or economic institutional change. It is unsurprising that their efforts to address the crisis on the fly, especially after Barack Obama took office, were limited and scattershot, with correspondingly limited success. Before the next crisis, (and there will be one), there is much to do to put in place an economic, political, and intellectual groundwork for creating a revised financial system to replace that of today dominated by Goldman Sachs and a few like companies.

COMMENTS

AN AMERICAN CRISIS: PROPRIETARY SCHOOLS AND NATIONAL STUDENT DEBT

CHARLES POLLACK†

ABSTRACT

Proprietary schools encounter increased scrutiny as they become more influential within the United States. Many students claim that these for-profit businesses fraudulently request student loans from the government. These allegations have created a debate over review standards in the circuit courts. A recent Supreme Court decision has further complicated this issue by allowing mandatory arbitration clauses in enrollment agreements.

This comment argues that the Ninth Circuit's review standard should be adopted by all courts. This would best allow students to raise claims while still protecting courts from frivolous lawsuits. In addition, if proprietary schools choose to include an arbitration clause in their enrollment agreements, they should explicitly share this information with all prospective students. These proposals are important to ensure that all students understand the consequences of enrolling in a proprietary school and to prevent an even greater American debt crisis.

---

† Staff Member, *American University Business Law Review*, Volume 1 Issue 1; J.D. Candidate, *American University, Washington College of Law*, 2014; M.A. History, *Boston University*, 2010; B.A. History and Political Science, *Boston University*, 2008. I want to thank Dean Billie Jo Kaufman for her great advice and guidance throughout my research. I also want to thank the entire *Business Law Review* staff for their time and editing suggestions, especially Jason Thelen, Ashley Teesdale, and Cameron C. Chong. Most of all I want to thank Jane Wetterau, my Note & Comment Editor, whose unwavering support and encouragement made this comment possible. To my parents, Steve and Linda, and my brother Joe—this is for you.

TABLE OF CONTENTS

I. PROPRIETARY SCHOOLS AND NATIONAL STUDENT DEBT

Nation-wide tuition increases, together with a weakened economy and competitive admissions, leave many American students unable to obtain a traditional university education.[1] This reality forces many students to consider alternative higher education options so they can find better job

---

[1] *See* U.S. BUREAU OF LABOR STATISTICS, BLS SPOTLIGHT ON STATISTICS, BACK TO COLLEGE 8 (2010), *available at* http://www.bls.gov/spotlight/2010/college/pdf/college.pdf (showing that the price of college tuition has consistently outpaced the rate of United States inflation for the last three decades); *cf.* Anthony Carnevale & Jeff Strohl, *How Increasing College Access Is Increasing Inequality, and What to Do About It*, in REWARDING STRIVERS: HELPING LOW-INCOME STUDENTS SUCCEED IN COLLEGE 74-75 (Richard D. Kahlenberg ed., 2010) (explaining that while American children have the most average schooling of any world population—at twelve and a half years—postsecondary performance and graduation rates are falling behind other industrialized countries).

opportunities.[2] The most popular alternative is a proprietary school, but there is growing concern that their recruitment schemes violate federal law.[3] Several former proprietary school students claim recruiters fraudulently induced them to request student loans for better job opportunities that never materialized.[4]

The federal circuit courts have heard several fraud complaints against proprietary schools, however, they have not applied a uniform review standard to determine whether a student had a valid tort or contract action.[5] A debate exists over how students enrolled at schools that are certified with the Department of Education ("ED") should structure their claims.[6] The

---

[2] *See* Amanda Harmon Cooley & Aaron Cooley, *From Diploma Mills to For-Profit Colleges and Universities: Business Opportunities, Regulatory Challenges, and Consumer Responsibility in Higher Education*, 18 S. CAL. INTERDISC. L.J. 505, 505-06 (2009) (detailing that a changing labor market has prompted people to seek non-traditional educational opportunities); *cf.* PEW RESEARCH CTR., SOC. & DEMOGRAPHIC TRENDS, IS COLLEGE WORTH IT?: COLLEGE PRESIDENTS, PUBLIC ASSESS VALUE, QUALITY AND MISSION OF HIGHER EDUCATION 1 (2011) (reporting results from a public poll that found fifty-seven percent of Americans believe that the traditional higher education system in the United States does not provide good value to students and seventy-five percent believe attendance is too expensive, but ninety-four percent still expect their child to attend college).

[3] *See* LAURA G. KNAPP ET AL., U.S. DEP'T OF EDUC., INST. OF EDUC. SCIS., NAT'L CTR. FOR EDUC. STATISTICS, NCES 2011-230, ENROLLMENT IN POSTSECONDARY INSTITUTIONS, FALL 2009; GRADUATION RATES, 2003 & 2006 COHORTS; AND FINANCIAL STATISTICS, FISCAL YEAR 2009, at 7 (2011) (detailing that in Fall 2009 approximately ten percent of all higher education students attended a for-profit institution); *see also* Higher Education Act, 20 U.S.C. § 1002(b)(1) (2006 & Supp. III 2010) (providing federal requirements for proprietary schools such as recognition by a regional accrediting agency since October 2007 and stipulating that the national accrediting agency must have certified an institution within the last two years). *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-4, FOR PROFIT SCHOOLS: LARGE SCHOOLS AND SCHOOLS THAT SPECIALIZE IN HEALTHCARE ARE MORE LIKELY TO RELY HEAVILY ON FEDERAL STUDENT AID 7 (2010) (characterizing proprietary schools' reliance upon federal student loan funding and its relation to fraudulent recruitment practices).

[4] *See* United States *ex rel.* Hendow v. Univ. of Phoenix, 461 F.3d 1166, 1169 (9th Cir. 2006) (filing by former for-profit counselors that the institution used fraudulent promises to comply with the False Claims Act ("FCA") and continued to use commissioned admissions recruiters in its business practices); Olsen v. Univ. of Phoenix, 244 P.3d 388, 389 (Utah Ct. App. 2010) (filing by student that university fraudulently included e-resource fee on tuition bill to which student was unaware).

[5] *Compare Hendow*, 461 F.3d at 1177-78 (finding that a student claim was sufficient irrespective whether it related to any initial certification with the government to comply with regulations), *with* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791, 797-98 (8th Cir. 2011) (concluding that a complaint cannot solely rely upon a plaintiff's experience and must specifically reference a violated federal provision for fund disbursement).

[6] *See generally*, 20 U.S.C. § 1094(a) (2006 & Supp. III 2010) (detailing several factors a school must comply with in order to obtain student loan funds, including a requirement that schools notify the Secretary of Education ("Secretary") whether the institution is no longer meeting a stipulated provision).

Ninth Circuit will hear most fraud claims by reasoning that every new federal aid request includes an implicit recertification to comply with federal guidelines, irrespective of whether the student cited specific provisions within the complaint.[7] Conversely, the Eighth Circuit only supports a claim if it relates to the school's initial certification to comply with all federal regulations.[8] This circuit disagreement ultimately creates an inequity for students by requiring a higher burden of proof in some jurisdictions.[9]

Divergent review standards for proprietary school fraud litigation are further complicated by an industry preference for arbitration.[10] The Supreme Court recently reinforced this practice in *AT&T Mobility LLC v. Concepcion* by prohibiting class action lawsuits in situations where the plaintiffs sign mandatory arbitration clauses.[11] While the Supreme Court did not expressly target proprietary schools in its *Concepcion* decision, the ruling nonetheless has broad implications for students signing enrollment agreements at for-profit institutions.[12]

This comment argues that the Ninth Circuit's review standard for proprietary school fraud should be applied across the entire federal system, and that the ED should require proprietary schools to explicitly share all relevant arbitration terms with prospective students. Part II describes American proprietary school development and the federal statutes implicated by questionable recruitment practices. Part III details the different circuit approaches to review proprietary school fraud litigation and the debate over implied certification. Part IV discusses the recent

---

[7] *See Hendow*, 461 F.3d at 1169 (allowing a student to file a fraud complaint under the Higher Education Act ("HEA") and FCA if he or she can show that a recruiter used fraudulent tactics to encourage a student loan request under the theory that once an institution has certified its compliance with the ED, it remains in compliance during all subsequent business).

[8] *See Vigil*, 639 F.3d at 797-98 (requiring complaints filed using the FCA to specifically state the HEA provision that an institution violated before receiving federal funds).

[9] *Compare Hendow*, 461 F.3d at 1177 (allowing a complaint to proceed without relying upon the HEA), *with Vigil*, 639 F.3d at 799-800 (dismissing a complaint for failure to state a claim because the HEA was not referenced).

[10] *See* Fensterstock v. Educ. Fin. Partners, 611 F.3d 124, 129 (2nd Cir. 2010), *vacated sub nom.* Affiliated Computer Servs., Inc. v. Fensterstock, 131 S. Ct. 2989 (2011) (arguing that an arbitration clause should not be enforced if hidden within the terms to an enrollment agreement); Bernal v. Burnett, No. 10-cv-01917-WJM-KMT, 2011 WL 2182903, at *1, *2-3 (D. Col. June 6, 2011) (claiming that a separate signed arbitration agreement did not make litigation forfeiture clear).

[11] *See* AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1752-53 (2011) (finding that mandatory arbitration clauses in an adhesion contract are not inherently unconscionable).

[12] *See id.* (focusing on cellular phone enrollment agreements with a mandatory arbitration clause).

Concepcion decision and its future impact on student litigation. Part V explains why the Ninth Circuit has established the preferable review standard and the benefit to requiring proprietary schools to unambiguously communicate arbitration clauses with potential students. Finally, Part VI asserts that a new review process is needed to protect students and ensure the United States' long-term economic success.

II. PROPRIETARY SCHOOL DEVELOPMENT, FEDERAL LAW, AND ENSUING CONTROVERSY

Proprietary schools' recent rise in popularity may seem like a modern American phenomenon, but they actually originated during the early eighteenth-century.[13] These institutions have expanded over several centuries into today's large for-profit corporations. While proprietary schools developed with noble intentions, students in the twenty-first century are claiming that these schools violate federal law by encouraging fraudulent loan requests. The student lawsuits have prompted increased government scrutiny.

A. Four Centuries of Proprietary Schools in American Higher Education

In the colonial period, proprietary education existed to provide students with an alternative to classical studies that some considered unnecessary luxuries for the wealthiest class.[14] An alternative colonial education focused on basic literacy, handwriting, arithmetic, and career training.[15] By the early nineteenth century, proprietary education expanded as many business leaders felt that traditional colleges did not sufficiently train students in the practical skills needed for most professions.[16] Proprietary schools subsequently garnered early support from students seeking the education that businesses most preferred.[17] These schools also expanded to

---

[13] *See* KEVIN KINSER, FROM MAIN STREET TO WALL STREET: THE TRANSFORMATION OF FOR-PROFIT HIGHER EDUCATION (ASHE HIGHER EDUCATION REPORT) 13-15 (2006) (detailing how proprietary schools originated from apprenticeships that emphasized the practical skills that a person needed to be successful within the workforce).

[14] *See id.* at 14-15 (expressing the importance of training people in the skills that they would need to earn a living).

[15] *See id.* (emphasizing that these base skills are needed for most all professions, particularly those in trade or commerce); *see also* Aaron Taylor, *"Your Results May Vary": Protecting Students and Taxpayers Through Tighter Regulation of Proprietary School Representations*, 62 ADMIN. L. REV. 729, 752 (2010) (noting that these schools relied upon a very basic curriculum, coupled with specialized training in a particular field).

[16] *See* KINSER, *supra* note 13, at 15 (detailing how early proprietary institutions built basic writing and arithmetic instruction around business classes).

[17] *See* RICHARD S. RUCH, HIGHER ED, INC.: THE RISE OF THE FOR-PROFIT UNIVERSITY 52 (2001) (explaining that proprietary education became popular among students who

build a strong reputation with minority groups that did not have the same educational opportunities as the white majority.[18] The early American goals to provide practical and equitable higher education has not wavered for over three centuries and has ultimately established an industry foundation that still exists today.[19]

Higher education is no longer reserved for the most affluent classes in a globalized twenty-first century.[20] College attendance in the United States has consequently risen over the past several decades as the economy increasingly demands workers with specialized skills.[21] These workers are needed to keep the United States atop world markets while other nations produce goods at a rate that threatens to end American dominance.[22] One factor that has helped several industrialized countries close the economic gap is a higher college completion rate.[23]

---

did not have the money to spare on traditional colleges because it was believed that specialized training would be rewarded with employment).

[18] *See* Bobby Wright, *For the Children of the Infidels?: American Indian Education in the Colonial Colleges*, 12 AM. INDIAN CULTURE & RESEARCH J. 1988, at 10 (exemplifying Native American access to proprietary institutions since their American founding).

[19] *See Mission Statement*, UNIVERSITY OF PHOENIX, http://www.phoenix.edu/about_us/about_university_of_phoenix/mission_and_purpose.html (last visited Oct. 25, 2011) ("University of Phoenix provides access to higher education opportunities that enable students to develop knowledge and skills necessary to achieve their professional goals, improve the productivity of their organizations and provide leadership and service to their communities.").

[20] *See* NAT'L CTR. FOR EDUC. STATISTICS, U.S. DEP'T OF EDUC., NCES 2009-020, DIGEST OF EDUCATION STATISTICS 2008 278 (2009) (table showing that student enrollment at American universities has exponentially increased over the last several decades from a little over two million students in 1950 to over eighteen million in 2007).

[21] *See, e.g.*, ANTHONY CARNEVALE ET AL., HELP WANTED: PROJECTIONS OF JOBS AND EDUCATION REQUIREMENTS THROUGH 2018 109 (2010) (explaining that employers will continue to seek workers in the future with some form of higher education or specialized training).

[22] *See* ECON. RESEARCH SERV., U.S. DEP'T OF AGRIC., REAL HISTORICAL GROSS DOMESTIC PRODUCT (GDP) SHARES AND GROWTH RATES OF GDP FOR BASELINE COUNTRIES/REGIONS (IN BILLIONS OF 2005 DOLLARS) 1969-2010 (2010), *available at* http://www.ers.usda.gov/Data/Macroeconomics/ (displaying the total United States GDP in comparison with the European Union and Asia, with an emphasis on China); *see also United States Share of World GDP Remarkably Constant*, NAT'L CTR. FOR POL'Y ANALYSIS (Dec. 2, 2009), http://www.ncpa.org/sub/dpd/index.php?Article_ID=18745 (explaining that while the United States GDP has remained constant over the last several decades, Asia (China) has experienced significant economic growth over the same time period).

[23] *See* Patrick Callan, *Introduction: International Comparisons Highlight Educational Gaps Between Young and Older Americans*, *in* MEASURING UP 2006: THE NATIONAL REPORT CARD ON HIGHER EDUCATION 7 (Nat'l Ctr. for Pub. Pol'y and Higher Educ., ed. 2006) (analyzing a downward trend in American college education that shows the United States ranks second worldwide in population percentage aged 35-64 with a college degree, but only seventh aged 25-34).

The American government has responded to the need for specialized workers by encouraging all students to obtain some form of higher education.[24] President Obama rhetorically asked Americans at the 2011 State of the Union Address if they were "willing to do what's necessary to give every child a chance to succeed."[25] He sought to prioritize education in his administration after a recent Georgetown University study showed that by 2018 over sixty percent of American jobs will require at least a bachelor's degree.[26] This projection has rejuvenated national interest in higher education and college attendance.[27] The federal government is committed to expanding educational access, however, dramatic tuition increases at traditional universities present a major obstacle to higher enrollments.[28]

Modern proprietary schools have adapted to national higher education interests by expanding in size and scope.[29] They are no longer local businesses with a single owner but are instead highly profitable national organizations that garner government regulation.[30] Proprietary schools that offer online classrooms and more flexible class schedules are increasingly able to accommodate more students while traditional universities restrict enrollments with higher tuition.[31] Proprietary education typically focuses on certificate and associate-level curriculums, but some offer bachelor's,

---

[24] *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §§ 801-805, 123 Stat. 115, 181-190 (codified in scattered sections in 29 U.S.C., 33 U.S.C., and 42 U.S.C.) (2009) (allocating federal funds to education, among other areas, to help facilitate better training for the American workforce).

[25] Barack Obama, President, Address Before a Joint Session of Congress on the State of the Union (Jan. 25, 2011) (referencing the Obama administration's Race to the Top education program that rewards states for implementing ambitious plans to improve teacher quality and student achievement).

[26] *See, e.g.*, CARNEVALE, *supra* note 21, at 109; *cf.* Carnevale, *supra* note 1, at 73 (graphing trends in social mobility with those Americans earning only a high school diploma in 2007 on a downward escalator that leads toward the lowest income class).

[27] *See, e.g.*, American Recovery and Reinvestment Act, 123 Stat. at 181 (targeting funds toward disadvantaged students as a means to diversify and improve American higher education).

[28] *See generally* David Leonhardt, *As Wealthy Fill Top Colleges, Concerns Grow Over Fairness*, N.Y. TIMES, Apr. 22, 2004, at A1 (citing trends at elite schools that suggest wealthy students are more likely to enroll in elite colleges).

[29] *See* CARNEVALE, *supra* note 21, at 109 (projecting that the future American workforce will require a more highly educated worker).

[30] *See* Higher Education Act, 20 U.S.C. § 1002(b)(1) (2006 & Supp. III 2010) (presenting the criteria for modern proprietary schools seeking federal student aid).

[31] *See* Sherry Linkon, *Education or Exploitation? For-Profit Schools and Working-Class Students*, CTR. FOR WORKING CLASS STUDIES (Sept. 20, 2010), http://workingclassstudies.wordpress.com/2010/09/20/education-or-exploitation-for-profit-schools-and-working-class-students/ (referencing how the changing market has given a tactical advantage to proprietary schools seeking to make a profit, while also encouraging many traditional universities to consider online programs).

master's, and doctoral-level coursework.[32] Both proprietary and traditional universities can therefore provide similar degree-granting programs.

B. Title IV and the Higher Education Act ("HEA")

Proprietary schools rely more heavily on federal student aid than traditional universities and colleges.[33] The ED manages the federal financial aid program under Title IV of the HEA to determine student and institutional eligibility.[34] Overall, approximately nineteen percent of all federal student aid currently goes to students attending proprietary schools and this percentage is projected to rise.[35]

Universities and colleges can receive Title IV funds if they offer specific student programs under the HEA.[36] They must also certify compliance with several ED disbursement requirements before requesting funds.[37] Certification is completed through a formal agreement with the Secretary of Education ("Secretary") stating that a school will comply with all rules while participating in the program.[38] This acknowledgment creates a two-step process for all higher education institutions to obtain federal student

---

[32] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-600, PROPRIETARY SCHOOLS: STRONGER DEPARTMENT OF EDUCATION OVERSIGHT NEEDED TO HELP ENSURE ONLY ELIGIBLE STUDENTS RECEIVE FEDERAL STUDENT AID 4-6 (2009) (distinguishing the various proprietary school programs by the time it takes for completion).

[33] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-4, *supra* note 3, at 7 (highlighting that during the 2008/2009 school year, for-profit schools received over $24 billion in grants and loans from the federal government).

[34] *See* Higher Education Act, 20 U.S.C. § 1001 (2006) (detailing the types of institutions that qualify for federal student aid under the ED's program).

[35] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-600, *supra* note 32, at 5 (comparing the proprietary sector to the public and private non-profit sector, which are respectively given forty-eight percent and thirty-three percent of the annual student loan disbursements); *see also* NAT'L CTR. FOR EDUC. STATISTICS, U.S. DEP'T OF EDUC., DIGEST OF EDUCATION STATISTICS 2009 Table 338 (2010) *available at* http://nces.ed.gov/programs/digest/d09/tables/dt09_338.asp?referrer=report (showing that over sixty-five percent of all American undergraduate students receive some form of financial aid from the federal government).

[36] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-4, *supra* note 3, at 13 (listing eligible Title IV institutions as those that include certificate, associate, bachelor's, graduate, or professional degree programs). *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE,GAO-09-600, *supra* note 32, at 6 (2009) (stating the proprietary sector disproportionately awards more certificates than it does bachelor or graduate degrees).

[37] *See* Higher Education Act, 20 U.S.C. § 1094(a) (2006 & Supp. III 2010) (providing several very specific requirements that include how a school reports its continued compliance with the federal program, qualifies as an eligible institution, and performs certain business operations so federal student safeguards are not ignored); *see also id.* at § 1094(a)(20) (prohibiting commissioned recruiters at all schools).

[38] *See id.* at § 1094(a)(3) (stating that the agreement with the Secretary includes the establishment of an administrative system that will maintain compliance with HEA guidelines).

loans: a school initially certifies with the ED that it is compliant with federal guidelines and then the school receives funds through individual student loan requests.[39] This process includes additional qualifications for proprietary schools.[40] It requires that for-profit institutions provide training for an industry-recognized credential or certification and is accredited by a nationally recognized agency.[41] If a proprietary school fails to comply with any HEA provision, the Secretary may place it on probation and revoke its student loan eligibility.[42]

C. The False Claims Act ("FCA") and Private Causes of Action

Students who feel that a proprietary school fraudulently caused them to obtain student loans may file a claim through the FCA.[43] This statute prohibits any entity from knowingly submitting a fraudulent request for government funding.[44] FCA claims are permitted for both the government and private citizens to recover damages for funds that were induced fraudulently.[45] The FCA also allows multiple parties to file claims as a class action.[46] Students that bring a *qui tam* action against proprietary

---

[39] *See id.* at § 1094(c)(1) (implementing procedures for the Secretary to verify school's continued compliance without explicit recertification).

[40] *See id.* at § 1094(a)(24) (attempting to make it even more difficult for a proprietary school to fraudulently request funds by requiring that it generate at least ten percent revenue outside federal student loans).

[41] *See* Higher Education Opportunity Act, 20 U.S.C. § 1002(b) (2006 & Supp. III 2010) (requiring proprietary institutions to exist for at least two years with regional accreditation and admit students beyond the age of compulsory school attendance, or who are concurrently enrolled in another secondary institution, before gaining loan eligibility). *See generally* ABOUT ACCSCT, ACCREDITING COMMISSION OF CAREER SCHOOLS AND COLLEGES OF TECHNOLOGY (ACCSCT) 8 (2011) *available at* http://www.accsc.org/Content/Accreditation/index.asp (explaining accreditation standards with a heavy reliance upon self-reporting that includes analyzing application materials, self-evaluations, annual reports, financial reports, student complaints, information from government agencies, on-site evaluations, and other related sources); ACCREDITATION HANDBOOK, DISTANCE EDUCATION AND TRAINING COUNCIL 16 (2011) (defining that a "bona fide" distance learning institution must enroll students, hire quality faculty, transfer materials in an organized manner to students, provide constant communication, and offer at least fifty-one percent of classes online).

[42] *See* Higher Education Act, 20 U.S.C. § 1094(d)(2)(B) (2006 & Supp. III 2010) (stating that the Secretary may put a proprietary institution on probation for a two year period if it fails to comply with any requirements under § (a)(24)).

[43] *See* False Claims Act, 31 U.S.C. § 3729 (2006) (regulating how the government may legally respond against any person or business that fraudulently obtains federal funds).

[44] *See id.* at § 3729(a)(1)(A) (including fraudulent acts against the government that a business deliberately creates and those where a business knowingly causes another person or entity to commit an act that the business knows to be fraudulent).

[45] *See id.* at § 3730(b)(1) (expressing that *qui tam* provisions exist under the FCA, which allow private citizens to bring suit on behalf of the government).

schools for violating the HEA, however, create a difficult question for courts: can an institution fraudulently receive student loans if the Secretary has not revoked certification?[47] The circuits have split over this issue.

D. Growing Concern with For-Profit Higher Education

Proprietary schools allocate significant resources to counter negative publicity in the twenty-first century.[48] This proactive approach emerged from frequent student lawsuits, governmental investigations, and national media attention.[49] Proprietary schools particularly rely upon television and internet advertisements to refocus public attention toward their historically positive educational goals.[50] Most advertising campaigns appear harmless, but a subtle issue exists.[51] Potential students often view these commercials and believe that the proprietary school will easily lead to the career or lifestyle shown in the advertisement.[52] Some proprietary school recruiters reinforce a false understanding about graduation outcomes by deliberately deceiving students to request federal loans through such tactics as false statements, assurances, and hyperbole.[53]

---

[46] *See* Higher Education Opportunity Act, 20 U.S.C. § 1094(a) (2006 & Supp. III 2010) (explaining that once an institution is deemed eligible for federal student loans, only the Secretary can revoke its eligibility).

[47] *See id.* at § 1094(c)(1) (stating that the Secretary has the sole ability to revoke loan eligibility). *Compare* United States *ex rel.* Hendow v. Univ. of Phoenix, 461 F.3d 1166 (9th Cir. 2006) (ignoring the issue whether the Secretary has acted), *with* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791, 800-01 (8th Cir. 2011) (requiring reference back to initial certifying document, which applied to the HEA, necessitates a non-definitive consideration about the Secretary's actions).

[48] *See* Chris Kirkham, *For-Profit Colleges Mount Unprecedented Battle for Influence in Washington*, HUFFINGTON POST (April 25, 2011, 3:16PM) http://www.huffingtonpost.com/2011/04/25/for-profit-colleges_n_853363.html? (explaining how proprietary school lobbying expenditures more than doubled between 2008 and 2010 as their industry incurred greater scrutiny from Washington politicians).

[49] *See, e.g.*, *Price of Admission: America's College Debt Crisis*, CNBC, http://www.cnbc.com/id/39911910 (last visited Nov. 12, 2011) (reporting on American student debt issues with a special emphasis on the role for-profit schools play in this crisis).

[50] *See Mission Statement*, UNIVERSITY OF PHOENIX, *supra* note 19 (noting that equal and affordable access to an education are two fundamental goals for the University of Phoenix).

[51] *See* University of Phoenix, *Thinking Ahead Commercial - University of Phoenix*, YOUTUBE (Jul. 20, 2011) http://www.youtube.com/watch?v=5mFMiTcFdNQ (showing happy and engaged students either in class or in the work force behind flashing messages that describe the benefits to a college education).

[52] *Cf. id.* (failing to reference any school-specific job placement data that supports greater student marketability after graduation).

[53] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-600, *supra* note 32, at 22-25 (presenting reports from undercover government agents who witnessed some school recruiters deliberately changing admissions test scoring scales to admit unqualified students).

Student skepticism toward proprietary schools has subsequently increased, even among such minority groups as Native Americans who have long benefited from proprietary schools.[54] The state legislative response to this concern is a possible reduction in tax support.[55] Several state attorney generals have also initiated inquiries into proprietary school business practices.[56] These investigations started after a federal government report identified several proprietary schools that encouraged admissions staff to use deceptive recruitment tactics.[57] State judicial departments are now trying to discern whether these practices are legal.[58] The Department of Justice ("DOJ") has also joined the states in these investigations to prepare for future litigation.[59] Frequent student lawsuits have prompted the

---

[54] *See* Armando Montaño, *States Move to Limit Spending on For-Profit Colleges While Tightening Oversight*, CHRONICLE OF HIGHER EDUC., July 16, 2011 (highlighting the Cherokee Nation which has prohibited its students from accepting scholarships from any proprietary school).

[55] *See id.* (detailing efforts made by several Democratic and Republican lawmakers to curb spending on for-profit schools).

[56] *See* Chris Kirkham, *Attorneys General in 10 States Launch Joint Investigation Into For-Profit Colleges*, HUFFINGTON POST (May 3, 2011, 7:10 PM) http://www.huffingtonpost.com/2011/05/03/for-profit-colleges-10-state-investigation_n_857199.html (citing that rising enrollments and increased reliance on federal student aid by for-profits as the reasons for increased industry scrutiny); *see also* Todd Wallack, *University of Phoenix Target of Mass. Probe*, BOSTON.COM (May 16, 2011, 6:07 PM) http://www.boston.com/business/ticker/2011/05/university_of_p.html (focusing on the University of Phoenix, the largest for-profit university, for its alleged deceptive recruitment practices); *Apollo Group, Inc. Reports Fiscal 2011 Third Quarter Results*, APOLLO GROUP, INC. (June 30, 2011) http://phx.corporate-ir.net/phoenix.zhtml?c=79624&p=irol-newsArticle&ID=1581481&highlight= (announcing that while enrollments were down at the University of Phoenix to just under 400,000 in the third quarter, revenues still topped $1,235.8 million).

[57] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-600, *supra* note 32, at 22-25 (documenting several situations where a government employee pretended to be a prospective student and was told false information or was helped with a minimum skills entrance examination to ensure they would qualify for admission).

[58] *Cf.* Kelly Field, *Faculty at For-Profits Allege Constant Pressure to Keep Students Enrolled*, CHRONICLE OF HIGHER EDUC., May 8, 2011, at A1, A10-A12 (investigating how faculty at for-profit schools are asked to change student grades and encouraged to recommend future student attendance to maintain revenue).

[59] *See* Press Release, Office of Pub. Affairs, Dep't of Justice, U.S. Files Complaint Against Education Management Corp. Alleging False Claims Act Violation (Aug. 8, 2011) *available at* http://www.justice.gov/opa/pr/2011/August/11-civ-1026.html (detailing the DOJ's rationale for filing a complaint against one of the largest proprietary school agencies for fraudulent recruitment practices that violate the FCA through United States *ex rel.* Washington v. Educ. Mgmt. Corp., Civil No. 07-461 (W.D. Pa. 2011)); *see also* Tamar Lewin, *For-Profit College Group Sued as U.S. Lays Out Wide Fraud*, N.Y. TIMES, (Aug. 8, 2011) http://www.nytimes.com/2011/08/09/education/09forprofit.html?_r=1&ref=tamarlewin (emphasizing the significance of the federal government's involvement in a suit against a proprietary school as evidence that the DOJ is also taking student financial safety seriously).

DOJ to file a complaint against the United States' second largest proprietary school owner, Education Management Corporation.[60]

In June 2011, the ED responded to growing public concern with proprietary schools by implementing new regulations that focus on gainful employment as a means to curb fraudulent practices.[61] For instance, proprietary schools are now required to prove that its students are gainfully employed upon graduation or else federal funding could be revoked.[62] Proprietary schools responded to the revised regulations by arguing that they are too harsh.[63] Student plaintiffs have conversely argued that gainful employment may ultimately become an effective regulatory measure, but it does not sufficiently address student fraud concerns.[64]

Proprietary school recruitment is an important issue for both federal and state governments because students who attend for-profit schools have a higher likelihood of defaulting on their student loans.[65] Default occurs when a student is delinquent for over 270 days.[66] Several factors account

---

[60] *See* Press Release, Office of Pub. Affairs, Dep't of Justice, *supra* note 59 (believing that the DOJ's litigation will force schools to reconsider their recruitment practices).

[61] *See* Program Integrity: Gainful-Employment Debt Measures, 76 Fed. Reg. 34,386 (June 13, 2011) (to be codified at 34 C.F.R. § 668) (updating the HEA to reflect the government's strong interest in releasing student loans only to promote academic and career opportunities).

[62] *See* Press Release, Justin Hamilton, Obama Administration Announces New Steps to Protect Students from Ineffective Career College Programs, U.S. Dep't of Educ. (June 2, 2011) *available at* http://www.ed.gov/news/press-releases/gainful-employment-regulations (announcing that if proprietary schools cannot show that at least one third of its students are employed and able to start repaying their loans upon graduation, then federal funding can be withheld); *see also* Larry Abramson, *Softened Regulations Issued for For-Profit Schools*, NAT'L PUB. RADIO, June 2, 2011, http://www.npr.org/2011/06/02/136876216/softened-regulations-issued-for-for-profit-schools (acknowledging that some for-profit schools may close in response to the new federal regulations).

[63] *See, e.g.*, Michael Horn, *New Higher Ed Regulations Leave Everyone Empty*, FORBES.COM (June 16, 2011, 10:51 AM), http://www.forbes.com/sites/michaelhorn/2011/06/16/new-higher-ed-regulations-leave-everyone-empty/ (acknowledging that there is a delicate balance between both sides on this issue, but a better solution still probably exists to prevent fraud).

[64] *See id.* (emphasizing that the ED only focused on one possible deceptive tactic—inflated employment statistics—that proprietary schools could use against students).

[65] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-600, *supra* note 32, at 15-18 (showing charts which detail student loan default rates at proprietary schools are more than double those found at traditional universities and colleges); *see also* ALISA F. CUNNINGHAM & GREGORY S. KIENZL, DELINQUENCY: THE UNTOLD STORY OF STUDENT LOAN BORROWING 40 (2011) (contrasting student borrowers from various higher education sectors to show that seventy-four percent of students attending two-year and forty-three percent of students attending four-year proprietary schools must start repaying their loans after one year of study for either failing to re-enroll or dropping below half-time status).

[66] *See* CUNNINGHAM & KIENZL, *supra* note 65, at 35 (defining that a default occurs

for high default rates at proprietary schools, including family education and income, which improper student recruitment only exacerbates.[67] Despite this problem, student claims for fraudulent proprietary school recruitment and loan inducement have found inconsistent treatment within the federal courts.[68] Judicial attention toward this issue is therefore needed to ensure that loans are not improperly released while the government seeks to bolster college attendance and proprietary schools rise in popularity.[69]

III. THE NINTH AND EIGHTH CIRCUITS' DIVERGING APPROACHES TO PROPRIETARY SCHOOL FRAUD

The federal circuits do not agree on the litigation process for student fraud claims against proprietary schools. The Ninth Circuit follows promissory fraud theory and does not distinguish between a school's false loan certification with the ED and false statements made to a student that induced a loan request.[70] Conversely, the Eighth Circuit applies initial falsification theory and finds that if an institution remains certified with the government, then it cannot be held liable for fraud unless a claim directly relates back to the certification.[71] The circuits differ on whether to use an implied certification standard and if a student's complaint must cite school

---

when a student is delinquent in making a payment; when the student is late between 60 and 120 days, this information is reported to a consumer credit agency).

[67] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-600, *supra* note 32, at 19-20 (suggesting that in addition to family education and income, older students with other family commitments tend to enroll at proprietary schools and do not have the resources to repay loans, leading to default).

[68] *Compare* United States *ex rel.* Main v. Oakland City Univ., 426 F.3d 914 (7th Cir. 2005) (reversing a district court decision to dismiss a complaint for failure to state a claim because a student can use the FCA to recover damages for fraudulent student loan requests) *and* United States *ex rel.* Hendow v. Univ. of Phoenix, 461 F.3d 1166 (9th Cir. 2006) (allowing students to recover damages for fraudulent recruitment by using implied certification to create an implicit school certification with each submitted loan request), *with* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791 (8th Cir. 2011) (failing to explicitly state a violated federal regulation under the FCA will result in a 12(b)(6) dismissal).

[69] *See generally* CARNEVALE, *supra* note 21 (failing to address this issue would cause the United States to face an even greater education and debt crisis by 2018); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-600, *supra* note 32, at 12 (emphasizing that students who default on their student loans leave taxpayers with the burden to repay the remaining balance while also forcing the student into a poor financial situation).

[70] *See Hendow*, 461 F.3d at 1172 (explaining that a false statement made at certification or through a student's subsequent request for funds are both actionable under the FCA, the material issue is whether a false representation fraudulently induced funds).

[71] *See Vigil*, 639 F.3d at 797-98 (concluding that a certified institution cannot fraudulently request funds when it is still pre-approved to make requests with the federal government, a decision that implicates proprietary schools certifying ED compliance under the HEA).

certification with the ED.[72]

A. Promissory Fraud Theory

The Ninth Circuit's promissory fraud theory adopts a four-part test from the Seventh Circuit to determine fraud.[73] The four requirements are: (1) a false statement or fraudulent course of conduct, (2) made with scienter, (3) that was material, and (4) causes the government to pay out money or forfeit monies due.[74] The Ninth Circuit places particular weight on the scienter component that requires an institution to actually know that their statements are false.[75] It must be shown that a school knowingly made false representations that are material to an alleged injury.[76]

The Ninth Circuit's four-part test also inherently requires implied certification to resolve cases.[77] This requirement assumes that when a business agrees to receive federal funding—through a contract, voucher, agreement, or form—its subsequent requests include an implicit agreement to remain compliant with federal regulations.[78] In *Unites States ex rel. Hendow v. University of Phoenix*, the Ninth Circuit considered a complaint where former employees alleged that the university deliberately made false statements to the government so it could receive federal loans.[79] The court found for Hendow and specifically cited implied certification in the decision, but it did not include a detailed justification for applying the

---

[72] *See id.* at 796 (detailing that once an institution certifies with the government, it remains in compliance unless subsequent fund requests ask for recertification prior to each new disbursement).

[73] *See Main*, 426 F.2d at 916-17 (describing a review standard later adopted by the Ninth Circuit).

[74] *See, e.g.*, *Hendow*, 461 F.3d at 1177-78 (stating that this standard is applied to all fraud cases within the circuit, irrespective of federal certification policies, while individual courts may reword the elements for their jurisdiction).

[75] *See id.* at 1174 (mentioning that the Ninth Circuit does not find a difference between its theory and the Seventh Circuit's False Certification Theory as they both rely upon the same elements and rationale).

[76] *See Main*, 426 F.3d at 916-17 (7th Cir. 2005) (explaining that if a false representation is material and causes the government to disburse funds, then it is irrelevant when a school signed a compliance agreement because a violation still exists).

[77] *See Hendow*, 461 F.3d at 1172 n.1 (stating that implied certification has been considered by other courts, such as the Court of Federal Claims).

[78] *See* Ab-Tech Const., Inc. v. United States, 31 Fed. Cl. 429 (1994) (payment vouchers); Shaw v. AAA Eng'g & Drafting Co., 213 F.3d 519 (10th Cir. 2000) (work order contracts); United States *ex rel.* Joslin v. Cmty. Home Health of Md., Inc., 984 F. Supp. 374 (D. Md. 1997) (Medicare claim forms); United States *ex rel.* Bennett v. Medtronic, Inc., 747 F. Supp. 2d 745 (S.D. Tex. 2010) (Medicare device coverage).

[79] *Hendow*, 461 F.3d at 1168.

standard.[80] The Ninth Circuit has found that liability can be assessed through the FCA using an implied certification standard.[81]

B. *Initial Falsification Theory*

The Eighth Circuit will apply a four-part test similar to the Ninth Circuit to resolve student fraud claims, but it conversely requires that a complaint focus on a school's initial certification with the government.[82] The court reasoned in *United States ex rel. Vigil v. Nelnet, Inc.* that a preliminary motion to dismiss could be granted when a person fails to claim fraud with reference to a specific government regulation in the cause for action.[83] The complaint should include enough factual information to show that a claim is plausible.[84] Any alleged false statement must further be material in causing the government to disperse funds.[85] Implied certification is consequently not applied by the Eighth Circuit; it requires specific evidence that a defendant expressly certified compliance and then intentionally violated its agreement.[86]

C. *Divergent Student Fraud Standards*

The Eighth Circuit's initial falsification theory exemplifies why it is significant that a school does not need to recertify its compliance with HEA guidelines with each student loan request.[87] After a school has been

---

[80] *Id.* at 1172 n.1 (stating that implied certification was not necessary to reach a decision in this case, but that it was still relevant enough to include in a note).

[81] Ebeid *ex rel.* United States v. Lungwitz, 616 F.3d 993, 998 (9th Cir. 2010) ("[A] complaint alleging implied false certification must plead with particularity allegations that provide a reasonable basis to infer that (1) the defendant explicitly undertook to comply with a law, rule or regulation that is implicated in submitting a claim for payment and that (2) claims were submitted (3) even though the defendant was not in compliance with that law, rule or regulation. We do not embrace [a] categorical approach that would, as a matter of course, require a relator to identify representative examples of false claims to support every allegation, although we recognize that this requirement has been adopted by some of our sister circuits.").

[82] *See* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791, 799-800 (8th Cir. 2011) (explaining that it is insufficient to merely present evidence of potential misconduct without any additional context to show why it proves that a federal provision was violated).

[83] *Vigil*, 639 F.3d at 791, 801-02 (describing how the FCA was intended for narrowly defined circumstances unless sufficient supporting authority could be produced).

[84] *Id.* at 796 (citing Ashcroft v. Iqbal, 129 S. Ct. 1937, 1948-49 (2009)) (stressing that enough factual material is required to show that a defendant adopted and implemented policies that violated federal regulations).

[85] *Id.* (citing Mikes v. Straus, 274 F.3d 687, 697 (2nd Cir. 2001)) (admitting that not all instances of regulatory noncompliance will violate the FCA if they are not material to the government's disbursement decision).

[86] *Id.* at 795-96 (explaining that the FCA is not violated through simple regulatory non-compliance, rather a defendant must knowingly defraud the government).

[87] *See* Higher Education Opportunity Act, 20 U.S.C. § 1094(a) (2006 & Supp. III

certified, the ED will review a student's loan request and dispense funds, unless the Secretary states that the school is not compliant.[88] This approach makes it more difficult to establish liability for fraudulent recruitment when the Secretary has not revoked a school's certification.[89] A student must file a fraud claim not for the loan that he or she withdrew, but against the school for its initial false certification with the government to comply with disbursement guidelines.[90] This is a tougher fraud standard to satisfy because a scienter requirement remains, meaning that a student must prove that a proprietary school knowingly made a false claim in relation to its initial certification with the ED.[91]

Initial falsification theory is beneficial, however, in retaining a review standard that is closest to the language used in the FCA.[92] The FCA only requires that a defendant knowingly make a false representation and does not ask the court to imply intent from another action.[93] The promissory fraud theory creates an additional burden on the court to determine whether one or more incidents violate a certification agreement.[94] It further does not provide a clear procedure to determine when a certification inference is justified.[95] Initial falsification theory avoids this issue by simply requiring that a plaintiff draft a complaint that specifically details any fraudulent behavior by the defendant to determine whether it violated any provision within the FCA.[96]

2010) (detailing the certification requirements that each school must satisfy receiving federal student loans).

[88] *See id.* at § 1094(c)(1) (empowering only the Secretary to make decisions).

[89] *See generally id.* at § 1094(d)(2) (describing the sanctions available to the Secretary for non-compliance).

[90] *See id.* (meaning a plaintiff cannot recover damages when the ED still certifies a proprietary school to receive federal funds).

[91] *See* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791, 801 (8th Cir. 2011) (reiterating that the FCA has a knowledge component and that any claim for relief must prove that a defendant has knowingly violated a stipulated regulation).

[92] *See, e.g.*, False Claims Act, 31 U.S.C. § 3729 (2006).

[93] *See* United States *ex rel.* Hutcheson v. Blackstone Med., Inc., 647 F.3d 377, 381 (1st Cir. 2011) (deciding that FCA cases should not be resolved by using any judicially-created framework for implied certification).

[94] *See* United States *ex rel.* Marcy v. Rowan Companies, Inc., 520 F.3d 384, 388-89 (5th Cir. 2008) (refusing to apply implied certification in Fifth Circuit decisions under the theory that a claim must be materially related to a violated government benefit).

[95] *See* S. REP. NO. 99-345, at 9 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266, 5274 (reporting Congress' intent for the FCA to hold a defendant liable for "[E]ach and every claim submitted under a contract, loan guarantee, or other agreement *which was originally obtained* by means of false statements or other corrupt or fraudulent conduct.") (emphasis added).

[96] *See* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791, 795-96 (8th Cir. 2011) (explaining that because the FCA is an anti-fraud statute a claim must be stated with particularity to satisfy federal rules of civil procedure).

Promissory fraud theory may require more effort from the courts, but it is ultimately less restrictive by allowing a plaintiff to avoid adherence to initial certification in the cause of action.[97] In *Hendow*, the Ninth Circuit attempted to limit any additional burden by providing a succinct four-part test to determine fraud.[98] This test does not discriminate between whether a claim is based upon fraudulent loan inducement or initial certification.[99] It is therefore more flexible than the Eighth Circuit requirements.[100]

The other notable difference between the circuits is their opinion toward implied certification. The Ninth Circuit favors this standard, but the Eighth Circuit instead relies upon an initial certification to resolve FCA cases.[101] Every new student loan application in the Eighth Circuit consequently is not an acknowledgement that a proprietary school remains in compliance with the HEA, but rather only signifies that a student requests funds and intends to use them at a particular school.[102] The circuits' competing review standards are created from a national judicial debate over how and if implied certification should be applied.[103]

Some federal jurisdictions, such as the Federal District Court for Maryland, do not use the implied certification standard to resolve FCA cases.[104] This court refused to apply implied certification and found that merely submitting forms did not recertify compliance, even if the party was aware of non-compliance.[105] The Federal Claims Court has conversely

---

[97] *See* United States *ex rel.* Hendow v. Univ. of Phoenix, 461 F.3d 1166, 1172 n.1 (9th Cir. 2006) (allowing implied certification to replace initial certification if not referenced in a complaint).

[98] *See id.* at 1177-78 (displaying that this standard is flexible within the circuit's district courts).

[99] *See id.* (assuming that all four elements are satisfied, a cause of action exists).

[100] *See Vigil*, 639 F.3d at 799 (requiring relation back to initial certification and a specific government regulation, without exception).

[101] *See id.* at 801-02 (creating a higher burden of proof to show fraud).

[102] *See id.* (claiming that if any fraud has occurred, it can only be in relation to the initial certification).

[103] *See* United States *ex rel.* Willis v. United Health Grp., Inc., No. 10-2747, 2011 WL 2573380, at *8 (3rd Cir. 2011) ("[O]ther courts of appeals have considered [implied certification] and a majority of those courts, including those in the Second, Sixth, Ninth, Tenth, Eleventh, and District of Columbia Circuits have recognized that there can be implied false certification liability under the FCA. . . . We now join with these many courts. . . .").

[104] *See* United States *ex rel.* Joslin v. Cmty. Home Health of Md., Inc., 984 F. Supp. 374, 384 (D. Md. 1997) (finding that a plaintiff that uses the FCA based only on their submission of payment claims to the government is insufficient to show liability under the act without directly citing a violated section within a federal statute).

[105] *See id.* at 384-85 ("While ignorance of the law is usually no excuse to justify one's actions, the FCA requires that a false statement be made with actual knowledge, deliberate ignorance, or reckless disregard of the statement's falsity.").

relied upon implied certification in its FCA cases.[106] It found that each request for additional funds under the FCA implied compliance recertification.[107] The federal circuit split over implied certification exists, even though most jurisdictions follow the latter standard when deciding private FCA claims.[108] The majority reasons that if a regulation imposes a conditional duty for federal funding, then an institution will be liable for fraud when it requests funds while non-compliant because every submitted claim implicitly includes compliance recertification.[109]

The circuit division over how to properly review student fraud claims against proprietary schools is subtle, but generates great consequence. As the Eighth Circuit noted in *Vigil*, the facts in its case were different from what the Ninth Circuit considered in *Hendow*.[110] The Eighth Circuit therefore distinguished its decision by stating that Vigil did not file a complaint challenging any specific certification provisions and the court did not want to assume his argument.[111] Both circuits accept that a four-step test similar to the promissory fraud theory is ultimately needed, but differ on whether to allow inferences over certification questions, often

---

[106] *See* Ab-Tech Construction, Inc. v. United States, 31 Fed. Cl. 429, 430-31, 434 (1994) (contracting to build an automated data processing facility for the United States Army Corps of Engineers); *see also* Small Business Act, 15 U.S.C. § 631 (2010) (encouraging a free and competitive market by requiring that minority business contractors have an equal opportunity to obtain government contracts).

[107] *See Ab-Tech*, 31 Fed. Cl. at 434 (articulating that a continual presentation of payment vouchers constituted an implied certification that Ab-Tech was continuing to adhere to the program; failure to notify the government about subcontracts thus violated federal statute even though Ab-Tech did not explicitly recertify with every payment).

[108] *See* United States *ex rel.* Augustine v. Century Health Servs., Inc., 289 F.3d 409, 415 (6th Cir. 2002) (explaining that implied certification exists and liability can attach to a defendant if he violates a continuing duty to comply with regulations that are a condition for payment); Mikes v. Straus, 274 F.3d 687, 700 (2nd Cir. 2001) (concluding that implied certification is appropriate when a statute or regulation *expressly* states that a provider must stay in compliance for payment) (emphasis in the original); Shaw v. AAA Eng'g & Drafting Co., 213 F.3d 519, 531, 533 (10th Cir. 2000) (finding that the *Joslin* court misinterpreted the application of implied certification because the scienter requirement from the promissory fraud theory must still be satisfied even if a business' recertification is implied).

[109] *But see* United States *ex rel.* Graves v. ITT Educ. Servs., Inc., 284 F. Supp. 2d 487, 497 (S.D. Tex. 2003) (stipulating that liability under the FCA only exists if a defendant has made a false claim; the mere violation of a regulation does not create liability under the FCA unless a false certification is actually submitted to the government).

[110] *See* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791, 796-97 (8th Cir. 2011) (explaining why a factual distinction between the Eighth and Ninth Circuits created different outcomes).

[111] *See id.* (reiterating that Vigil only attached several documents to the complaint without any context to show when and how Nelnet certified its federal compliance).

resulting in different outcomes for similar claims.[112]

A final distinction between the Ninth and Eighth Circuits is that they respectively represent the highest percentage of Democratic and Republican court appointments.[113] From a political perspective, one potential explanation for why the Eighth Circuit has a slightly stricter standard is that its more conservative justices tend to favor less government regulation over business.[114] Nevertheless, the circuits' different philosophies have ultimately established an unsettled national standard for proprietary school fraud cases.

IV. MANDATORY ARBITRATION AND THE FUTURE OF STUDENT FRAUD LITIGATION

While the circuit courts remain divided over review standards for proprietary school fraud litigation, a recent United States Supreme Court decision may nullify this debate by allowing mandatory arbitration agreements in adhesion contracts.[115] The Court in *AT&T Mobility LLC v. Concepcion* considered a class action lawsuit against AT&T for fraudulently promoting a free phone in exchange for a service agreement, but then charging the customer sales tax on the phone's value.[116] The service agreement mandated arbitration for any legal disputes and forbade class actions.[117] The plaintiffs relied upon a California Supreme Court

---

[112] *Compare* United States *ex rel.* Hendow v. Univ. of Phoenix, 461 F.3d 1166, 1170 (9th Cir. 2006) (citing United States v. Neifert-White Co, 390 U.S. 228 (1968)) ("The False Claims Act, however, is not limited to such facially false or fraudulent claims for payment," but "is 'intended to reach all types of fraud, without qualification, that might result in financial loss to the Government.'"), *with Vigil*, 639 F.3d at 799 (8th Cir. 2011) (citing Allison Engine Co., Inc. v. United States *ex rel.* Sanders, 553 U.S. 662 (2008)) ("If a false statement 'is not made with the purpose of inducing payment of a false claim. . . .[T]he direct link between the false statement and the Government's decision to pay or approve a false claim is too attenuated to establish liability.'").

[113] *Compare* THE JUDGES OF [THE NINTH CIRCUIT] IN ORDER OF SENIORITY, http://www.ca9.uscourts.gov/content/view_seniority_list.php?pk_id=0000000035 (showing that approximately sixty percent of Ninth Circuit justices were appointed by Democratic presidents), *with* EIGHTH CIRCUIT COURT OF APPEALS JUDGES, http://www.ca8.uscourts.gov/newcoa/judge.htm (displaying that approximately eighty percent of Eighth Circuit justices were appointed by Republican presidents).

[114] *Cf.* ANDREW HEYWOOD, POLITICAL IDEOLOGIES: AN INTRODUCTION 69-70 (2003) (sharing how modern conservatism developed and disfavors governmental regulations over public affairs).

[115] *See* Molly Redden, *Supreme Court Decision on Arbitration May Have Eroded For-Profit Students' Right to Sue*, CHRONICLE OF HIGHER EDUC., June 21, 2011 (explaining how a case involving class actions and arbitration clauses in relation to cell phones will hinder a student's ability to sue the proprietary school industry).

[116] AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011) (emphasizing how the plaintiffs were also not aware of any mandatory arbitration clause associated with the promotion for a free phone).

[117] *Id.* at 1744 (restating the agreement included a provision that allowed AT&T to

ruling that found arbitration clauses prohibiting class actions in consumer contracts unconscionable.[118] The Supreme Court reversed the California court's decision on the grounds that state law is preempted by the Federal Arbitration Act ("FAA").[119] This decision may not have explicitly applied to proprietary schools, but *Concepcion* has nonetheless become an important case for students attempting to recover damages for fraudulent recruitment practices.[120]

A. The Concepcion Standard and Proprietary Schools

Concepcion was applied to a proprietary school case within a couple months after the decision was announced. In *Bernal v. Burnett*, several students brought a class action against Alta Colleges Inc. for using deceptive and high-pressure recruitment practices to induce enrollment.[121] Alta was specifically accused of misrepresenting attendance costs, the chances for job placement, and salary expectations upon graduation.[122] Before the named plaintiffs agreed to take classes, however, they signed an arbitration agreement and a jury trial waiver.[123]

The *Bernal* court rejected the plaintiff's primary argument that collateral estoppel applied in this case.[124] It stated that the agreement could only be

---

unilaterally change the terms to the agreement, which the plaintiffs claimed was frequently employed in conjunction with the arbitration clause).

[118] *See* Discover Bank v. Superior Court, 113 P.3d 1100 (Cal. 2005) (finding that the waiver of class actions in consumer adhesion contracts was unconscionable in certain situations and their prohibition is not prohibited by the Federal Arbitration Act ("FAA")).

[119] *See* Federal Arbitration Act, 9 U.S.C. § 2 (1947) (enforcing agreements to arbitrate as "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract"); *Concepcion*, 131 S. Ct. at 1756.

[120] *See* Affiliated Computer Servs., Inc. v. Fensterstock, 131 S. Ct. 2989 (2011) (detailing how a student claim was dismissed by the Supreme Court after *Concepcion*).

[121] Bernal v. Burnett, No. 10-cv-01917-WJM-KMT, 2011 WL 2182903, *1 (D. Col. June 6, 2011) (alleging that key facts about the school's operation were made before students enrolled in online programs).

[122] *See id.* (arguing that these tactics violated the Colorado Consumer Protection Act and the plaintiffs requested class certification, an injunction against the school for continued fraudulent behavior, and monetary compensation to the affected students); *see also* Colorado Consumer Protection Act, COLO. REV. STAT. § 6-1-105 (2010) (codifying various deceptive methods a business may employ that will make it liable for damages).

[123] *See Bernal*, 2011 WL 2182903 at *2 (including the following clause, "Both the Student and College irrevocably agree that any dispute between them shall be submitted to arbitration").

[124] *See* BLACK'S LAW DICTIONARY 298 (9th ed. 2009) (defining collateral estoppel as: "The binding effect of a judgment as to matters actually litigated and determined in one action on later controversies between the parties involving a different claim from that on which the original judgment was based"); *see also Bernal*, 2011 WL 2182903 at *2-*3 (presenting arbitration decision prior to litigation where an arbitrator ruled that there

invalidated if the students claimed the arbitration clause was unconscionable.[125] The court ultimately used the *Concepcion* standard to resolve the case against the plaintiffs.[126] The judge in *Bernal* sympathized with the students, however, and acknowledged in the opinion that *Concepcion* was a "serious blow to consumer class actions and likely foreclosed the possibility of any recovery for many wronged individuals."[127] The court was nonetheless bound by the *Concepcion* decision to enforce the FAA over state law.[128]

After *Bernal*, the Supreme Court considered *Fensterstock v. Education Financial Partners* where several plaintiffs claimed that their loan repayment schedule was altered by Education Finance Partners without notice or permission.[129] The loan agreement signed by the parties included a mandatory arbitration clause and prohibited class actions.[130] The Supreme Court granted certiorari on this case and immediately overruled the Second Circuit's decision that the FAA did not preempt state law.[131] The case was subsequently remanded back to the lower court so a decision consistent with *Concepcion* could be reached.[132]

---

was no specific provision in agreement to compel arbitration, but under Colorado law, the agreement was not unconscionable).

[125] *Cf.* Rent-A-Center, West, Inc. v. Jackson, 130 S. Ct. 2772, 2778 (2010) (finding that when a mandatory arbitration clause is at issue, a claim that the clause is unconscionable must be made against the clause itself and not against the entire contract); Central Bank Denver, NA v. Mehaffy, Rider, Windholtz & Wilson, 940 P.2d 1097, 1103 (Colo. App. 1997) (citing RESTATEMENT (SECOND) OF JUDGMENTS § 28(2)(b) (1982)) (articulating that collateral estoppel does not apply when the issue is one of law and a new determination is needed to account for a change in the law "or otherwise avoid inequitable administration of the laws").

[126] *See, e.g.*, *Bernal*, 2011 WL 2182903 at *5 (citing AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1747) ("When state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward: The conflicting rule is displaced by the FAA.").

[127] *See id.* at *7 (detailing an overall displeasure with applying the *Concepcion* decision to the facts in this case).

[128] *See* Federal Arbitration Act, 9 U.S.C. § 2 (1947) (providing a federal government preference for arbitration if included in a contract).

[129] Fensterstock v. Educ. Fin. Partners, 611 F.3d 124, 128-30 (2nd Cir. 2010), *vacated sub nom.* Affiliated Computer Servs., Inc. v. Fensterstock, 131 S. Ct. 2989 (2011) (describing how Fensterstock was a lawyer but even he claimed to not fully understand or could not immediately find any mandatory arbitration clause in the loan repayment agreement).

[130] *See id.* at 129 (noting that the arbitration clause was hidden within enrollment terms).

[131] *See* Affiliated Computer Servs., Inc. v. Fensterstock, 131 S. Ct. 2989 (2011) (explaining its decision in only two sentences).

[132] *See, e.g.*, Fensterstock v. Educ. Fin. Partners, 426 F. App'x. 14 (2nd Cir. 2011) (remanding case back to district court because its initial review was no longer viable after *Concepcion*).

B. *Concepcion's Future Effects on Fraud Claims Against Proprietary Schools*

Concepcion was not decided to directly limit litigation by student plaintiffs, but subsequent judicial opinions appear to have had that effect.[133] Bill Ojile, lead counsel for Alta in the *Bernal* case, has stated that the *Concepcion* decision will ultimately deny class action status to student plaintiffs.[134] Students would consequently be forced to choose between taking classes with a mandatory arbitration clause in their enrollment agreement and not attending a proprietary school.[135] *Concepcion's* impact on proprietary school fraud litigation is therefore quite important.

Mandatory arbitration is beneficial in allowing the courts to unload cases from its docket.[136] It also removes technical procedure from a proceeding and allows both parties to have their issue resolved without delay.[137] Students may feel that a mandatory arbitration clause limits their ability to recover, but it could also allow them to have their case heard in a circuit that does not follow implied certification.[138] Students who cannot satisfy initial falsification requirements in the Eighth Circuit would still be able to file their complaint with an arbiter. Arbitration will at least allow all students an opportunity to recover damages while the circuit courts apply different FCA litigation standards.

The Supreme Court's decision to enforce arbitration changed how proprietary schools can protect themselves against fraud lawsuits.[139] *Bernal* and *Fensterstock* are the two immediate examples. The cases are distinguished in that the former separated its arbitration clause from the enrollment agreement while the latter left the clause among other terms.[140]

---

[133] *See id.* (tracing complaint progress through judicial system before and after *Concepcion*).

[134] *See* Dana Olsen, *School Battles in Wake of Supreme Court Arbitration Decision*, LAW.COM (last visited Oct. 30, 2011), http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202499577280 (explaining why counsel for proprietary schools still believe that arbitration is an appropriate remedy because it still allows students an opportunity to have their grievances heard by a neutral decision-maker without overloading an already crowded court docket).

[135] *See* AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1748-54 (2011) (establishing that a business, including schools, can now simply avoid litigation by inserting a mandatory arbitration clause in its business agreements).

[136] See GEORGE GRAHAM, TO VALIDATE CERTAIN AGREEMENTS FOR ARBITRATION, H.R. DOC. NO. 96-646, at 1-2 (1924) (citing that arbitration will keep expenses to a minimum as a justification for passing the FAA).

[137] *Id.*

[138] *See* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791, 798 (8th Cir. 2011).

[139] *See Concepcion*, 131 S. Ct. at 1748-54 (2011) (permitting proprietary schools to use adhesion contracts to prevent class actions and compel arbitration rather than rely upon the litigation process).

[140] *Compare* Bernal v. Burnett, No. 10-cv-01917-WJM-KMT, 2011 WL 2182903, *2

The courts enforced arbitration in each case, but the outcome was more predictable for the students in *Bernal* than in *Fensterstock*. How proprietary schools decide to present mandatory arbitration to prospective students may therefore become an issue in the future. It will ultimately depend upon resolution to complaints challenging *Concepcion's* collateral consequences and whether the Supreme Court will limit its decision to certain agreements.[141]

V. THE NEED TO SIMPLIFY FRAUD CLAIMS UNDER THE HEA AND FCA AFTER *CONCEPCION*

Proprietary schools will continue to earn large profits as they expand across the country, but their recruitment practices must be monitored.[142] The government response to this expansion must also be increased, however, as many students feel that it has not sufficiently responded to the problem.[143] The government will therefore need to implement changes that balance the for-profit nature of proprietary schools, the financial interests of students, and the current economic times. There are two solutions that do not require significant changes to current programs, or court review standards, that could be implemented to remedy this situation: implementing implied certification across all circuits and requiring all proprietary schools to include arbitration clauses in separate agreements.

A. Reconciling Promissory Fraud and Initial Falsification Theories

The implied certification standard promoted in *Hendow* should be employed across all circuits and would sufficiently remedy problematic litigation issues with the Eighth Circuit's initial falsification theory.[144] This

---

(June 6, 2011), *with* Fensterstock v. Educ. Fin. Partners, 611 F.3d 124, 129 (2nd Cir. 2010), *vacated sub nom.* Affiliated Computer Servs., Inc. v. Fensterstock, 131 S. Ct. 2989 (2011).

[141] *See* Martha Neil, *After Supreme Court Win Forcing Customers to Arbitrate, AT&T Now Sues to Stop the Arbitration*, A.B.A.J. (Aug. 17, 2011), *available at* http://www.abajournal.com/news/article/after_supreme_court_win_requiring_customers_to_arbitrate_att_now_tries/ (announcing new litigation from AT&T to restrict its victory in *Concepcion* by arguing that customers cannot initiate unlimited arbitrations in order to prevent a company merger).

[142] *See* LAURA G. KNAPP ET AL., U.S. DEP'T OF EDUC., NAT'L CTR. FOR EDUC. STATISTIC, NCES 2011-230 ENROLLMENT IN POSTSECONDARY INSTITUTIONS, FALL 2009; GRADUATION RATES, 2003 & 2006 COHORTS; AND FINANCIAL STATISTICS, FISCAL YEAR 2009 (2011) *available at* http://nces.ed.gov/pubsearch (projecting that proprietary school enrollments will increase as more students seek higher education).

[143] *See* Horn, *supra* note 63 (arguing that the government's attempt to balance public protection with business freedom has created a new standard that leaves everyone frustrated with federal funding being now dependent upon schools passing an arbitrary minimum employment standard).

[144] *See* United States *ex rel.* Hendow v. Univ. of Phoenix, 461 F.3d 1166, 1172 n.1

standard has faced criticism at the district court level over its application, though most courts acknowledge that the standard exists.[145] Implied certification would allow the Eighth Circuit to assume that any request for funds implicitly includes an agreement that an institution still meets all HEA standards, making a pretrial dismissal motion for failure to state a claim less likely to succeed.[146] The Eighth Circuit's restrictive standard prevents such loan cases from proceeding past the pleading stage because the potential victim did not properly cite fraud to a particular HEA provision, something a student presumably has never seen nor even knew existed.[147]

Implied certification should especially be used in all circuits following the *Concepcion* decision.[148] If the Eighth Circuit standard remained, the *Concepcion* decision would require a student to prove that a school defrauded the government on its initial compliance certification by relying upon only one experience.[149] The Ninth Circuit's scienter requirement resolves this issue by establishing a high standard for the plaintiff to satisfy that will protect a court against frivolous legal claims.[150] Promissory fraud theory is therefore preferable to allow more students an opportunity to raise potential violations; the alternative is a prohibition on actions that simply fail to meet a technical requirement. The Ninth Circuit approach helps offset the greater financial resources available to proprietary schools and recognizes that its students tend to come from the lowest financial class.[151]

(9th Cir. 2006) (mentioning that other courts have used an implied certification standard, but this court will not discuss its merits because it is beyond the purview of the case).

[145] *Compare* United States *ex rel.* Main v. Oakland City Univ., 426 F.3d 914 (7th Cir. 2005) (relying on implied certification), *with* United States *ex rel.* Marcy v. Rowan Companies, Inc., 520 F.3d 384, 388-89 (5th Cir. 2009) (ignoring implied certification's application).

[146] *See Hendow*, 461 F.3d at 1177-78 (9th Cir. 2006) (allowing a student to at least bring his case in front of a judge or jury).

[147] *Cf.* GAO-09-600, *supra* note 32, at 19-21 (identifying common characteristics for persons most likely to attend proprietary schools—older age, minority status, and limited parental education—that make them particularly susceptible to default and coercion).

[148] *See generally* AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011) (limiting plaintiff ability to recover damages after signing an arbitration agreement by prohibiting class actions).

[149] *See generally* United States *ex rel.* Vigil v. Nelnet, Inc., 639 F.3d 791 (8th Cir. 2011) (exemplifying that if plaintiffs cannot jointly submit their claims before the court, it becomes more difficult to prove that a school violated the HEA).

[150] *See generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976) (defining scienter as "a mental state embracing intent to deceive, manipulate, or defraud").

[151] *Cf.* GAO-09-600, *supra* note 32, at 7 (showing that adherence to the Ninth Circuit standard would give students with lesser means a better opportunity to bring their claim

If a student can show that a school knowingly made false statements, a fraud claim should exist.[152] In the Eighth Circuit, a student needs to argue beyond his or her personal experience to prove that initial certification was fraudulent.[153] This standard creates an additional burden to frame an argument with HEA language or accept case dismissal. The Ninth Circuit's promissory fraud theory is therefore more practical than the Eighth Circuit's standard in proprietary school fraud cases by allowing students to more easily construct a case.[154]

B. Requiring Proprietary School Notification Over Arbitration Clauses

The ED should require proprietary schools to notify potential students about any arbitration clauses during the recruitment process to counter the use mandatory arbitration. These mandatory provisions place students at a great disadvantage, especially when the right to litigate is forfeited without their knowledge.[155] Schools should need to present arbitration clauses to prospective students similar to Alta Colleges, Inc. in *Bernal*.[156] This would at least allow students to know at the outset that they cannot litigate against the school for any reason. If students do not agree to these terms, then they can seek an alternative option such as another proprietary school or traditional college.

The notification requirement only works, however, if some proprietary schools do not mandate arbitration. The *Concepcion* ruling may ultimately cause most schools to include arbitration clauses because it forbids class actions and upholds the FAA over contrary state law.[157] If all proprietary

---

before a court).

[152] *See* United States *ex rel.* Marcus v. Hess, 317 U.S. 537, 543 (1943), *superseded by statute*, Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119, *as recognized in* Schindler Elevator Corp. v. United States *ex rel.* Kirk, 131 S. Ct. 1885 (2011) (expressing that after an initial fraudulent certification, every subsequent request for funds makes a defendant liable under the FCA).

[153] *See Vigil*, 639 F.3d at 799 (applying initial certification theory to all FCA claims).

[154] *Id.* (explaining that unless a claim explicitly includes details about making, using, or submitting fraudulent certifications, a claim is insufficient within the Eighth Circuit; merely alleging why certifications are false is not enough).

[155] *See* Fensterstock v. Educ. Fin. Partners, 611 F.3d 124, 128 (2nd Cir. 2010), *vacated sub nom.* Affiliated Computer Servs., Inc. v. Fensterstock, 131 S. Ct. 2989 (2011) (describing how plaintiff signed a "Private Consolidated Loan Application and Promissory Note" that included an arbitration clause hidden among its terms); Bernal v. Burnett, No. 10-cv-01917-WJM-KMT, 2011 WL 2182903, *2 (D. Colo. June 6, 2011) (detailing how plaintiffs were required to fill out an "Agreement to Binding Arbitration and Waiver of Jury Trial" form before they could enroll).

[156] *See Fensterstock*, 611 F.3d at 128 (hiding an arbitration clause within the enrollment agreement's terms).

[157] *See, e.g.*, AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011) (allowing businesses to include a mandatory arbitration clause without it being unconscionable).

schools choose to include arbitration clauses in their enrollment agreements, the industry will not offer any alternatives. Student plaintiffs seeking to litigate would then be required to go through a two-step process by first arguing that the enrollment agreement was unconscionable and then that student loans were induced fraudulently and in violation of the FCA.[158] Action should be taken to protect disadvantaged consumers, who do not understand complex legal contracts, from more resourceful business executives.

VI. AN AMERICAN CRISIS

Proprietary school fraud is not a simple issue to solve. AT&T's recent decision to essentially restrict its *Concepcion* victory emphasizes this point.[159] This development also exemplifies why it is important for the court system to install uniform litigation and arbitration standards for proprietary school fraud cases. Court decisions can have unexpected consequences that create unpredictability.[160] Reform is therefore needed so that both students and schools can understand their legal options. It is also needed to protect the United States' future educational growth and economic health.

The American dream is most easily obtained with a college education, so it is imperative that corporations do not exploit students for their own economic gain. It should not be ignored that student loan debt has surpassed credit card debt in the United States.[161] American students consequently must be diligent before obtaining student loans. Those who leave college with significant debt will not only complicate their own lives, but also hurt the American economy. This problem is exacerbated if proprietary schools are permitted to encourage students to request loans they cannot afford to repay.

Higher education will remain an American priority while the economy rebounds from its current economic instability. As college and graduate

---

[158] *Cf.* Rent-A-Center, West, Inc. v. Jackson, 130 S. Ct. 2772, 2778 (2010) (distinguishing the differences between claiming a clause is unconscionable and an entire contract is unconscionable).

[159] *See* Neil, *supra* note 141.

[160] *See id.* (explaining how two firms have created a "Stop the Merger" campaign to prohibit AT&T from merging with T-Mobile by relying upon the *Concepcion* decision to encourage several plaintiffs to bring arbitration cases against AT&T that will prevent the merger to proceed; AT&T did not anticipate that its victory would create such a problem and it consequently is attempting to curb the decision so it can merge).

[161] *See* Mary Pilon, *Student-Loan Debt Surpasses Credit Cards*, WALL STREET JOURNAL, Aug. 9, 2010, http://blogs.wsj.com/economics/2010/08/09/student-loan-debt-surpasses-credit-cards/ (detailing how more students now owe money on their student loans than Americans currently owe on their credit cards for the first time in American history).

school applications increase with students attempting to shield themselves from the economic downturn, the country has an urgent need to protect its students. The legal system must be able to address student plaintiff concerns and to discipline proprietary schools who fraudulently recruit students. This is needed to prepare students for the workforce and to prevent another American debt crisis.

BUSINESSES CAN-SPAM NO MORE: A LOOK AT HOW THE *FACEBOOK, INC. V. MAXBOUNTY, INC.* DECISION WILL NEGATIVELY IMPACT THE WAY BUSINESSES MARKET ON SOCIAL NETWORKING WEBSITES

YARITZA VELEZ†

ABSTRACT

Since the passing of the CAN-SPAM Act in 2003, courts have grappled with its application in a world where emerging technology quickly changes the way consumers and businesses communicate with each other. In recent years, courts have displayed a trend of broadening the definition of "electronic mail messages" under the Act to include various forms of electronic communication other than traditional e-mail. In March 2011, the United States District Court for the Northern District of California held in Facebook, Inc. v. MaxBounty, Inc. *that messages sent to Facebook Walls and News Feeds fall under the definition of "electronic mail messages." The* MaxBounty *decision will result in businesses taking a closer look at the types of marketing messages they send to popular social networking websites, such as Facebook and Twitter, and determining whether the costs associated with complying with the CAN-SPAM Act will outweigh the benefits of using social networking websites as marketing platforms. Social networking websites have proven to be an efficient and effective means for businesses to communicate with their customers and market their products and services, so Congress, the Federal Trade Commission, or both, must take action and provide businesses with the guidance and support they need to ensure compliance with the Act.*

---

† Staff Member, *American University Business Law Review*, Volume 1; J.D. Candidate, May 2013, *American University, Washington College of Law*; A.B. International Business with emphasis in Finance, B.S. German, 2005, *The University of Georgia*. Thank you to Cristina Puglia and Jason Thelen for your wonderful guidance and to the *Law Review* staff and editors for your effort and dedication. A special thank you to Mom, Dad, and Ariana for all of your love and support.

TABLE OF CONTENTS

INTRODUCTION

In 2003, Congress passed the Controlling the Assault of Non-Solicited Pornography and Marketing Act (the "CAN-SPAM Act" or the "Act")[1] in an effort to decrease the amount of unsolicited electronic mail messages that attack the Internet and threaten the convenience and efficiency of electronic communication.[2] While the Act does not prohibit the use of unsolicited electronic mail messages, it does require that all "commercial electronic mail messages" meet the requirements set forth in the CAN-SPAM Act.[3]

In *Facebook, Inc. v. MaxBounty, Inc.*,[4] the United States District Court for the Northern District of California expanded the definition of "electronic mail messages" and held that messages sent to Facebook[5] Wall[6] and News Feeds[7] fall under the purview of the CAN-SPAM Act.[8] The court rejected the argument that the CAN-SPAM Act only applied to traditional e-mail messages and instead relied on the holdings of two cases that addressed messages sent to inboxes on the social networking website, MySpace.com.[9] The court determined that messages sent to Facebook

---

[1] Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, 15 U.S.C. §§ 7701-7713 (2006).

[2] *See* S. REP. 108-102, at 1 (2003) (maintaining that the 140 million Americans who regularly used e-mail found their inboxes inundated with unsolicited and unwanted promotions and advertisements that contained fraudulent and objectionable content).

[3] *See* 15 U.S.C. § 7704(a) (2006) (listing six requirements with which commercial electronic mail messages must comply).

[4] No. CV-10-4712-JF, 274 F.R.D. 279, 284 (N.D. Cal. 2011).

[5] *See generally* Facebook, N.Y. TIMES, http://topics.nytimes.com/top/news/business/companies/facebook_inc/index.html (last revised Sept. 23, 2011) (noting that Facebook, Inc. was founded in 2004 and is the world's largest social networking site with 800 million users as of September 2011).

[6] *See Help Center – What Can I Do on the Wall (timeline)?*, FACEBOOK, http://www.facebook.com/help/?page=820 (last visited Oct. 21, 2011) (defining a "Wall" as a place where users post and share content with friends).

[7] See *Help Center – How Can I Use News Feed to Get the Most Out of My Facebook Page?*, FACEBOOK, http://www.facebook.com/help/?page=1029 (last visited November 3, 2011) (defining "News Feed" as a feature that tells users about their friends' recent activity on Facebook.com).

[8] *MaxBounty*, 274 F.R.D. at 284.

[9] *See id.* (relaying the findings in *MySpace, Inc. v. Wallace*, 498 F. Supp. 2d 1293, 1300-1301 (C.D. Cal. 2007) and *MySpace, Inc. v. The Globe.com, Inc.*, No. CV 06-3391-RGK (JCx), 2007 WL 1686966, at *1, *5 (C.D. Cal. Feb. 27, 2007) and ultimately deciding to apply a similar approach for determining whether messages sent to Walls and News Feeds must comply with the CAN-SPAM Act); *Wallace*, 498 F. Supp. 2d at 1300-1301 (holding that messages sent through MySpace.com fell within the definition of "electronic mail message" because they were sent to an "electronic mail address"); *The Globe.com*, 2007 WL 1686966, at *5 (concluding that evidence indicating that every MySpace message contained routing information letting MySpace servers know where to send the message bolstered the finding that MySpace messages fell under the CAN-SPAM Act).

Walls and News Feeds were, in fact, sent to a "destination . . . to which an electronic mail message can be sent" because the messages required Facebook to engage in some routing activity.[10] The court also stated that it was Congress's intent to include messages sent to Facebook Walls and News Feeds as part of the definition of "electronic mail message."[11]

The expansion of the definition of "electronic mail messages" is consistent with recent court decisions broadening the definition and will likely affect messages sent to other social networking websites.[12] The expansion will affect businesses using social networking websites as marketing platforms because those messages must now comply with the requirements set forth by the CAN-SPAM Act.[13] An example of a business that now must comply with the Act is Pepsi, a well-known beverage brand under the umbrella of the large corporation, PepsiCo, Inc.[14] In 2010, Pepsi launched a social networking Internet campaign called the Pepsi Refresh Project through which Pepsi funds ideas in the categories of arts and music, education, and communities through an online voting competition.[15] Participants compete against each other by promoting their ideas on social networking websites, such as Facebook and Twitter,[16] to

---

[10] *MaxBounty*, 274 F.R.D. at 283.

[11] *See id.* (reiterating the point in *The Globe.com* that determining that the messages at issue here were "electronic mail messages" was consistent with Congress's intent to mitigate messages that overburden the Internet).

[12] *See* Tonia Klausner et al., *Federal Court Approves the Application of the CAN-SPAM Act to Messages Sent Within Social Networking Platforms: Ruling Carries Implications for Commercial Messaging on Social Networks*, 13 E-COMMERCE L. REP. 10, 10 (2011) (suggesting that the *MaxBounty*, *Wallace*, and *The Globe.com* decisions demonstrate a trend toward a broader application of the Act to include messages from other social networking websites as part of the definition of "electronic mail message").

[13] *See* Andrew M. Baer, *Facebook Gets Creative, Hits Affiliate Marketers with CAN-SPAM Suits*, BAER CROSSEY BLOG (Nov. 4, 2010), http://www.baercrossey.com/221/facebook-can-spam (arguing adamantly against the *MaxBounty* decision and saying that applying CAN-SPAM requirements to social networking messages is a "brain twister").

[14] *See* PepsiCo, *The PepsiCo Family*, PEPSICO.COM, http://www.pepsico.com/Company/The-Pepsico-Family/PepsiCo-Americas-Beverages.html (last visited Oct. 21, 2011) (providing an overview of Pepsi and listing Mountain Dew, Diet Pepsi, and Gatorade as other well-known beverages in the portfolio to which Pepsi belongs).

[15] *See* Sean Gregory, *Behind Pepsi's Choice to Skip this Year's Super Bowl*, TIME, (Feb. 3, 2010), http://www.time.com/time/business/article/0,8599,1958400,00.html (emphasizing that Pepsi launched its new social media campaign in 2010 instead of "pouring millions of dollars into a Super Bowl commercial").

[16] *See generally* Twitter, BUSINESS INSIDER, http://www.businessinsider.com/blackboard/twitter (last visited Dec. 4, 2011) (describing Twitter as a popular social networking website founded in 2006 that enables its users to send messages of up to 140 characters, known as "Tweets").

obtain votes from the public.[17]

This Comment considers the growing trend of expanding the definition of "electronic mail message" and argues that the *MaxBounty* decision will likely affect the way businesses engage in social media marketing. Part II provides necessary background information about the CAN-SPAM Act for understanding the *MaxBounty* decision. It then introduces Pepsi as an example of a business whose charitable social-network-marketing campaign will likely be affected by *MaxBounty*. Part III argues that the *MaxBounty* conclusion of including messages sent to Facebook Walls and News Feeds as part of the definition of "electronic mail message" is not consistent with Congress's intent. Part III then determines that Facebook and Twitter would have proper standing under the Act to bring claims against Pepsi and that the messages used in the campaign would qualify as commercial electronic mail messages. In light of the findings in Part III, Part IV recommends that either Congress or the Federal Trade Commission act to provide businesses with the proper tools to comply with the Act. Finally, Part V concludes that without immediate action, businesses using social networking websites as a means to market products and services could face possible penalties and even litigation.

II. UNDERSTANDING THE CAN-SPAM ACT PROVIDES A BASIS FOR UNDERSTANDING *MAXBOUNTY* AND HOW THE DECISION WILL LIKELY AFFECT BUSINESSES

This next part begins by providing a backdrop for understanding the *MaxBounty* decision by explaining the CAN-SPAM Act and why it came to be.[18]

A. In 2003, Congress Passed the CAN-SPAM Act as an Attempt to Decrease the Level of Unsolicited Electronic Mail Messages

In 2003, unsolicited commercial electronic mail, commonly known as "spam," had become a significant problem that threatened the convenience and efficiency of electronic mail.[19] In fact, unsolicited commercial electronic mail accounted for over half of all electronic mail traffic.[20] Not

---

[17] *See generally* PepsiCo, *How It Works*, REFRESHEVERYTHING.COM, http://www.refresheverything.com/how-it-works (last visited Oct. 21, 2011) (detailing a step-by-step process of what participants must do to succeed in obtaining Pepsi funding for their ideas).

[18] 15 U.S.C. §§ 7701-7713 (2006).

[19] 15 U.S.C. § 7701(a)(2) (2006); *accord* S. REP. 108-102, at 2 (2003) (comparing the volume of spam in recent years and noting an increase in 2003 from earlier years).

[20] *See* 15 U.S.C. § 7701(a)(2) (establishing that unsolicited commercial electronic mail was up from an estimated seven percent in 2001 and continued to rise).

only was spam a burden on consumers, it imposed significant costs to Internet access service providers, businesses, and other entities that invested in technology and infrastructure to support the unsolicited traffic.[21] Major consumer advocacy organizations at the time had been pressuring Congress to provide the Federal Trade Commission ("FTC") with the power to take action to control unsolicited commercial electronic mail messages.[22] The FTC shared similar concerns with these organizations and further expressed that fraudulent and deceptive spam threatened consumer confidence and online commerce.[23]

In December 2003, Congress passed the CAN-SPAM Act in an effort to decrease the amount of unsolicited commercial electronic mail messages transmitted over the Internet.[24] The purpose of the Act was not to eliminate unsolicited commercial electronic mail messages altogether, but rather to regulate the transmission of these messages.[25] All unsolicited commercial electronic mail messages must comply with the requirements set forth in the Act, which include, among several things, providing a valid physical address of the sender and a clear notice that the message is an advertisement.[26]

Penalties under the Act for non-compliance can be very costly.[27]

---

[21] *See id.* § 7701(a)(6) (emphasizing that Internet access services, businesses, and educational and non-profit institutions can only handle a finite volume of mail before needing to further invest in infrastructure).

[22] *See* Declan McCullagh, *Groups Seek Federal Action on Spam*, CNET NEWS, (Sept. 4, 2002, 3:46 PM), http://news.cnet.com/2100-1029-956502.html (reporting that the Telecommunications Research and Action Center, the National Consumers League, and Consumer Action had proposed rules to outlaw commercial electronic mail that misrepresented the content of the message or did not provide a way to unsubscribe from the mailings).

[23] *See Unsolicited Commercial E-Mail: Hearing Before the S. Comm. on Commerce, Science and Transp.*, 108th Cong. 2, 9 (2003), *available at* http://www.ftc.gov/os/2003/05/spamtestimony.pdf (statement of the Fed. Trade Comm'n) (sharing the results of the "False Claims in Spam" study, which indicated that sixty-six percent of spam contained at least one form of deception).

[24] *See* S. REP. NO. 108-102 (2003), at 1 ("[T]o regulate interstate commerce by imposing limitations and penalties on the transmission of unsolicited commercial electronic mail via the Internet.").

[25] *See* Thomas K. Ledbetter, *Stopping Unsolicited Commercial E-mail: Why the CAN-SPAM Act is Not the Solution to Stop Spam*, 34 SW. U. L. REV. 107, 112-13 (2004) (suggesting that the CAN-SPAM Act actually creates legal spam because the Act allows spam as long as it meets the statutory requirements); *see also* W. Parker Baxter, *Has Spam Been Canned? Consumers, Marketers, and the Making of the CAN-SPAM Act of 2003*, 8 N.Y.U. J. LEGIS. & PUB. POL'Y 163, 170 (2004) (observing that sending an unlimited amount of unsolicited commercial electronic mail is legal as long as the message provides information enumerated in the requirements).

[26] 15 U.S.C. § 7704.

[27] *See* Steven Musil, *Facebook Awarded $711 Million in Spam Lawsuit*, CNET NEWS (Oct. 29, 2009, 7:35 PM), http://news.cnet.com/8301-1023_3-10387021-93/facebook-awarded-$711-million-in-spam-lawsuit/ (reporting that in 2008 a district court in

Actions brought by a state attorney general or a state official or agency for non-fraudulent violations under CAN-SPAM are subject to damages calculated by multiplying the number of violations by up to $250.[28] Additionally, actions brought by Internet access service providers for non-fraudulent violations are subject to damages determined by multiplying the number of violations by up to $100.[29] While some argue that these penalties do not deter spammers, the FTC expressed its satisfaction with the Act's progress in its 2005 report to Congress.[30]

Courts in the past have grappled over the application of the CAN-SPAM Act, particularly the interpretation of "electronic mail message," in the context of today's ever-changing Internet society.[31] In March 2011, the United States District Court for the Northern District of California took the Act further than ever before.[32]

B. The Ruling in MaxBounty is the Most Expansive Judicial Interpretation of "Electronic Mail Messages" Under the CAN-SPAM Act

In *Facebook, Inc. v. MaxBounty, Inc.*,[33] the United States District Court for the Northern District of California held that messages sent to Facebook Walls and News Feeds are considered "electronic mail messages" for the

---

California awarded Facebook $711 million in damages suffered from CAN-SPAM Act violations); Elinor Mills, *Facebook Awarded $873 Million in Spam Case*, CNET NEWS (Nov. 24, 2008, 12:23 PM), http://news.cnet.com/8301-1009_3-10106932-83.html (maintaining that in 2009 the same district court awarded Facebook $873 million for CAN-SPAM Act violations).

[28] 15 U.S.C. § 7706(f).

[29] *Id.* § 7706(g)(3)(A)(i).

[30] *Compare* Joshua A. T. Fairfield, *Cracks in the Foundation: The New Internet Legislation's Hidden Threat to Privacy and Commerce*, 36 ARIZ. ST. L.J. 1193, 1222 (2004) (contending that the threat of monetary damages does not deter the worst offenders because the offenders are usually undercapitalized and pursuing fines makes little sense) *and* John Soma et al., *Spam Still Pays: The Failure of the CAN-SPAM Act of 2003 and Proposed Legal Solutions*, 45 HARV. J. ON LEGIS. 165, 178-79 (2008) (doubting that the penalties deter spammers because prosecutors face the daunting task of finding the spammer and then proving that the messages violated the Act) *with* FEDERAL TRADE COMMISSION, *EFFECTIVENESS AND ENFORCEMENT OF THE CAN-SPAM ACT: A REPORT TO CONGRESS* 7 (2005) [hereinafter EFFECTIVENESS AND ENFORCEMENT REPORT], *available at* http://www.ftc.gov/reports/canspam05/051220canspamrpt.pdf (indicating that MX Logic, an email filtering company, reported a nine percent decrease in spam from 2004 to 2005 and that America Online received seventy-five percent less spam in 2004 than in 2003).

[31] *E.g.*, MySpace, Inc. v. The Globe.com, Inc., No. CV 06-3391-RGK (JCx), 2007 WL 1686966, at *4. (C.D. Cal. Feb. 27, 2007).

[32] Facebook, Inc. v. MaxBounty, Inc., 274 F.R.D. 279, 283 (N.D. Cal. 2011) (interpreting "electronic mail messages" to also include messages sent to Facebook Walls and News Feeds).

[33] *MaxBounty*, 274 F.R.D. 279.

purposes of the CAN-SPAM Act.[34] This was the first time a court had made such a broad interpretation of the definition of "electronic mail messages" under the CAN-SPAM Act.[35]

In *MaxBounty*, Facebook alleged that MaxBounty, an advertising and marketing company, violated the CAN-SPAM Act because MaxBounty engaged in "impermissible advertising and commercial activity" on Facebook.com.[36] Facebook claimed that MaxBounty, through its affiliates, created fake Facebook Pages[37] intended to direct "unsuspecting" users away from Facebook.com to third-party commercial websites.[38] According to Facebook, these fake Pages deceitfully displayed messages indicating that upon registration, a user would receive a promotional offer.[39] Instead of getting the offer, however, users were redirected to various third-party commercial websites, where they had to sign up for additional "sponsor offers" in order to receive the initial promised offer.[40] Facebook claimed that MaxBounty's scheme tainted the Facebook experience and caused economic losses in the form of subscription fees to Facebook users.[41] Additionally, Facebook claimed to have suffered more than $5,000 in economic damages in its efforts to combat MaxBounty's spam.[42] MaxBounty argued that Facebook's CAN-SPAM claim was invalid because the messages posted on Facebook.com were not "electronic mail messages" and, therefore, did not fall under the purview of the CAN-SPAM Act.[43]

Although no other court in the Ninth Circuit had directly addressed whether the CAN-SPAM Act applied to messages sent to Facebook Walls and News Feeds,[44] the court here rejected MaxBounty's narrow definition

---

[34] *Id.* at 284.

[35] *See* John L. Nicholson, *The CAN-SPAM Act Applies to Social Media Messaging, Rules Federal Court in California*, PILLSBURYLAW.COM (April 7, 2011), http://www.pillsburylaw.com/siteFiles/Publications/IntellectualPropertyVirtualWorldsVideoGamesClientAlertCACourtRulesCANSPAMApplicabletoSocialMediaMessaging04072011final.pdf (establishing that the MaxBounty ruling is the most expansive judicial interpretation of the messages that fall under the CAN-SPAM Act).

[36] *MaxBounty*, 274 F.R.D. at 281.

[37] *See Help Center – What is a Facebook Page?*, FACEBOOK, http://www.facebook.com/help/?page=904 (last visited Oct. 31, 2011) (defining a "Page" as a Facebook profile for businesses and organizations).

[38] *MaxBounty*, 274 F.R.D. at 281.

[39] *Id.*

[40] *Id.*

[41] Complaint at 15 Facebook, Inc. v. MaxBounty, Inc., 274 F.R.D. 279 (2011) (No. CV 10-4712 HRL), 2010 WL 4236598.

[42] *Id.*

[43] *MaxBounty*, 274 F.R.D. at 281.

[44] *See Id.* at 282 (confirming that no court in the Ninth Circuit had ever directly addressed whether the CAN-SPAM Act applied to social networking messages that

of electronic mail messages and held that these messages were regulated by the Act.[45] The court determined that these messages were in fact "electronic mail messages" as defined under the CAN-SPAM Act because they were sent to "electronic mail addresses."[46] In this case, the Facebook Walls and News Feeds served as "electronic mail addresses" because Facebook engaged in routing activity during the transmission of the messages.[47]

The court in *MaxBounty* reasoned that including messages sent to Facebook Walls and News Feeds under the definition of "electronic mail messages" was consistent with Congress's intent "to mitigate the number of misleading commercial communications that overburden infrastructure of the [Internet]."[48] The court relied on *MySpace, Inc. v. Wallace*,[49] which found that the plain language of the definition of "electronic mail message" supported Congress's intent to include messages sent to social networking websites.[50] Specifically, the *Wallace* court determined that the reference to "local part" and "domain part" in the definition of "electronic mail address" was merely an example of where electronic mail messages could be sent and that Congress intended to include other forms, even though the other forms were not specifically mentioned in the Act.[51] Furthermore, because at the time Congress passed the Act electronic messages could be sent in many ways, the *Wallace* court concluded that Congress was aware of the various forms and, therefore, intended to include messages sent to social networking websites as part of the "electronic mail messages" definition.[52] The *Wallace* court further stated that interpreting the definition in a more limited manner would "conflict with the express language of the Act and undercut the purpose for which it was passed."[53]

To better understand the reasoning behind the *MaxBounty* decision, this

---

were not delivered to an "inbox").

[45] *Id.* at 284.

[46] *Id.* at 283-84.

[47] *See id.* ("While the routing . . . [was] less complex and elongated than those employed by [Internet service providers], any routing necessarily implicates issues . . . which CAN-SPAM seeks to address.") (quoting MySpace, Inc. v. The Globe.com, Inc. No. CV 06-3391-RGK (JCx), 2007 WL 1686966, at *5 (C.D. Cal. Feb. 27, 2007)).

[48] *Id.* at 284.

[49] 498 F. Supp. 2d at 1300 (holding that messages sent to a user's "inbox" in MySpace qualified as "electronic mail messages" under the CAN-SPAM Act).

[50] *See MaxBounty*, 274 F.R.D. at 283 (citing *Wallace*, 498 F. Supp. 2d at 1300).

[51] *See Wallace*, 498 F. Supp. 2d at 1300 (inferring that the word "commonly," which preceded the terms "local part" and "domain part," suggested one of many examples of an "electronic mail address").

[52] *See id.*

[53] *Id.*

Comment will next discuss two major components of the CAN-SPAM Act, specifically, the private right of action and the definition of commercial electronic mail message.[54]

C. *The CAN-SPAM Act Provides a Private Right of Action to a Narrow Group of Plaintiffs, Namely "Providers of Internet Access Service"*

The CAN-SPAM Act provides a private right of action to a "provider of Internet access service" that has been "adversely affected" by a violation of the Act regarding the transmission of commercial electronic mail messages.[55] Providers of Internet access service can recover actual monetary losses incurred as a result of the violation or statutory damages based on the number of unlawful messages transmitted.[56]

An Internet access service provider is one that "enables users to access content, information, electronic mail, or other services offered over the Internet."[57] Traditional Internet access service and email providers, such as America Online, Microsoft, and EarthLink, would likely fall under this definition,[58] but it is unclear whether Congress intended to limit the private right of action to only these entities.[59]

Courts, on the other hand, have allowed entities that do not necessarily fall under the traditional definition of "provider of Internet access service" to bring claims under the CAN-SPAM Act.[60] Specifically, social networking websites may qualify as an Internet access service provider for the purposes of the Act.[61] Even a provider of electronic mail service alone may qualify as an Internet service access provider, so long as the provider

---

[54] Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, 15 U.S.C. §§ 7706(g)(1), 7702(2)(A) (2006).

[55] 15 U.S.C. § 7706(g)(1).

[56] *Id.* §§ 7706(g)(1), (3).

[57] 15 U.S.C. § 7702(11) (2006); 47 U.S.C. § 231(e)(4) (2006).

[58] *See* S. REP. NO. 108-102, at 2-3 (2003) (recognizing America Online, Microsoft, and EarthLink as clear examples of Internet service and email providers and discussing the billions of spam messages these provides blocked each day in 2003).

[59] *See* Vanessa J. Reid, *Recent Developments in Private Enforcement of the CAN-SPAM Act*, 4 AKRON INTELL. PROP. J. 281, 290-91 (2010) (suggesting that the Senate Report leaves open the question of whether other entities, if any, could bring private claims under the Act).

[60] *See, e.g.*, MySpace, Inc. v. The Globe.com, Inc., No. CV 06-3391-RGK (JCx), 2007 WL 1686966, at *3 (C.D. Cal. Feb. 27, 2007).

[61] *See* Facebook, Inc. v. ConnectU LLC, 489 F. Supp. 2d 1087, 1094 (N.D. Cal. 2007) (determining that Facebook qualifies under the definition because even though it does not initiate Internet connection, it provides further access to online content and communication); *The Globe*, 2007 WL 1686966, at *3 (finding the definition of "provider of Internet access service" to be broad enough to include social networking websites like MySpace, Inc.).

has physical control over or access to the server hardware.[62]

Only providers of Internet access service that are "adversely affected" by the unsolicited electronic mail messages can bring suit under the CAN-SPAM Act.[63] An "adverse effect" is a significant harm uniquely experienced by the Internet access service provider.[64] These harms generally include (1) investing in network equipment to accommodate increased bandwidth, (2) purchasing and upgrading software and systems to filter spam, and (3) expending personnel to deal with customer complaints and implement technology.[65] However, irreparable harm with respect to the Internet access service provider's reputation may also be considered an "adverse affect."[66]

D. While the CAN-SPAM Act Does Not Prohibit the Use of Unsolicited "Commercial Electronic Mail Messages," it Does Regulate Such Messages

The CAN-SPAM Act does not necessarily prohibit the use of unsolicited "commercial electronic mail messages."[67] Rather, the Act regulates the transmission of these messages and the entities that initiate and send them by imposing identification and labeling requirements.[68]

---

[62] *See* Hypertouch, Inc. v. Kennedy-W. Univ., No. C04-05203 SI, 2006 WL 648688, at *3 (N.D. Cal. Mar. 8, 2006) (concluding that a provider of "traditional e-mail" services forced to increase its capacity due to spam messages sent to its servers is an Internet access service provider); *see also* White Buffalo Ventures, L.L.C. v. Univ. of Tex. at Austin, 420 F.3d 366, 373 (5th Cir. 2005) (finding that a university that provides Internet access and is responsible for blocking unsolicited commercial electronic mail qualifies as an Internet access service provider under the Act).

[63] 15 U.S.C. § 7706(g)(1) (2006).

[64] *See* Gordon v. Virtumundo, Inc., 575 F.3d 1040, 1053-54 (9th Cir. 2009) (articulating that the harm must be "something beyond the mere annoyance of spam and greater than the negligible burdens . . . in the ordinary course of business").

[65] *See, e.g.*, ASIS Internet Servs. v. Active Response Grp., No. C07 6211 TEH, 2008 WL 2952809, at *5 (N.D. Cal. July 30, 2008) (identifying "network crashes, higher bandwidth utilization, and increased costs for hardware and software upgrades, network expansion and additional personnel" as qualified harms).

[66] *See* Facebook, Inc. v. Fisher, No. C09-05842 JF (PVT), 2009 WL 5095269, at *1, *2 (N.D. Cal. Dec. 21, 2009) (citing Shuhlbarg Intern. Sales Co. v. John D. Brush & Co., 240 F.3d 832, 841 (9th Cir. 2001)) ("Evidence of threatened loss of prospective customers or goodwill certainly supports a finding of the possibility of irreparable harm.").

[67] *See* S. Jenell Trigg, *The CAN-SPAM and Other Restrictions on Commercial E-mail*, 23 COMM. LAW., Winter 2006, at 14, 15 (noting that the CAN-SPAM Act is sometimes called the "You Can Spam Act" because it permits unsolicited mail messages as long as the messages meet the statutory requirements).

[68] *See* Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, 15 U.S.C. § 7704(a)(2006) (listing six requirements all commercial electronic mail messages must follow); *see also* Trigg, *supra* note 67, at 15-16 (distinguishing "senders" from "initiators" and noting that more than one entity may be considered an initiator and there can be multiple senders in one message).

1. The CAN-SPAM Act Regulates Two Types of Entities in the Transmission of Commercial Electronic Mail Messages: Senders and Initiators

The CAN-SPAM Act applies to both the senders and initiators of commercial electronic mail messages.[69] A "sender" is the entity whose product or service is advertised by the message.[70] To illustrate, if Business A hires Business B to handle its electronic marketing campaign, Business A would be the "sender" because its products and services are the content advertised. Business B would be the "initiator," or the entity that actually does the sending.[71] Initiators are many times third-party entities that are "hired" to send promotional or advertising messages on behalf of another business.[72]

2. Electronic Mail Messages Must be "Commercial" Messages to Fall Under the Purview of the Act

An electronic mail message sent for the primary purpose of serving as a commercial advertisement or promotion of a commercial product or service is "commercial" under the CAN-SPAM Act.[73] The Senate gave the example of a commercial message as a marketing e-mail or advertisement promoting content on a commercial website.[74] However, a more subtle, yet just as "commercial" as the previous example, is a message that urges a recipient to visit a particular commercial website.[75]

If a message is solely "transactional or relationship" in nature, however, it is not commercial.[76] A "transactional or relationship" message is a

---

[69] *See* BUREAU FOR CONSUMER PROT., FED. TRADE COMM'N, THE CAN-SPAM ACT: A COMPLIANCE GUIDE FOR BUSINESS 2 (2009) [hereinafter COMPLIANCE GUIDE], *available at* http://business.ftc.gov/documents/bus61-can-spam-act-compliance-guide-business.pdf (asserting that the law makes clear that both the company whose product is promoted and the company that actually sends the message may be held liable).

[70] *See* Trigg, *supra* note 67, at 16 (defining "sender" as the entity "whose product, service, or Internet website is advertised or promoted by the commercial message").

[71] *See id.* at 15 (citing 15 U.S.C. § 7702(9), which defines "initiate" as "to originate or transmit [an electronic mail] message or to procure the origination or transmission of such message").

[72] *See* S. REP. NO. 108-102, at 15 (2003) (explaining that a company hired by another to "[compose], [address], and [coordinate] the sending of a marketing appeal" initiates the message).

[73] 15 U.S.C. § 7702(2)(A).

[74] *See* S. REP. NO. 108-102, at 14 (2003) (clarifying that simply containing a link to a commercial website does not necessarily make the message "commercial," if the primary purpose of the message is not marketing).

[75] *See id.* (indicating that a message urging a recipient to visit a commercial website is just as much of a marketing message as one urging the purchase of a product or service).

[76] 15 U.S.C. § 7702(2)(B).

message between parties that already have a business relationship with each other and serves to facilitate, complete, or confirm a previous transaction, or to provide specific information about a product or service used or purchased by the recipient.[77] However, if a message contains both commercial and transactional or relationship content, the message is deemed commercial if the recipient reasonably interprets the subject line or body of the message as being commercial.[78] This interpretation is based on a variety of factors, such as the placement of the commercial message, the graphics and font used to highlight the commercial content, and the proportion of the commercial content to noncommercial content.[79]

3. Under the CAN-SPAM Act, an "Electronic Mail Message" Must be Sent to a Unique "Electronic Mail Address"

The CAN-SPAM Act defines an "electronic mail message" as a message that is sent to a unique "electronic mail address."[80] Under the Act, an "electronic mail address" is a "destination . . . to which an electronic mail message can be sent or delivered" and commonly consists of a unique username ("local part") and an Internet domain ("domain part").[81] Although not statutorily required, electronic mail messages that involve some routing activity on the part of the Internet access service provider are considered electronic mail messages because these messages contain data that informs the servers where to send the messages.[82] Even messages sent to nontraditional Internet access service providers qualify, as long as some routing activity is employed.[83]

---

[77] *Id.* § 7702(17)(A); *see* S. REP. NO. 108-102, at 16 (illustrating receipts, monthly account statements, and product recall notices as examples of transactional or relationship messages).

[78] 16 C.F.R. § 316.3(a)(3)(i)-(ii) (2010).

[79] *See* Trigg, *supra* note 67, at 17 (arguing that even newsletters or other subscription-based mail and alerts, which the FTC has categorized as "transactional or relationship" in nature, could be construed as "commercial" if a disproportionate amount of advertising and promotional content is included).

[80] 15 U.S.C. § 7702(6).

[81] *Id.* § 7702(5).

[82] *See* MySpace, Inc. v. The Globe.com, Inc., No. CV 06-3391-RGK (JCx), 2007 WL 1686966, at *5 (C.D. Cal. Feb. 27, 2007) (accepting the explanation that MySpace messages contain routing information letting the servers know where to send the messages as a valid reason for qualifying these messages as "electronic mail messages" because any routing activity implicates issues regarding the volume of spam that the Act seeks to address).

[83] *Id.*

4. All Commercial Electronic Mail Messages Must Comply with the Requirements Set Forth in the CAN-SPAM Act

All commercial electronic mail messages must comply with the identification and labeling requirements under the Act.[84] Specifically, the message header, or "from" line, cannot contain false or misleading information.[85] The message subject line cannot mislead a recipient about the content of the message.[86] Additionally, the message must include the following disclosures: clear and conspicuous identification that the message is an advertisement;[87] a valid physical postal address of the sender;[88] and a clear and conspicuous notice of how the recipient can opt-out from future messages.[89]

Now that this Comment has provided an overview of the CAN-SPAM Act and the latest interpretation of "electronic mail message" by the *MaxBounty* court, this Comment will next introduce a business that may potentially be affected by the recent decision.[90]

E. Marketing on Social Networking Websites Has Grown Increasingly Popular with Businesses; the Example Analyzed in This Comment is No Exception

Businesses, both small and large, recognize the importance social media marketing has on brand connection and use social networking websites to promote their products and services and connect with their target markets.[91] Pepsi, the company discussed in this Comment, is no exception.

---

[84] 15 U.S.C. § 7704(a); *accord* COMPLIANCE GUIDE, *supra* note 69, at 1 (elaborating on the types of messages covered under the Act, such as messages that promote content on commercial websites, business-to-business messages, and messages to former customers announcing a new product line).

[85] 15 U.S.C. § 7704(a)(1); *see* COMPLIANCE GUIDE, *supra* note 69, at 2 (clarifying that the header information must be accurate and identify the person or business initiating the message).

[86] 15 U.S.C. § 7704(a)(2).

[87] *Id.* § 7704(a)(5)(i); *see* COMPLIANCE GUIDE, *supra* note 69, at 2 (stating that the law is flexible in ways to comply).

[88] 15 U.S.C. § 7704(a)(5)(iii); *see* BUREAU FOR CONSUMER PROT., *supra* note 69, at 2 (naming a street address, a post office box, or a private mailbox registered with a valid agency as acceptable forms of physical addresses).

[89] 15 U.S.C. § 7704(a)(5)(ii).

[90] *See* Facebook, Inc. v. MaxBounty, Inc., 274 F.R.D. 279 (N.D. Cal. 2011) (implying businesses that send marketing messages to Facebook Walls and News Feeds must now comply with the Act).

[91] *See* Valerie Brennan, *Navigating Social Media in the Business World*, LICENSING J., Jan. 2010, at 8, 8-9 (indicating that social networking websites allow businesses to answer customers' questions on public websites and permit customers to comment via social media applications and communicate in real-time); *see also Social Marketing Takes Hold, But Traditional Marketing Still Thrives*, BUSINESS NEWS DAILY (May 16,

1. Pepsi Sends Marketing Messages to Facebook and Twitter to Promote the Brand Through the Pepsi Refresh Project

Pepsi, a brand of the PepsiCo, Inc. Americas Beverages division, was founded in 1898 by Caleb Bradham, a druggist from North Carolina, who first formulated the drink, Pepsi-Cola.[92] The Pepsi brand includes other beverages, such as carbonated soft drinks, juices, ready-to-drink tea and coffee drinks, isotonic sports drinks, bottled water, and enhanced waters.[93]

In 2010, Pepsi shocked the marketing world when it decided to abandon its traditional Super Bowl marketing activities and instead launched a social networking campaign, the Pepsi Refresh Project (the "Refresh Project").[94] The Refresh Project is a charitable marketing campaign through which Pepsi funds ideas and projects in the areas of art and music, education, and communities through an online voting competition.[95] Pepsi selects participants through an online application process and encourages the participants to use social networking websites to promote their ideas and get votes from the public.[96] Pepsi suggests that participants post and share photos, videos, messages, and other online communications about their ideas on social networking websites, such as Facebook and Twitter, to obtain as many votes as possible.[97] If a participant gets enough votes during the competing month, he becomes a finalist and qualifies to receive

---

2011, 9:53 AM), http://www.businessnewsdaily.com/social-marketinging-small-business-1294/ (reporting that marketing on social networking websites is valuable to small businesses that are time- and resource-starved); BURSON-MARSTELLER, THE GLOBAL SOCIAL MEDIA CHECK-UP: INSIGHTS FROM THE BURSON-MARSTELLER EVIDENCE BASED COMMUNICATIONS GROUP 4 (2010) (relaying that seventy-nine percent of the hundred largest companies on the Fortune 500 list use social networking sites to communicate with customers).

[92] The PepsiCo Family, PEPSICO.COM, http://www.pepsico.com/Company/The-Pepsico-Family/PepsiCo-Americas-Beverages.html (last visited Oct. 21, 2011).

[93] *Id.*

[94] *See* Natalie Zmuda, *Pass or Fail, Pepsi's Refresh Will be Case for Marketing Textbooks*, 81 ADVER. AGE, Feb. 8, 2010, *available at* http://adage.com/article/digital/marketing-pepsi-refresh-case-marketing-textbooks/141973/ (calling the Pepsi Refresh Project a "bold social media experiment"); *see also Pepsi: Focus on Social Media Advertising May Not be Reflected Across the Market*, DATAMONITOR, Mar. 2010, at 41, 41 (implying that Pepsi took a risk in not advertising during the Super Bowl).

[95] *See How It Works*, *supra* note 17 (displaying four grant levels in the amounts of $5,000, $10,000, $25,000, and $50,000 awarded to projects of varying sizes and categories).

[96] *See* PepsiCo, *Workin' the Web*, REFRESHEVERYTHING.COM, http://www.refresheverything.com/promotion-guide/social/ (last visited Oct. 21, 2011) ("The sooner you start getting followers re-tweeting and friends 'liking,' the sooner you get voters voting.").

[97] *See id.* (outlining a "social battle plan" to promote ideas and reminding participants that "sharing is caring" and they will get more votes by "keeping [the] conversation going").

funding from Pepsi for his idea.[98]

III. THE RECENT *MAXBOUNTY* DECISION WILL AFFECT THE PEPSI REFRESH PROJECT

The court in *MaxBounty* determined that including messages sent to Facebook Walls and News Feeds as part of the definition of "electronic mail messages" was consistent with Congress's intent to mitigate the volume of unsolicited electronic communications that overburden the Internet.[99] This Comment argues that the court's conclusion is misplaced and businesses, such as Pepsi, that use social networking websites as marketing platforms must now comply with the requirements set forth in the CAN-SPAM Act.[100]

A. The MaxBounty *Conclusion is Not Consistent with Congress's Intent to Mitigate the Volume of Unsolicited Electronic Messages on the Internet*

Including messages sent to Facebook Walls and News Feeds as part of the definition of "electronic mail messages" is not consistent with Congress' intent to mitigate unsolicited electronic messages because (1) the requirements with which commercial electronic mail messages must comply were not intended for messages sent to Facebook Walls and News Feeds[101] and (2) the language Congress used in discussing the purpose of the CAN-SPAM Act does not correspond to these messages.[102] Although the court in *MaxBounty* ruled only on messages sent to Facebook Walls and News Feeds, it is important to also analyze messages sent to Twitter Timelines[103] because these messages may also fall under the purview of the Act.[104]

---

[98] *How It Works*, *supra* note 17.

[99] Facebook, Inc. v. MaxBounty, Inc., 274 F.R.D. 279, 284 (N.D. Cal. 2011) ("A determination that the communications at issue here are 'electronic messages' thus is consistent with the intent of Congress.").

[100] 15 U.S.C. § 7704.

[101] *See generally* 15 U.S.C. § 7701 (stating Congress's findings and policy underlying the CAN-SPAM Act).

[102] *See* S. REP. NO. 108-102, at 3 (2003) (discussing the Act in terms not consistent with messages sent to Facebook Walls and News Feeds).

[103] *Help Center – What is a Timeline?*, TWITTER, https://support.twitter.com/groups/31-twitter-basics/topics/109-tweets-messages/articles/164083-what-is-a-timeline (last visited Oct. 21, 2011) ("A timeline is a Twitter term used to describe a collected stream of Tweets listed in real-time order.").

[104] *See* Klausner, *supra* note 12 (suggesting that recent court decisions are moving toward a broader application of the CAN-SPAM Act to include messages sent to other social networking websites, not just Facebook and Twitter).

1. The CAN-SPAM Requirements Were Not Intended to Regulate Messages Sent to Facebook Walls and News Feeds or Twitter Timelines

i. No Deceptive Subject Lines

The CAN-SPAM Act requires all that commercial electronic mail messages accurately reflect the information in the subject line so as to not misrepresent the content of the message.[105] However, subject lines do not exist on messages sent to Facebook Walls and News Feeds[106] or Twitter Timelines.[107] In fact, not even messages that are sent directly to another user on Facebook and Twitter, and perhaps more closely resemble traditional e-mail messages, contain subject lines.[108]

ii. No Transmission After Opting Out

The Act requires that a sender stop sending unsolicited messages within ten business days of receiving an opt-out request from a recipient.[109] However, this requirement does not apply to messages sent to Facebook Walls and News Feeds because the recipient controls the messages he receives and does not rely on the sender to stop sending messages.[110] Similarly, on Twitter, if a recipient wishes to stop receiving Tweets from a sender, the recipient simply stops following that sender.[111]

---

[105] 15 U.S.C § 7704(a)(2).

[106] *See What Can I Do on the Wall (timeline)?*, *supra* note 6 (indicating that a user utilizes the "share menu," which does not contain a subject line, to post and share content that can then appear on his friends' News Feeds).

[107] *See Help Center – How to Post a Tweet*, TWITTER, https://support.twitter.com/groups/31-twitter-basics/topics/109-tweets-messages/articles/15367-how-to-post-a-tweet (last visited Oct. 21, 2011) (displaying an image of the "What's happening?" box that appears at the top of a user's home page and showing that it has no subject line).

[108] *See Help Center – Why Don't Messages Have Subject Lines?*, FACEBOOK, http://www.facebook.com/help/?page=18845 (last visited Oct. 21, 2011) (explaining that private messages do not contain subject lines in order to make conversations easier to read); *Help Center – What Is a Direct Message? (DM)*, TWITTER, https://support.twitter.com/groups/31-twitter-basics/topics/109-tweets-messages/articles/14606-what-is-a-direct-message-dm (last visited Oct. 21, 2011) (showing an image of a Direct Message, which closely resembles a Tweet and has no subject line).

[109] 15 U.S.C. § 7704(a)(4).

[110] *See Help Center – How Do I Control What I See in My News Feed?*, FACEBOOK, http://www.facebook.com/help/?page=878 (last visited Oct. 21, 2011) (providing two ways to stop receiving another user's messages: filtering by friend lists and hiding a person); *Help Center – How Do I Stop Receiving Updates from a Page?*, FACEBOOK, http://www.facebook.com/help/?page=903 (last visited Oct. 21, 2011) (last visited Oct. 21, 2011) (informing a user who no longer wishes to receive updates from a Page to unsubscribe from that Page).

[111] *See Help Center – How to Unfollow Users on Twitter*, TWITTER, https://support.twitter.com/groups/31-twitter-basics/topics/108-finding-following-

iii. Requiring Identifiers, Opt-out Notices, and Valid Physical Addresses

The Act requires that an electronic mail message include: (a) clear and conspicuous identification that the message is an advertisement;[112] (b) clear and conspicuous notice for a recipient to opt-out;[113] and (c) the sender's valid physical postal address.[114] However, requiring that messages sent to Facebook Walls and News Feeds include an identifier, opt-out notice, and a valid physical address would be incredibly cumbersome and almost defeat the purpose of marketing on Facebook.[115] At a minimum, the required information would probably include the following: "This message is an advertisement. If you no longer wish to receive messages from us, click *here*. Widgets, Inc., 1234 Main Street, Anywhere, US 12345." This message contains 149 characters, which is just over one-third of the Facebook message character limit.[116] Moreover, using the same example, complying with these requirements would be practically impossible for messages sent to Twitter Timelines because Tweets are limited to 140 characters.[117]

Were Congress truly concerned about "[undermining] the usefulness and efficiency" of electronic communication, it would not impose an obligation requiring additional information and, thereby, limit the efficiency of communicating on social networking websites.[118] Social networking websites, such as Facebook and Twitter, are popular with businesses because they allow businesses to communicate efficiently with customers,[119] so it is unlikely that Congress intended to destroy the very

---

people/articles/15355-how-to-unfollow-users-on-twitter (last visited Oct. 21, 2011) (stating that a user can "unfollow" another for any reason and providing guidelines for users who suspect spam).

[112] 15 U.S.C. § 7704(a)(5)(A)(i).

[113] *Id.* § 7704(a)(5)(A)(ii).

[114] *Id.* § 7704(a)(5)(A)(iii).

[115] *See* Brennan, *supra* note 91 at 8-9 (discussing that businesses view direct and quick communications with customers as benefits and goals of marketing on social networking websites).

[116] *See* Fatima, *Character Counter for Your Facebook Status Message in Firefox, Addictive Tips*, ADDICTIVE TIPS (May 12, 2011), http://www.addictivetips.com/internet-tips/character-counter-for-your-facebook-status-message-in-firefox/ (stating that Facebook messages are limited to 420 characters).

[117] *See Help Center – About Tweets*, TWITTER, https://support.twitter.com/groups/31-twitter-basics/topics/109-tweets-messages/articles/127856-about-tweets-twitter-updates (last visited Oct. 21, 2011) (last visited Oct. 21, 2011) (indicating that the purpose of the 140-character limit is to "keep it short and sweet").

[118] *See* S. REP. No. 108-102, at 6 (2003) (implying the need for Congress to act to control the massive volumes of spam that impose significant economic burdens and threaten the "usefulness and efficiency" of e-mail).

[119] *See* Brennan, *supra* note 91, at 8 (noting that companies embrace social

thing it was trying to protect, which was "an extremely important and popular means of communication . . . [that is] extremely convenient and efficient . . . [and] offer[s] unique opportunities for the development and growth of frictionless commerce."[120]

2. The Language Congress Used in Discussing the CAN-SPAM Act Does Not Correspond to Messages Sent to Facebook Walls and News Feeds or Twitter Timelines

When Congress discussed the need for passing the CAN-SPAM Act, it used language that does not correspond to messages sent to Facebook Walls and News Feeds or Twitter Timelines.[121] For instance, when describing issues related to spam, Congress expressed the concern that recipients could not manage "the constant inflow of spam into an e-mail inbox."[122] While this is a valid concern for traditional e-mail users, it is not one for Facebook users because Facebook users do not manage messages sent to their Walls or News Feeds in an "inbox," and, therefore, do not manage the "inflow of spam" in this manner.[123] Furthermore, messages on News Feeds are constantly changing as friends post new updates, so messages do not remain in a stationary location.[124] Similarly on Twitter, users do not manage their Tweets in an "inbox."[125] Instead, a recipient views Tweets in a Timeline, which also constantly changes, and from there can decide what Tweets to remove.[126]

Additionally, Congress stated that spam messages deceived recipients because recipients "[could not] often tell without opening the individual

---

networking websites because the websites create an "interactive community where [businesses and customers] can communicate, share, post, blog, and create content in real time").

[120] 15 U.S.C. § 7701(a)(1).

[121] *See* S. REP. NO. 108-102, at 3 (2003) (using terms and phrases, such as "inbox" and "opening a message," that are specific to traditional e-mail messages). *But see* MySpace, Inc. v. Wallace, 498 F. Supp. 2d 1293, 1300 (declaring that Congress was aware of the various forms of electronic communications when it passed the CAN-SPAM Act, so the Act encompasses more than just traditional e-mail messages).

[122] S. REP. NO. 108-102, at 3.

[123] *See Help Center – How Do I Remove a Wall Post or Story?*, FACEBOOK, http://www.facebook.com/help/?page=820 (last visited Oct. 21, 2011) (informing users that clicking on the "x" that appears on the message enables users to manage their messages).

[124] *See Help Center – What is News Feed?*, FACEBOOK, http://www.facebook.com/help/?page=408 (last visited Oct. 21, 2011) (describing "News Feed" as a "constantly updating list of stories from people and Pages that [the user follows]").

[125] *See How to Unfollow Users on Twitter*, *supra* note 111 (inferring that users manage their Tweets in a Timeline by "unfollowing" a user).

[126] *Id.*; *What is a Timeline?*, *supra* note 103.

messages" what the messages actually contained.[127] However, messages sent to Facebook Walls and News Feeds are not "opened"; once sent, the messages automatically appear in the Wall or News Feed, so the recipient can immediately tell what the messages contain.[128] Likewise on Twitter, Tweets sent to a recipient automatically appear in his Timeline, so the recipient can view a Tweet without having to "open" it.[129]

Despite the arguments against including messages sent to Facebook Walls and News Feeds and Twitter Timelines, businesses marketing on Facebook and Twitter must likely comply with the requirements set forth in the CAN-SPAM Act.[130] This Comment will now analyze and discuss why Pepsi is one such business.

B. Pepsi's Refresh Project Messages Sent to Facebook and Twitter Must Now Comply with the CAN-SPAM Act

This Comment begins its analysis by applying the private right of action tests discussed in Part II to Facebook and Twitter, the primary social networking websites used in the Refresh Project.[131] It then determines that both Facebook and Twitter would have standing to bring forth action under the CAN-SPAM Act.[132]

1. Facebook Would Have Standing to Bring Forth Action Under the CAN-SPAM Act

i. Facebook is an Internet Access Service Provider

Facebook is an Internet access service provider and would, therefore, have standing to bring forth action under the CAN-SPAM Act.[133] Facebook is considered an "Internet access service provider" because even though Facebook does not provide users an initial connection point to the Internet, it does allow users to "access content, information, electronic

---

[127] S. Rep. No. 108-102, at 3.

[128] *See Help Center – What Happens When I Create Content on My Wall (timeline)?*, FACEBOOK, https://www.facebook.com/help/?faq=229002897114226#What-happens-when-I-create-content-on-my-Wall-(timeline)? (last visited Nov. 11, 2011) (explaining that when a user updates his status, Facebook generates a message on the News Feeds of the user's friends).

[129] *See What is a Timeline?*, *supra* note 103 (indicating that a Timeline shows a stream of Tweets in real-time order from people a user follows).

[130] 15 U.S.C. § 7704 (2006).

[131] *Id.* § 7706(g)(1).

[132] *Id.*

[133] *See* Facebook, Inc. v. ConnectU LLC, 489 F. Supp. 2d 1087, 1094 (N.D. Cal. 2007) (finding that the language of the Act is broad enough to encompass Facebook as an Internet access service provider because Facebook provides further access to content and communications on the Internet).

mail, [and] other services" on the Internet.[134] Facebook provides users access to content and information about other Facebook users, which include friends they follow and pages they "like."[135] Additionally, Facebook enables users to view electronic mail that are privately sent to them on Facebook.com.[136] Facebook also connects users to other services on the Internet, such as a chat feature,[137] video call,[138] and games and applications.[139]

ii. Facebook Could be Adversely Affected by the Refresh Project Messages

Facebook could be adversely affected by the Refresh Project messages because these messages could be considered a burden "beyond the mere annoyance of spam."[140] Millions of messages are transmitted as a result of the Refresh Project,[141] which could lead Facebook's Security Team[142] to expend additional resources to update anti-spam efforts, increase server bandwidth to support the volume of messages, and incur costs to maintain

---

[134] *Id.*; 47 U.S.C. § 231(e)(4).

[135] *See* Facebook, FACEBOOK, http://www.facebook.com/facebook?sk=info (last visited Nov. 7, 2011) (boasting that millions of people use Facebook to keep up with friends, share links and videos, and learn about other people).

[136] *See Help Center – Messages*, FACEBOOK, http://www.facebook.com/help/?page=184809401568848 (last visited Nov. 7, 2011) (noting that users can exchange private messages, e-mails, and mobile texts with their friends).

[137] *See Help Center – Chat and Video Calling*, FACEBOOK, http://www.facebook.com/help/?page=168570673202050 (last visited Nov. 7, 2011) (describing "chatting" as a form of instant messaging with other users).

[138] *See Help Center – What is Video Calling?*, FACEBOOK, https://www.facebook.com/help/?faq=124810367603371#What-is-video-calling? (last visited Nov. 7, 2011) (indicating that "video calling" allows users to talk to each other face-to-face).

[139] *See Help Center – What is an App on Facebook?*, FACEBOOK, https://www.facebook.com/help/?faq=217453588274571#What-is-an-app-on-Facebook? (last visited Nov. 7, 2011) (explaining that "apps" allow users to play games, remember birthdays, send gifts, and much more).

[140] *See* Gordon v. Virtumundo, Inc., 575 F.3d 1040, 1053-54 (9th Cir. 2009) (asserting that to satisfy the Act's standing provision the harm to an Internet access service provider must be "something beyond a mere annoyance of spam").

[141] *See* Jennifer Preston, *Pepsi Bets on Local Grants, Not the Super Bowl*, N.Y. TIMES, Jan. 30, 2011, at B4, *available at* http://www.nytimes.com/2011/01/31/business/media/31pepsi.html (announcing that nineteen percent of the seventy-seven million Refresh Project votes (or 14,630,000 votes) were cast through Facebook as of January 2011).

[142] *See* Elinor Mills, *At Facebook, Defense is Offense*, CNET NEWS (Jan. 31, 2011, 4:00 AM), http://news.cnet.com/8301-27080_3-20029954-245.html (crediting Facebook's Security Team for "trying to prevent financially motivated scammers from taking over user accounts and distributing spam").

and repair the servers.[143] Furthermore, even though Facebook is a leader in social networking,[144] the large amount of Refresh Project messages could contribute to the erosion of Facebook's reputation, if the messages are seen as spam.[145]

2. *Twitter Would Have Standing to Bring Forth Action Under the CAN-SPAM Act*

i. *Twitter is an Internet Access Service Provider*

Twitter would have standing under the CAN-SPAM Act because it is a social networking website that provides further access to "content, information, electronic mail, [and] other services" on the Internet and, therefore, qualifies as an Internet access service provider.[146] Even though Twitter is not a traditional Internet access service provider, such as America Online, it allows users to view content and information about other Twitter users and popular topics online.[147] Additionally, Twitter provides users with access to electronic mail and to other services, such as Twitter's link shortening service.[148]

---

[143] *See* Spencer E. Ante, *Facebook is Hunting for More Money*, BLOOMBERG BUSINESSWEEK (March 26, 2009, 2:15 PM), http://www.businessweek.com/technology/content/mar2009/tc20090326_604141.htm (analyzing the tens of millions of dollars Facebook spends a year on computer servers, storage, electricity, and Internet bandwidth to support its growing volume of users and data transmitted); *see also* Complaint at 9, Facebook, Inc. v. Guerbuez, No. C08-03889 JF HRL (N.D. Cal. Dec. 10, 2008), 2008 U.S. Dist. LEXIS 108924 (claiming that Guerbuez's four million spam messages to Facebook.com cost Facebook a great deal of time and money in monitoring, reviewing, and attempting to eradicate the messages).

[144] *See* Facebook, N.Y. TIMES, *supra* note 5 (reporting that Facebook had 800 million users as of September 2011).

[145] *See* Facebook, Inc. v. Fisher, No. C 09-05842 JF (PVT), 2009 WL 5095269, at *1, *2 (N.D. Cal. Dec. 21, 2009) (recognizing that spamming can result in injury to a company's reputation); *see also* Complaint at 9, *Guerbuez*, No. C08-03889 JF HRL (claiming that Facebook suffered significant harm to its reputation and goodwill because of the four million spam messages the defendant sent).

[146] 47 U.S.C. § 231(e)(4) (2006); *see* MySpace, Inc. v. TheGlobe.com, Inc., No. CV 06-3391-RGK (JCx), 2007 WL 1686966, at *1, *3 (C.D. Cal. Feb. 27, 2007) (holding that social networking websites fall under the Act's broad definition of Internet access service provider).

[147] *See* About, TWITTER, http://twitter.com/about#about (last visited Nov. 7, 2011) (pointing out that some Twitter users never actually Tweet and instead use Twitter as a means to get the latest information about their interests); *Help Center – About Trending Topics*, TWITTER, https://support.twitter.com/groups/31-twitter-basics/topics/111-features/articles/101125-about-trending-topics (last visited Oct. 21, 2011) (describing the "Trending Topics" feature as a way for users to find out about the "most tweeted" topics and "most breaking" news stories from around the world).

[148] *See What is a Direct Message?*, *supra* note 108; *see Help Center – About Twitter's Link Service*, TWITTER, https://support.twitter.com/groups/31-twitter-basics/topics/111-features/articles/109623-about-twitter-s-link-service-http-t-co (last visited Nov. 7, 2011) (providing that the link shortening service not only shortens

ii. Twitter Could be Adversely Affected by the Refresh Project Messages

Twitter could be adversely affected by the growing volume of Refresh Project Tweets that are transmitted.[149] Not only are the participants steadily sending Tweets to promote their ideas and obtain votes, the Project's popularity has also led to an increase in the number of users following Pepsi's Twitter page.[150] While this growing popularity is good news for Pepsi, the increased volume of Tweets could require Twitter to invest in additional network equipment to compensate for the added traffic.[151] The increased volume would likely create additional work for Twitter's Trust and Safety division,[152] which is the body responsible for reviewing the messages and determining whether the messages are spam and warrant account termination.[153] Furthermore, Refresh Project messages that include hashtags[154] and encourage retweeting could be mistaken for spam and result in further scrutiny and review by the Trust

---

URLs that appear in Tweets, but also helps protect users from malicious websites).

[149] *See Pepsi Refresh Project – Huge Potential Viral Marketing Success*, ONLINE PR MEDIA (Feb. 13, 2010), http://www.onlineprnews.com/news/21625-1266081151-pepsi-refresh-project-huge-potential-viral-marketing-success.html (praising the Refresh Project as a "viral marketing success" and noting the growing number of Twitter feeds as a result).

[150] *See Pepsi Refresh: Failure of Marketing or Social Media?*, BHATNATURALLY (Apr. 2, 2011), http://www.lbhat.com/advertising/pepsi-refresh-failure-of-marketing-or-social-media/ (reporting that Pepsi's Twitter page reached 60,000 followers as a result of the Refresh Project campaign).

[151] *Cf.* Jennifer Valentino-DeVries, *Twitter Servers Can't Keep Up With World Cup Traffic*, WALL ST. J. BLOG (June 16, 2010, 1:37 PM), http://blogs.wsj.com/digits/2010/06/16/twitter-servers-cant-keep-up-with-world-cup-traffic/ (revealing that Twitter engineers were held with the daunting task of fixing server outages due to heavy traffic during the World Cup).

[152] *See* Delbius, *WDYDWYD?*, DELBIUS TUMBLR (June 15, 2010), http://delbius.tumblr.com/post/702546189/wdydwyd (relaying the Trust and Safety teams mission statement as "[keeping] user trust and [protecting] user's rights" and describing the spam team as a division dedicated to fighting spam, phishing, hacking, and malware issues); *see also* Charles Arthur, *Spam, Spam, Spam: Twitter's Arms Race*, GUARDIAN (Apr. 7, 2011, 5:26 AM), http://www.guardian.co.uk/technology/2011/apr/07/twitter-internet (indicating that the Trust and Safety division grew from one member to thirty members in the last three years to fight the increasingly sophisticated spamming techniques).

[153] *See* Michael Learmonth, *"LOL is This You?" Twitter Getting Serious About Spam Issue*, ADVER. AGE DIGITAL (Mar. 15, 2010), http://adage.com/article/digital/digital-marketing-twitter-spam-issue/142800/ (reporting that the Trust and Safety division takes appropriate measures before terminating an account for spam and that each complaint about a wrongful termination is reviewed manually).

[154] *See Help Center – What are Hashtags ("#" Symbols)?*, TWITTER, https://support.twitter.com/articles/49309-what-are-hashtags-symbols (last visited Sept. 17, 2011) (describing "hashtags" as "#" symbols used to mark keywords or topics in a Tweet); see also Preston, *supra* note 141 (implying that Pepsi urged Refresh Project participants to use the hashtag "#PepsiRefresh").

and Safety division.[155]

After determining that Facebook and Twitter have standing under the CAN-SPAM Act, this Comment argues that the Refresh Project messages are commercial electronic mail messages the Act seeks to regulate.[156]

C. The Refresh Project Messages Are Commercial Electronic Mail Messages and, Therefore, Fall Under the Purview of the CAN-SPAM Act

1. The Refresh Project Participants Are "Initiators" and Pepsi Is a "Sender"

The CAN-SPAM Act would apply to both Pepsi and the Refresh Project participants.[157] To begin, Pepsi acts as a "sender" on both Facebook and Twitter because it is the entity "whose product . . . is . . . promoted by the commercial message."[158] Upon clicking on the link to vote that is provided in messages on Facebook or Twitter, users are redirected to the Refresh Project website. The website not only contains a similar blue background and heading as the official Pepsi website,[159] it also generously displays the Pepsi name and logo and images of Pepsi beverages.[160] Additionally, the Refresh Project website includes links to the official Pepsi website, where visitors can purchase Pepsi merchandise,[161] and to the Pepsi YouTube pages, where visitors watch featured commercials of celebrity icons promoting Pepsi beverages.[162] Even the messages sent by Refresh Project participants requesting votes often contain the Pepsi name and logo, which further exposes the Pepsi brand to the public.[163]

The Refresh Project participants serve as "initiators" because they

---

[155] *See* Charlotte McEleny, *Brands on Twitter Risk Being Labeled as Just Spammers*, NEW MEDIA AGE, Aug. 6, 2009, at 4, 4 (asserting that brands that use hashtags and retweets are often seen as spam marketers); *accord Competitions Using Hashtags on Twitter are Seen as Spam*, NEW MEDIA AGE, Aug. 13, 2009, at 4, 4.

[156] 15 U.S.C. § 7702(2) (2006).

[157] *See* Trigg, *supra* note 67, at 15-16.

[158] *Id.* at 16.

[159] PEPSI, http://www.pepsi.com/?noredir=1 (last visited Nov. 10, 2011).

[160] PEPSI REFRESH PROJECT, http://www.refresheverything.com (last visited Nov. 7, 2011).

[161] *See* PEPSI, *supra* note 159 (displaying a menu on the left-hand side of the main page titled "Pepsi Shop," where visitors can purchase clothing, "drinkware," and vintage totes).

[162] *See* Pepsi's Channel, YOUTUBE, http://www.youtube.com/pepsi (showing video clips of Michael Jackson, Brittany Spears, and Mariah Carey promoting Pepsi drinks).

[163] *E.g.* OurDelavanPRP (pepsi refresh project), FACEBOOK, http://www.facebook.com/#!/pages/OurDelavanPRP-pepsi-refresh-project/159838897362453 (last visited Nov. 7, 2011).

perform the act of sending the promotional messages on behalf of Pepsi.[164] Even though Pepsi does not "hire" the participants to coordinate the marketing campaign,[165] Pepsi does select these participants through an application process.[166] Once selected, the participants proceed to ask friends and followers on Facebook and Twitter to vote for their Pepsi Refresh ideas and share or retweet the messages.[167] These activities "promote" Pepsi's products because the requests often provide a link that redirects the voters to the Refresh Project website and feature Pepsi's name and logo; further, the identifiers for the sender may also contain Pepsi's name and logo.[168] Facebook friends and Twitter followers that continue to share and retweet the participants' messages with other users are not "initiators" because while they do not "merely [engage] in routine conveyance" of the messages,[169] they were not selected, or "hired," by Pepsi to participate in the campaign.[170] Additionally, given the popularity of the Refresh Project and the ease of sharing information on social networking websites, the task of tracking each friend or follower who shares participants' ideas across the Web is virtually impossible.[171]

2. *The Refresh Project Messages Are "Commercial" Messages*

The messages sent through the Refresh Project are "commercial" messages because their primary purpose is to promote Pepsi's brand and beverages, which are commercial products.[172] Although the campaign appears to be more of a charitable campaign because it funds ideas that

---

[164] *See* Trigg, *supra* note 67, at 15-16 (listing various scenarios where an initiator can send promotional messages on behalf of another entity).

[165] *See* S. REP. NO. 108-102, at 15 (2003) (establishing that if one company "hires" another to handle its marketing campaign, the "hired" company is an "initiator").

[166] *See How It Works*, *supra* note 17 (displaying one of the first steps of the Refresh Project as submitting an application from which Pepsi chooses its participants).

[167] *See Workin' the Web*, *supra* note 96 (reminding participants that the more they engage their social networks, the more votes they will likely receive).

[168] *See* OurDelavanPRP (pepsi refresh project), *supra* note 163 (representing an example of a participant who included the Pepsi name and logo as part of his Facebook profile picture and username which act as identifiers). *But see* Burge Bird Rescue, FACEBOOK, http://www.facebook.com/pages/OurDelavanPRP-pepsi-refresh-project/159838897362453#!/pages/Burge-Bird-Rescue/75904893556 (last visited Nov. 7, 2011) (displaying only the name and logo of the non-profit organization competing for a Pepsi grant).

[169] S. REP. NO. 108-102, at 15 (emphasizing the technical characteristics associated with "routine conveyance").

[170] *Cf. id.* (explaining that an entity hired or otherwise induced by another to send marketing messages is an "initiator").

[171] *See* Preston, *supra* note 141 (announcing that as of January 2011, seventy-seven million votes were cast).

[172] *See generally* 15 U.S.C. § 7702(2)(A) (2006).

support a good cause, the ultimate goal of the Refresh Project is to serve as a marketing tool.[173] For one, the funds to support the ideas come out of Pepsi's marketing budget.[174] Additionally, Pepsi launched the Refresh Project in lieu of purchasing advertising time during the Super Bowl, which further illustrates that Pepsi's primary purpose was to promote its brand and products.[175] The participants' messages are the result of this endeavor, but the messages themselves also contain their own commercial qualities: the messages urge friends and followers to visit the Refresh Project website, a commercial website, to vote for their ideas.[176]

The Refresh Project messages are not "transactional or relationship" in nature because the messages are not between parties that have engaged in a previous business relationship, such as that of a vendor and a customer where the exchange of receipts, account statements, and product recall notices would likely be viewed as part of a previous transaction.[177] Moreover, the recipient would likely interpret the Refresh Project messages as commercial because these messages often times contain commercial content, namely the Pepsi brand name and logo, in the body of the messages and even as part of the username and profile picture.[178] Furthermore, a recipient who wishes to vote for an idea is redirected to the Refresh Project website, where he immediately sees "Pepsi.com" the top of the page, accompanied by a red, white, and blue Pepsi logo that is a stark contrast to the light blue background.[179] The logo is located at the top of the page, making it unlikely for the recipient not to interpret the content as commercial.[180]

---

[173] *See* Zmuda, *supra* note 94 (calling Pepsi's Refresh Project a "case for marketing textbooks").

[174] *See id.* (noting that Pepsi shifted as much as one-third of its marketing budget to support interactive and social media initiatives).

[175] *See* Gregory, *supra* note 15 (stating that after twenty-three years of memorable Super Bowl commercials that included images ranging from Cindy Crawford to dancing bears, Pepsi decided skip the 2010 Super Bowl).

[176] *See* S. REP. NO. 108-102, at 14 (2003) (indicating that a message urging a recipient to visit a commercial website is the same as one urging the purchase of a product).

[177] *See id.* at 16 (explaining that transaction or relationship messages should be related to some sort of business relationship or transaction between the parties).

[178] *See* OurDelavanPRP (pepsi refresh project), *supra* note 163 (serving as an example of a Refresh Project participant's message containing both the Pepsi brand name and logo).

[179] *See* Tranquil Space Foundation, PEPSI REFRESH PROJECT, http://www.refresheverything.com/tsfound (last visited Nov. 10, 2011) (serving as an example of the Refresh Project page a voter is redirected to once he clicks on the link to vote for the idea).

[180] *Id.*

3. Before MaxBounty, *Refresh Project Messages Would Not Have Fallen Under the CAN-SPAM Definition of "Electronic Mail Messages"*

Prior to *MaxBounty*, the Refresh Project messages would not have been considered "electronic mail messages" as defined by the CAN-SPAM Act because these messages are not traditional e-mail messages.[181] Previously, the *Wallace* and *TheGlobe.com* courts expanded the definition of "electronic mail message" beyond traditional e-mail to include social networking website messages, but only to the extent that the messages were sent to a user's inbox.[182] The courts in *Wallace* and *TheGlobe.com* concluded that an inbox was an "electronic mail address" and, thus, considered messages sent to a MySpace inbox to be "electronic mail messages."[183] Therefore, because the Refresh Project messages were sent to Walls, News Feeds, and Timelines, and not to inboxes, the messages would not have been considered "electronic mail messages" prior to the *MaxBounty* decision.

4. After MaxBounty, *Refresh Project Messages Are Considered "Electronic Mail Messages" Under the CAN-SPAM Act*

Like the messages in *MaxBounty*, the Refresh Project messages would be considered "electronic mail messages" because these messages are, in fact, sent to "unique electronic mail addresses," as determined by the *MaxBounty* court.[184] Participants transmit messages from their Facebook accounts to a recipient's Facebook Wall and News Feed, an act that requires "at least some routing activity on the part of Facebook."[185] Similarly, because Twitter is also a social networking website involved in

---

[181] MySpace, Inc. v. TheGlobe.com, No. CV 06-3391-RGK (JCx), 2007 WL 1686966, at *1, *4-5 (C.D. Cal. Feb. 27, 2007) (concluding that messages sent to an inbox in MySpace were "electronic mail messages" under the CAN-SPAM Act); *accord* MySpace, Inc. v. Wallace, 498 F. Supp. 2d 1293, 1300-01 (C.D. Cal. 2007).

[182] TheGlobe.com, 2007 WL 1686966, at *4-5; Wallace, 498 F. Supp. 2d at 1300-01; *see* Facebook, Inc. v. MaxBounty, Inc., 276 F.R.D 279, 282 (N.D. Cal. 2011) (recognizing that no other court in the Ninth Circuit had addressed social networking communications that were not delivered to an inbox).

[183] *See Wallace*, 498 F. Supp. 2d at 1300-01 (determining that MySpace messages resided on a unique URL, which included a string of characters containing the username and reference to the domain "myspace.com"); *see also* TheGlobe.com, 2007 WL 1686966, at *4-5 (concluding that MySpace messages resided at a unique URL and the Internet destination, www.myspace.com).

[184] *See MaxBounty, Inc.*, 276 F.R.D, at 283 (finding that Facebook Walls and News Feeds qualify as "unique electronic mail addresses because Facebook was involved in the routing activity). *But see* Liisa M. Thomas, Sending Marketing Messages Within Social Media Networks, 14 J. INTERNET L. 3, 4 (2010) (doubting that messages sent by Facebook Pages would not fall under CAN-SPAM because Pages cannot send private messages to users).

[185] *MaxBounty, Inc.*, 276 F.R.D, at 283-84.

routing messages to a location other than an inbox, i.e. a Timeline, it is likely that a court would also qualify Tweets as "electronic mail messages."[186]

IV. CONGRESS OR THE FTC SHOULD ACT TO ADDRESS POTENTIAL ISSUES BUSINESSES FACE AFTER *MAXBOUNTY*

The interpretation that messages sent to Facebook Walls and News Feeds fall under the definition of "electronic mail messages" will prove to be burdensome for businesses using social networking websites as marketing platforms because these messages would now have to comply with the requirements in the CAN-SPAM Act.[187] In some cases, compliance may not be possible and could ultimately lead to businesses violating the requirements of the Act.[188] The following recommendations provide a possible solution to this problem: (1) Congress should amend the requirements with which all commercial electronic mail messages must comply to include requirements that are specific to messages sent to social networking websites[189] or (2) the FTC should provide specific compliance guidelines for businesses that use social networking websites to market their products and services.[190]

A. Congress Should Amend the CAN-SPAM Act Requirements to Include Specific Requirements for Commercial Electronic Mail Messages

Congress should amend 15 U.S.C. § 7704 to include requirements that are specific to messages sent to social networking websites by making legislative changes to the statute.[191] Specifically, Congress should amend the requirement prohibiting deceptive subject lines[192] and the requirement for including clear and conspicuous identification that the message is an advertisement.[193]

Because subject lines do not exist for messages sent to Facebook Walls, News Feeds, or Twitter Timelines, complying with the requirement that

---

[186] *See id.* (recognizing that *any* routing by an Internet access service provider, which includes a social networking website, is sufficient to qualify as an "electronic mail message").

[187] 15 U.S.C. § 7704; *See* Baer, *supra* note 13 (asserting that extending CAN-SPAM to social networking websites would be "a massive headache . . . for marketers").

[188] 15 U.S.C. § 7704.

[189] *Id.* § 7704(a)(3), (5).

[190] *Id.* § 7704(a)(5)(A)(i)–(iii).

[191] *See id.* at § 7704 (showing no language or provision specifically addresses messages sent to social networking websites).

[192] *Id.* § 7704(a)(3).

[193] *Id.* § 7704(a)(5).

prohibits deceptive subject lines would be impossible.[194] Congress should amend this requirement by excluding messages that are sent to social networking websites and providing a legal definition that differentiates these messages from traditional e-mail messages.[195] If the Act forces social networking websites to comply with the subject line requirement, it essentially forces the websites to include message subject lines, which would undermine the efficiency and innovative technology of marketing on social networking websites.[196]

On the other hand, recommending that Congress exclude messages sent to social networking websites from complying with the subject line requirement of the Act may leave a gap open for creative and sophisticated spammers to exploit.[197] Additionally, Congress may find itself drafting a new definition every several years to accommodate the technological advances in the Internet messaging world, making the legislative process inefficient and keeping spammers ahead of law enforcement.[198] Nevertheless, Congress must act to help businesses comply with the subject line requirement; therefore, messages sent to social networking websites should be excluded from the subject line requirement.[199]

Congress should also amend the requirement for including "clear and conspicuous identification that the message is an advertisement"[200] by requiring that messages sent to social networking websites include an acronym, designating it as an advertisement.[201] The designation would allow businesses to identify the message as an advertisement and businesses would be free from violating the identification requirement.[202] While including the acronym is an additional step, it would take up very

---

[194] *Id.* § 7704(a)(3).

[195] *See id.* § 7704 (omitting language that specifically excludes messages sent to social networking websites as complying entities and that legally defines these messages).

[196] *See Why Don't Messages Have Subject Lines?*, *supra* note 108 (explaining that these messages no longer exist because it makes conversations more efficient and easier to read).

[197] *See* Arthur, *supra* note 152 (citing the head of Twitter's Trust and Safety Team who stated that spammers have evolved and become increasingly more sophisticated over the years).

[198] *See* Paul K. Ohm, *On Regulating the Internet: Usenet, A Case Study*, 46 UCLA L. REV. 1941, 1961 (1999) (declaring that lawmaking is a slow process that has trouble keeping pace with the rapid shifts in technology).

[199] 15 U.S.C. § 7704(a)(3).

[200] *Id.* § 7704(a)(5).

[201] *See* Fairfield, *supra* note 30, at 1238 (citing several state statutes that regulate spam and finding that the label "ADV" is a useful designation to show that the message is an advertisement).

[202] *Id.*

little time and character space[203] and would not be overly burdensome on businesses.

B. *The FTC Should Provide Additional Guidelines for Messages Sent to Social Networking Websites*

If Congress does not amend the Act, the FTC should provide businesses that send marketing messages to social networking websites with guidance on how to comply with the requirements.[204] Specifically, the FTC should clarify how these messages would comply with current disclosure requirements, such as inclusion of a clear and conspicuous identification that the message is an advertisement,[205] a clear and conspicuous notice to opt-out,[206] and a valid physical address of the sender.[207] The FTC could suggest the use of URL shorteners[208] to ensure that the required information is available on another website and to minimize the number of characters used. Messages sent to social networking websites have character limitations that would be exceeded if the full text required by the Act had to be included.[209] URL shorteners are already popular with businesses that advertise on platforms with limited character space, such as Twitter, so guidance suggesting the use of URL shorteners would not likely burden the businesses.[210] Furthermore, the FTC has already approved the general use of hyperlinks to disclose additional information, so long as the hyperlinks meet the FTC's listed guidelines.[211]

---

[203] *See* Twitter, *supra* note 16 (noting that Tweets are limited to 140 characters); *Fatima*, *supra* note 116 (indicating that Facebook Wall and News Feed messages are limited to 420 characters).

[204] *See* COMPLIANCE GUIDE, *supra* note 69 (excluding CAN-SPAM guidance specifically targeted at messages sent to social networking websites); *see also New FTC Video Helps Businesses Comply with CAN-SPAM Rule*, FTC.GOV (July 14, 2011), http://www.ftc.gov/opa/2011/07/canspam.shtm (displaying a video of how to comply with the CAN-SPAM Act but making no mention of messages sent to social networking websites or the *MaxBounty* decision).

[205] 15 U.S.C. § 7704(a)(5)(A)(i).

[206] *Id.* § 7704(a)(5)(A)(ii).

[207] *Id.* § 7704(a)(5)(A)(iii).

[208] *See* Susan Gunelius, *What is a URL Shortener?*, ABOUT.COM, http://weblogs.about.com/od/twitterfaqs/f/FAQURLShortener.htm (last visited Oct. 31, 2011) (defining a "URL shortener" as an online application that shortens a full URL to an abbreviated version of approximately ten to twenty characters).

[209] *See Twitter*, *supra* note 16 (indicating that Tweets have a limitation of 140 characters); Fatima, *supra* note 116 (stating that messages sent to Facebook Walls and News Feeds are limited to 420 characters).

[210] *See* David Weiss, The Security Implications of URL Shortening Services, UNWEARY (Apr. 3, 2009, 3:41 PM), http://unweary.com/2009/04/the-security-implications-of-url-shortening-services.html (noting that the increase of Twitter's popularity has given rise to more URL shortening services).

[211] *See* FEDERAL TRADE COMMISSION, DOT COM DISCLOSURES: INFORMATION ABOUT

However, the FTC guidance for the CAN-SPAM disclosures in a hyperlink does not specifically mention URL shorteners.[212] Therefore, the FTC has yet to provide guidance about whether URL shorteners qualify as a "clear and conspicuous" means to disclose the required CAN-SPAM information. The FTC may take issue with the fact that the true destination of the URL is not obvious from the URL shortener itself.[213] Additionally, if a URL shortening service is compromised, the URL may redirect recipients to phishing or malware websites.[214] Despite the potential issues with URL shorteners, however, they are convenient and easy to adopt and would be a step in the right direction in assisting businesses with compliance.[215]

CONCLUSION

In conclusion, the continued expansion of the definition of "electronic mail messages" under the CAN-SPAM Act will likely cause issues for businesses that currently use social networking websites as marketing platforms. As the CAN-SPAM Act is written today, businesses are at risk of being in violation. Though a recommendation for Congress to exclude social networking messages from the present law could lead to potential gaps for spammers to exploit, it is one step closer to helping ensure businesses comply with the Act. If Congress does not amend the Act, the FTC should provide guidance suggesting the use of URL shorteners. Although this suggestion could also lead to other potential issues, the suggestion is at least a starting point to assist businesses. Unless Congress amends its requirements or unless the FTC provides additional guidelines, businesses sending these types of messages could face possible penalties and even litigation.

ONLINE ADVERTISING 7-10 (2000) (outlining specific requirements for businesses using hyperlinks to ensure additional CAN-SPAM disclosures are "clear and conspicuous").

[212] *See generally id.* (providing no guidance regarding hyperlinks that are specifically targeted to URL shorteners).

[213] *See* Weiss, *supra* note 210 (pointing out an obvious risk of URL shorteners is that the true URL destination is "opaque").

[214] *See id.* (finding that redirecting recipients to phishing or malware websites is a remote, but valid problem).

[215] 15 U.S.C. § 7704(a)(5)(A)(i)–(iii) (2003).