Legislation Cannot Replace Ethics in Regulatory Reform

A. David Austill, J.D., LL.M., M.B.A., C.P.A.
Professor of Accounting & Business Law
McAfee School of Business Administration
Union University
Jackson, Tennessee 38305
Phone: 1-731-661-5369
Fax: 1-731-661-5366
E-Mail: daustill@uu.edu

Abstract

After one considers all of the technical reasons for the economic melt-down and the collapse of large financial institutions, one is left with some basic conclusions. Perhaps the failure was human; the will to be unethical in ignoring those basic moral and ethical obligations to stakeholders, professional societies, and the public was stronger than legal and regulatory restraints placed on those who collectively caused the crisis. To be sure, there were failures in maintaining statutory or administrative rules and in Congressional oversight and regulatory supervisory process. Even in the absence of adequate rules and governmental supervision, firms in the financial and mortgage lending industries still maintained the ethical requirements of corporate social responsibility. Furthermore, corporate managers, directors, and employees, who were agents of those very firms, owed ethical duties to their firms, owners of those firms, and to society that trusted all of them to do right. In passing the Dodd-Frank Act of 2010, Congress has beefed up regulatory requirements and oversight of mortgage lenders, large financial institutions, and hedge funds. This paper discusses the ethical lapses within the financial industry, the failure of governmental oversight, and some specifics of Dodd-Frank. It reviews the favorable provisions and shortcomings of the new legislation and asks whether the legislation will be effective. Without ethics of the players, it probably will not be effective in the end.

INTRODUCTION

After one considers all of the technical reasons for the economic melt-down and the collapse of large financial institutions, one is left with some basic conclusions. Perhaps the failure was human; the will to be unethical in ignoring those basic moral and ethical obligations to stakeholders and professional societies was stronger than legal and regulatory restraints, as lacking as they may have been, placed on those who collectively caused the crisis. In governmental zeal to remedy regulatory weaknesses in the financial industry, governments overlook the reality that greed, especially when combined with opportunity, can never be completely restrained.

In America one could reasonably conclude that corporate greed unchecked after the repeal of the Glass-Stegall Act, and which was further facilitated by high-tech information systems and financial models, was a principal cause of the melt-down. The ethical duty of due diligence appears to have been met by crunching numbers using models rather than giving common-sense consideration. Algorithms replaced due diligence. This seems to have been the case in making mortgage loans and afterwards in selling securitized mortgage securities and other derivatives. The lack of due diligence laid waste by corporate greed was obvious. Ethical lapses sometimes result from group-think. In group-think persons forego discernment when faced with peer competition or standard behavior. Everyone else does it; therefore, it must be acceptable. Group-think can lead one or the pack to ignore moral and ethical duty—to ignore consequences—when an individual might otherwise have recognized moral duty to stakeholders based on religion, social compact, or Kantian imperative. One can easily conclude group-think lead large financial institutions, their executives, and the financial media to consider the level of earnings as the single most important indicator of the success of those firms and executives.

This paper considers the American experience in dealing with the financial crisis. After a general review of fraud and fiduciary duties, the paper considers the players involved in the financial crisis and weaknesses in regulation, due diligence, and ethics leading to the crisis. A discussion of the America's new financial reform law, the Dodd-Frank Act of 2010, is provided followed by a discussion of whether Dodd-Frank can be effective given the history of ineffective regulation and the propensity for greed.

FRAUD, DUE DILIGENCE, AND FIDUCIARY DUTY

It should be no surprise that fraud within the financial industry was, and remains, a problem that was a significant factor in the meltdown of the financial industry. By no means was fraud the only material reason, however. Fraud is a prime problem in doing business in the United States as it is around the world. Some places are more prone to accepting fraud and corruption as normal business practice than others. For the period from January 2008 to December 2009, the Association of Certified Fraud Examiners conducted a study of 1,843 cases worldwide of occupational fraud (Nilsen, 2010). The study published in its *2010 Report to the Nations on Occupational Fraud and Abuse* (ACFE, 2010) revealed that globally business and other organizations lose about five percent (about \$2.0 trillion (U.S.)) of their annual revenue to fraud. Fraud can be at various levels with the median loss being \$160,000.

Almost one quarter of the frauds involved losses of $1 million. High-level perpetrators do the most damage with fraud committed by owners and executives more than three times as costly as frauds committed by managers and more than nine times as costly as employee frauds. Fraud of executives generally takes longer to detect than fraud of others. This may be explained in part because, when executives commit fraud, there is usually collusion with other key managers within the organization who keep the fraudulent activity secreted.

Financial statement fraud, the type of fraud perpetrated by Countrywide Financial, Enron, WorldCom, and Parmalot, generally does not constitute a significant portion of the types of occupational fraud (4.3 percent). However, in terms of the magnitude of loss of all occupational fraud it represented a median loss almost ten times greater that corruption and 17 times greater than asset misappropriation ($1,730,000, $175,000, and $100,000, respectively) (Nilsen, 2010). Within an organization, occupational frauds usually take place by participants within certain departments of the organization. 72 percent of these frauds were perpetrated by an employee in one of four departments: accounting (24.3%), operations (20.7%), executive or upper management (13.9%), or sales (13.1%) (Nilsen, 2010). Again, Countrywide Financial followed this pattern. Initial detection of occupational fraud is more likely to come via tip (40.2 percent rather than through any other means, for example, management review (15.4 percent), internal audit (13.9 percent), or external audit (4.6 percent). As will be discussed infra, the Dodd-Frank Act provides strong protections of, and inducements for, whistleblowers to do what they should have done, and were ethically obligated to do, without whistleblower statutes.

Professionals have a duty to use due diligence, meaning, to practice their craft with the knowledge and skill of an ordinarily prudent professional in good standing. This is the case for licensed professionals like certified financial analysts. Negligence results when injuries result from the professional's failure to use due diligence. Furthermore, due diligence is a fiduciary duty owed by executives and directors of a company to the company and to company owners. Fiduciary duty goes much farther than due diligence. Generally, directors and officers of corporations are required to act in good faith, to exercise the care an ordinarily prudent person would exercise in similar circumstances, and to do what they believe is in the best interests of the corporation.[1] For example, a manger has a duty of good faith and fair dealing and a duty of loyalty, meaning, to keep the company informed of all material facts, to act in the company's best interests, to protect the assets of the company, not to waste company assets, and not to have a conflict of interest with the company. These are legal duties as well as ethical duties. Even without governmental regulation these duties still existed. Even though a corporate manager may perceive pressure from shareholders or superiors or the financial press to increase profits, and even if other companies within the industry are participating in the activity, these circumstances do not alter the manager's fiduciary duty.

Directors and officers who fail to meet these fiduciary duties resulting in damage to the corporation or its shareholders may be held liable for negligence. The business judgment rule may act as a defense to such negligence action, but the business judgment rule defense requires the officer or director to have acted in good faith and in the best interest of the corporation.[2] Ignorance is bliss would not be effective as a defense. As discussed later in the paper, managers at the credit rating agencies and at large financial institutions who followed competitors in foolhardy, risky ventures in issuing and/or trading in MBSs and CDOs breached their fiduciary duties and have shown themselves to be negligent.

HOW DID WE GET HERE IN THE FIRST PLACE?

Recall that the author's proposition in this paper is that legislation cannot replace ethics in regulatory reform. Indeed Dodd-Frank provides for extensive new regulation of the financial services industry, but can it be effective in stopping abuses and systemic risk? Perhaps the best place to start is this discussion is how the U.S., and, in fact, the World, got into this mess in the first place. Blame can be pointed at several governmental institutions, the Congress, big banks, consumers, over-demanding investors, poor managers, untrustworthy credit rating agencies, quasi-governmental corporations, and investment speculators. There is plenty of blame to go around and all of it is legitimate to some degree. Blame may be assessed based on lack of or effectiveness of governmental supervision or regulation. Certainly there was criminal behavior. However, the author believes the core deficiencies were simply the failure or refusal to follow ethical norms—to possess and use common virtues—of those due diligence and competence, justice, truth telling, and integrity. Too many players "sold their soul" to the game, or to profits, or to their bosses. They were in the words of C.S. Lewis "men without chests" (Lewis, 1943).

Governmental Policy Failures

It was during President Bill Clinton's administration with Andrew Cuomo as Housing and Urban Development (HUD) Secretary when the rules for home ownership financing became relaxed in 1996 (Roberts, 2008). For 1996, HUD gave the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") an explicit target of 42 percent of their mortgage financing had to go to borrowers with income below the median in their area. The target was increased to 50 percent in 2000 and to 52 percent in 2005.

[1] Revised Model Business Corporation Act §§ 8.30 (a) and 8.42 (a).

[2] See, for example, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), holding that directors did not make an informed decision and thus had no business judgment rule defense when they approved a merger hastily in a two-hour special board meeting without the board having had time to consider the intrinsic value of the corporation's stock. Perhaps the failure to consider the risky nature of derivatives and without understanding the valuation algorithms would be tantamount to making an uninformed decision in bad faith.

Furthermore, targets were increased from 1996 to 2008 to require mortgage purchases by these two government-sponsored enterprises (GSE's) to consist of at least 12 percent of special affordable loans typically to borrowers with income less than 60 percent of their area's median income, 20 percent in 2000, 22 percent in 2005, and 28 percent in 2008. The goals were met between 2000 and 2005 (Roberts, 2008). Simply, mortgage lenders could make more loans because Fannie Mae and Freddie Mac would purchase more mortgages.The relaxation of mortgage lending rules resulted in an expansion of subprime lending, more money for home purchases, greater demand for home ownership, housing inflation (especially in certain regions and cities like Las Vegas, Arizona, California, and Florida, real estate speculation, etc. In essence, the directive to Fannie Mae and Freddie Mac to ease up on loan requirements was an invitation to reduce controls historically in place to reduce credit risks which naturally held down home ownership. The government wanted something (a social good) without economic risks. In fairness, the Republican Congress provided little oversight during the period form 1994 to 2006, when they lost control of both houses of the Congress.

A second area of political culpability was the Republican Congress' repeal of the Glass-Steagall Act as a part of the enactment of the Graham-Leach-Bliley Act in 1999. Since 1933, commercial banks had to remain separated from investment banking activities. This limited speculation and risk of commercial banks in the U.S. Though the policy of Glass-Steagall had been effective for over sixty years and had not inhibited the formation of capital in the U.S., as evident by the sustained growth of the American stock markets for nearly twenty years in the 1980s and1990s, Congressional and Presidential financial policies and oversight of big banks were effectively abandoned in favor of financial deregulation. A perfect storm brewed from the combination of the explosion of unregulated hedge funds, trading of risky derivatives, and a less regulated banking industry that was unchecked for growth by mergers.

Failure to Consider Known Warnings

Regarding risky derivatives two significant events were disregarded. First, in 1995 Orange County, California faced insolvency and filed for bankruptcy under Chapter 9 of the Bankruptcy Reform Act when the City's cash reserves were lost through derivatives investments in the amount of $1.7 billion. Orange County had made good profits up until then but it did not consider the heightened risk of derivatives investments. This should have been a wake-up call, especially to governmental entities.

Second, during the period 1997-1998 Brooksley Born, an expert in derivatives and the then Chairperson of the Commodity Futures Trading Commission, warned the Congress, the Fed, and the Treasury Department that unchecked trading of derivatives, especially credit default swaps, in the credit market could lead to disaster and bring down the economy (Schmitt, 2009).[3] Rather than give due consideration to an expert's opinion, her warning was ignored. Alan Greenspan said the market would take care of the situation. Timothy Geithner and Arthur Levitt, Commissioner of the Securities and Exchange Commission, disagreed with her and wanted her stopped. Richard Rubin and Lawrence Summers at the Treasury tried to change her mind. Summers, acting as Treasury's bulldog, attempted to put political pressure on her. Senator Phil Graham was instrumental in reducing her regulatory power and later enacting the Commodity Futures Modernization Act freeing derivatives trading and gutting her agency's regulatory powers over derivatives.

It is important to note just how close we got to a financial meltdown at the time of Born's admonition to the Fed and the Treasury. About this time a large private investment firm (a hedge fund with $1 trillion in assets) and a big player in the derivatives market, Long Term Capital Management, in May 1998 was about to go into insolvency and result in an industry meltdown impacting the national economy. The aforementioned actors, aware of Born's warning, managed to put enough pressure on the very large financial firms and banks, including some foreign firms like Deutsche Bank, to pool $3.625 billion to cover some of Long Term Capital Management's derivatives losses and avoid an industry meltdown (Schmitt, 2009; Wikipedia, 2010). Of course, Brooksley Born's warning proved apocalyptic in the end. Ironically, some of those key players who refuted her warning, in particular Geithner and Summers, are President Obama's key economic advisors, and Robert Rubin later became Director and Senior Counselor at Citigroup, a large banking firm that received a large bailout form the federal government.

Non-political persons and entities acting within the letter of the criminal law, but probably not within the civil legal and ethical limits in meeting fiduciary responsibilities, were prime culprits in the financial crisis. These actors were the big banks and the credit rating agencies. Subprime lenders like Countrywide Financial are exempted from this discussion because their culpability is based on law breaking, more specifically, civil and criminal fraud. Generally, the large banks and financial investment firms were at fault. Professor Charles W. Murdock characterizes their fault as the primary root cause "by funding subprime lenders, buying their mortgages and securitizing them, slicing them to form CDOs through derivatives, and leaning on the credit rating agencies to get AAA ratings for junk" (Black, 2010). Robert Wade (2010), Professor of Political Economy and Development at the London School of Economics, argues that the political strength of the large banks and financial firms allowed the government's regulatory power to be eroded resulting in almost no regulation at all.

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[3] See *The Warning*, an October20, 2009, Front Line documentary aired nationally on the Public Broadcasting System, the video is available at http://www.pbs.org/wgbh/pages/frontline/warning/view . This documentary chronicled events and the ample warning that the federal government had of the potential financial crisis that eventually came to be. These events were generally not given any significance during the period 1997-1999 by the American press or by economic and financial experts.

Thus, a market framework existed of "asymmetric incentives on money managers (to take big gambles confident that gains could be privatized and losses put onto others, as in bonuses based on short-term performance with no penalty for longer-term losses) and herding incentives on money managers (to crowd into investments others have already made, because their performance is judged relative to others). This market environment generated a high and rising level of financial fragility in the financial markets."

Failure of Corporate Leadership—Lack of Due Diligence and Virtue

As maximization of profits through legal means is not unlawful, what were the ethical concerns about their activity? There is one principal ethical problem with their group action leading to the explosion, and later the implosion, of derivative trading and credit default swaps. Simply put, managers and directors of those large banks and financial firms, domestically and internationally, breached their fiduciary duty to their corporations and shareholders through accepting extraordinary levels of risk without advising shareholders of those risks and through making uninformed decisions about investing in these derivatives.

The author maintains a view that during good economic times people get stupid with their own money, money managers get stupid and reckless with other peoples' money, and government regulators and legislators ignore signs of upcoming financial catastrophe. In the last 25 years in the U.S., we have witnessed four of these financial catastrophes—(1) the savings and loan crisis involving speculative real estate in the mid-to-late 1980s, (2) the dot com bubble of the mid-to-late 1990s, (3) the accounting scandals in the early part of this decade, and (4) the financial crisis under present discussion. The most significant problem in each of these situations was not the lack of regulation, as there was plenty of law to protect everyone. The problem was human—a lack of integrity and virtue. Virtuous managers maintaining integrity act prudently; they consider risks involved in their activities and decisions; they assess risks using the best available means; they are not blinded by greed or competition or vanity.

Failure to read the heightened risks in the housing market

How could so many intelligent professionals have ignored the apparent risks in the U.S. housing market? The following are some of the indicators of those risks which would lead even a person "with one eye and half sense" to conclude that the housing market was but a house of cards and the securities based on them--junk. The first indicator was the fact that the demand for homeownership grew at such a fast pace that it was unsustainable over time creating a heightened risk to homeowners and investors. Home ownership in the U.S. grew from 63.9 percent in 1985 to 69 percent in 2004 with every age group (except the 65 years and older) declining in the decade of 1985-1994 (Garriga et al., 2006). Home ownership of the youngest age group (less than 35 years) made the greatest gains from 1994 to 2004 (15.5 percent increase to 43.1 percent) while the most economically stable groups did not increase significantly. For example, for the ten-year period the other age groups increased by only 7.3, 2.7, 3.0, and 4.8 percent, respectively. It is the youngest aged group that would naturally be more risky in their ability to repay loans, less financially experienced, and more manipulable than the more mature groups.

Homeownership by family status reflected the largest growth in nonfamily households. For the decade 1994 to 2004, males without families increased by 17.2 percent and females increased by 9.9 percent. Also, homeownership by single-parent households for the period 1994-2004, which had declined in the previous decade, increased sharply for both males and females by 12.9 and 15.2 percent, respectively. Historically, the most financially stable group for homeownership was married-couple families. This could be explained by the ability to have two incomes to support payment of the mortgage. The data reflects greater speculation in the housing market and greater risk of non-payment because there is not a second source of income. Minority homeownership grew substantially during the decade 1994-2004, almost double that of non-Hispanic whites. For Black, American Indian, Asian or Pacific Islander, and Hispanic or Latino groups, the percent changes in the homeownership rate over the previous decade were 16.1, 7.5, 16.6, and 16.7 percent, respectively. For first-time or young buyers of homes, down payment rates decreased for several reasons.

The second indicator of heightened risk required the investor to consider how it was possible to expand homeownership so quickly and beyond historical norms (other than through a program like the GI Bill following World War I and the Korean War)? Programs and policies were initiated that required lower equity and closing costs to the borrower. Government-sponsored entities, Fannie Mae and Freddie Mac, ginned up a large demand for homeownership by providing a source of capital for mortgage lenders. To meet HUD's goals for greater minority and female homeownership, Fannie and Freddie began to accept greater credit risk in the loans they purchased form mortgage lenders. This was done through accepting more private mortgage insurance in lieu of greater equity by the borrower. Any mortgage loan with less than 20 percent equity in the purchase price required private mortgage insurance. Assuming that the private mortgage insurance is properly valued, that house values are properly stated, and loans are not manipulated—none of which proved accurate in the current housing crisis—using this form of insurance in lieu of equity would not increase risk to the mortgagee.

Given the policy change of easy money provided by Fannie and Freddie, mortgage lenders starting processing more loans with more credit risk since they knew they would be able to sell those mortgages to Fannie and Freddie. Aggressive business practices too often became sharp business practices. Lenders allowed borrowers to replace equity with loans to finance the down payment to meet the 20 percent equity requirement. In a loan called an "80-20 loan" or "no-down payment loan", the borrower signed a second note for 20 percent of the purchase price, usually at a rate two percent higher than the primary mortgage rate. Similarly, in an "80-15-5 loan", the buyer provided five percent equity as a down payment, borrow 15 percent in a second loan, and have an 80 percent primary mortgage.

Chambers, Garriga, and Schlagenhauf calculate that the 80-15-5 loan actually resulted in a lower annual payment for a 30-year $100,000 loan than when private mortgage insurance is used. It should be readily apparent, however, that both the 80-20 and 80-15-5 loans are much more risky than a loan using private mortgage insurance (Garriga et al., 2006, Table 6). Mortgages lenders then began allowing gifts from non-profit organizations, such as the Nehemiah Program or the AmeriDream Down payment Assistance Program, to cover the down payment and closing costs (Garriga et al., 2006). One should note that a homebuyer who cannot save enough money to make a down payment and/or to pay closing costs for non-government subsidized loans created an unprecedented credit risk to lenders.

The third and particularly troublesome indicator of heightened risk was the explosion of subprime loans, most notably by certain lenders like Countrywide Financial, New Century Financial Corporation, and Indy Mac Mortgage. Subprime loans were favorable for lenders and investors because they had a high profitability to the initial lender in terms of a two percent higher mortgage rate, higher closing fees, and prepayment penalties. Investors in the securitized mortgages received higher investment profits from secured investments, assuming the loans were repaid. Subprime loans were not new nor are they unethical per se. However, when they are predicated on intentional or negligent misrepresentation, they are both unethical and illegal. Unethical or fraudulent lenders followed a progression. First, "teaser loans" were made available to qualify borrowers without sufficient equity; second, no document or "liar loans" were used to qualify borrowers with poor credit history; and third, "ninja loans" were made in which the borrower had no income, no job, and no assets. The end result too often was "jingle mail" in which the mortgagor cannot pay, or chooses not to pay, the mortgage note and simply tenders the house back to the mortgagee by mailing the keys to the mortgagee to allow the mortgagee to foreclose and sell the property (Brooks and Dunn, 2010). In the end, the number of subprime and other risky mortgages totaled 27 million—half of the mortgages in the U.S. (Wallison, 2010).

The overall economic, social, and political environments relating to the housing market were ignored by lenders, investors in these mortgages, and the credit rating firms. Given this brief background of the risks these entities should have noted that housing prices were rising sharply especially in certain areas of the country at unsustainable levels given the relative stagnation of working families' wages. The federal minimum wage had not increased from $5.15 an hour from 1997 to 2007, when it was increased by $0.75 (U.S. Dept. of Labor, 2010). During this time labor rates were depressed for low-end wages in large part due to a seemingly never-ending supply of cheap Hispanic labor coming from Mexico and Central America and the relocation of manufacturing offshore to Mexico and China. The migration of Hispanic workers to the U.S., and especially to those cities and states with the most notable housing inflation, contributed to an inflationary spiral in housing simply on the basis of supply and demand. The political situation had turned sharply against illegal immigration in this decade as the migration could not be allowed to continue because of the undesirable social externalities of illegal immigration. Households were loaded with mortgage and consumer debt and bankruptcy filings for consumers were high until they were curtailed temporarily by the Bankruptcy Reform Act of 2005. During the period 1997 to 2005, annual non-business bankruptcy filings ranged from 1,217,972 to 2,039,214 (American Bankruptcy Institute, 2010). Generally, households with lower incomes are more likely to seek bankruptcy protection under Chapter 7 or Chapter 13 of the Bankruptcy Reform Act. These would also be households for which more of the subprime mortgages were given on a comparison basis reflecting greater risk to lenders and mortgage investors.

The Credit Rating Agencies—Conflict of Interest, Greed, and Incompetence

Credit rating agencies (Moody's Corp., Standard & Poor's (S & P), and Fitch Ratings) have sizeable culpability in the financial crisis as they consistently gave higher credit ratings than mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) deserved. Mortgage lending firms and banks maintaining extraordinarily lenient mortgage loan practices (as discussed *supra*) sought and obtained AAA ratings for the vast majority of the roughly $3.2 trillion in MBSs sold between 2002 and 2007 (Lardner, 2010). For example, from 2005 to the third quarter of 2007, S&P rated approximately $855 billion of AAA subprime, first-lien residential mortgage-backed securities (Woellert and Kopecki, 2008). It seems incongruent that the words "subprime mortgage" and "AAA" can be uttered in the same breath considering that heightened risk is the paramount determinant of a subprime loan. An industry practice of having the issuer pay for the credit rating is a clear conflict of interests (Lardner, 2010) which creates an avenue for greed to override professional judgment and duty to stakeholders other than the client. The toxicity of the rated assets was not accurately measured or was ignored altogether in order to grant the securities investment grade ratings. This lack of due diligence and fraudulent activity are reflected in admissions contained in e-mails and House Subcommittee transcripts stating the following (Woellert and Kopecki, 2008):

- From an S & P employee: "Let's hope we are all wealthy and retired by the time this house of cards falters."
- From Raymond McDaniel, COB and CEO of Moody's: What happened in '04 and '05 with respect to subordinated tranches is that our competition, Fitch and S & P, went nuts. Everything was investment grade. We tried to alert the market. We said we're not rating it. This stuff isn't investment grade. No one cared because the machine just kept going."
- From a Moody's employee: "[It] seems to me that we had blinders on and never questioned the information we were given. It is our job to think of the worst-case scenarios and model them. Combined, these errors make us look either incompetent at credit analysis, or like we sold our sole to the devil for revenue." (Brooks and Dunn, 2010).
- From Stephen W. Joynt, President and CEO of Fitch Inc. in New York: "[It] is clear that many of our structured finance rating opinions have not performed well and have been too volatile….We did not foresee the magnitude or velocity of the decline in the U.S. housing market, nor the dramatic shift in borrower behavior brought on by the changing practices in the market….Nor did we appreciate the extent of shoddy mortgage origination practices and fraud between 2005 and 2007." (Woellert and Kopecki, 2008)

One might wonder how the reckless, or even criminal, credit ratings of CDOs and MBSs would allow the credit rating firms to continue in existence. Compare their actions to Arthur Anderson in the Enron and WorldCom cases. One can only conclude that the duplicity and complicity of issuers and users of the credit rating firms were such that it is hard to find a victim, foreign governments, American taxpayers and shareholders notwithstanding.[4]

THE U.S. REGULATORY SOLUTION—DODD-FRANK ACT

On July 21, 2010, President Barak Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (hereinafter "Dodd-Frank"). Although the American Congress completed its work on legislating financial services reform before the European Union, Dodd-Frank was late in passage following the near collapse of the large financial services industry and after the G-20 had several summits since 2008, namely, Washington, London, Pittsburg, and Toronto to discuss the financial crisis and to map out a strategy to assure a similar crisis will not occur again.

Dodd-Frank is a comprehensive act whose scope extends much farther than is necessary to avert a similar crisis. The legislative enactment is 864 pages long—the small print, single-spaced version. Dodd-Frank may be seen as a government "reinvention" of the financial industry, whether it needed it or not. This was accomplished by the following nutshell summary of the bill to reinvent financial regulation (Dennis and Cuadra, 2010):

- *Avoiding the "too big to fail" notion*. Several significant provisions in the bill try to reinvent an industry that was allowed to get too big—not by natural growth but through acquisitions without either the Federal Trade Commission, Department of Justice, the Federal Deposit Insurance Corporation (FDIC), or the Federal Reserve (the Fed) doing their respective parts to watch out for the evils that can be caused by very large companies and banks. Provisions in the bill allow the government through actions of the Treasury, the Fed, and the FDIC to seize and close down large failing firms in an orderly fashion. In such a case the shareholders and unsecured creditors would bear the financial loss rather than the federal government. At the discretion of a regulatory council (the Financial Services Oversight Council, headed by the Treasury and including other existing regulatory entities), additional capital requirements may be set to cover potential losses.
- *Regulating derivatives*. In trying to get its regulatory arms around the domestic portion of the derivatives industry that had ballooned to an unregulated $600 trillion worldwide, derivatives would now have to be valued and aired by the markets rather than private deals lacking transparency. Nearly all derivatives deals will now have to be conducted through central clearinghouses so investors can be confident about settling their bets, and firms will have to have the capital necessary to cover unexpected losses. Most derivatives would be traded on public exchanges. Finally, large Wall Street banks will have to spin off some of their trading of derivatives.
- *Reducing risk to the global financial system*. The Financial Services Oversight Council will provide an early warning system to identify systemic risks posed by large financial firms and potentially risky financial products.
- *Stopping regulatory shopping to improve oversight and transparency*. Because in the past there has been a patch work of regulators in the financial industry allowing problems to go undetected or weakening governmental oversight, clearer lines of responsibility will be drawn. The Office of the Comptroller of the Currency will have jurisdiction over national banks and the FDIC will have jurisdiction over state banks. The Office of Thrift Supervision is to be eliminated.
- *Protecting consumers in financial services transactions*. Before Dodd-Frank there were seven federal regulators who were charged with protecting consumers in their dealings with the financial industry. As these regulators were not proven to be effective in the years before the financial crisis, the bill creates the Consumer Financial Protection Bureau. This new federal agency will be housed inside the Fed, and it is given extraordinary power by the Congress to write and enforce rules and regulations governing mortgages and other financial products and to examine banks with more than $10 billion in assets (Dennis and Cuadra, 2010).

To be sure, some of the provisions are very good; some were unnecessary and will probably result in excessive regulatory burden by offering very little utility given the additional cost of compliance; and some provisions did not go far enough. The end result of Dodd-Frank was the enactment of a very partisan bill, beyond the political desires of the American electorate, at a time when political indicators show a sharp turn toward political and economic conservatism that may cause some portions of the bill to be legislatively reversed in the out years. Particularly suspect is Title X which is given its own legislative name, the Consumer Financial Protection Act of 2010, and creates a new federal bureaucracy called the Bureau of Consumer Financial Protection. This provision expands an already bloated federal government by requiring the formation of new bureaucracies such as an Office of Fair Lending and Equal Opportunity, an Office of Financial Education, an Office of Service Member Affairs, and an Office of Financial Protection for Older Americans (Flynn, 2010). The new Bureau of Consumer Financial Protection assumes responsibility for many of the consumer financial protection laws dealing with such matters as interest on consumer loans, debt collection practices, credit reporting, home loan closings, and electronic funds transfer.[5]

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[4] On August 31, 2010 the SEC announced that it would not sue Moody's for fraud because the activities at the center of the SEC investigation took place in Europe, beyond the agency's jurisdictional reach before enactment of Dodd-Frank. Dodd-Frank Act now gives the SEC power to sue credit rating firms engaged in "otherwise extraterritorial fraudulent misconduct" (Goldfarb 2010).

[5] See e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, 111th Congr., 2d Sess. (July 21, 2010), §§ 1081, et seq.

THE GOOD AND BAD OF DODD-FRANK

Perhaps the best part of Dodd-Frank is also its weakest part. Since the private trading in risky derivatives in MBSs and CDOs created a vehicle for the financial crisis, it is certainly good that these forms of securities will be brought more fully into light by establishing markets and at least limiting some bank exposure to them. However, the weakest part is the failure of the Congress to simply take dealing in these securities away from commercial banks. As noted earlier, the Glass-Steagall Act was effective. Foreign banks did not have superiority over American banks; they were not more creative; the financial industry during the Glass-Steagall era was not retarded; there were boom periods; and there were no multiple stock market busts within in ten-year period as there have been in this decade after the Glass-Steagall repeal. There is no adequate explanation for Congress to forego simply taking away the large banks' opportunity to deal in these risky securities. Why didn't Congress dust off Glass-Stegall and re-enact it? Why didn't Congress adopt the proposed Volker Rule, which would have barred commercial banks, catering to private customers, from engaging in any speculative transactions?

It appears that allowing banks to continue to invest in derivatives, even though they are banned from making private deals on derivatives, does not entirely solve the problem. Recall that Alan Greenspan was surprised that within the derivatives market "counterparty surveillance" failed, i.e., having the other party to the market transaction looking out for his own interest to protect himself from misrepresentation by the other party. Blind greed remains a tremendous motivator for large banking firms. Perhaps, Congress was swayed by the big money of big banks. Senator Christopher Dodd stated that improving regulation made more sense than restraining an industry that was critical to the American economy and that faced fierce competition from foreign banks which would not be placed under similar restrictions (Wade, 2010).

Either accepting the Congress' approach or re-enactment of Glass-Steagall is preferable to Robert Wade's, professor of political economy and development at the London School of Economics, view. His approach is the Draconian measures of requiring all large banks in the U.S. (assets over $100 billion) and E.U. to be owned by the state and in the alternative to abolish limited liability in ownership of financial firms to create joint and several liability to the owners of the big banks. In either case, there would be less systemic risks and no government bailouts because there would not be asymmetric incentives to take big gambles (privatized profits) while being shielded from losses (taxpayer-borne losses) (Wade, 2010).

Through Dodd-Frank, Congress has created more bureaucracy in dealing with big banks and financial firms at a time in which there is no evidence of regulatory effectiveness of federal financial or business regulators. What federal regulator has proven to be very effective in the last nearly twenty years—the FTC (allowed the financial firms to get too large and powerful), the FDIC (did not control risky ventures or make sure banks were properly capitalized in light of those risks and could not control the size of banks), the Fed (cheap money for years creating the housing bubble), SEC (failed to prevent, timely investigate, or shut down securities fraud in too many high profile cases), or the Office of the Comptroller of the Currency (took the side of the credit rating agencies when several state attorneys general complained that ratings were improper)?

The track record of using good discretion is simply not there. It would have been better to let commercial banks be distinct from investment banks. Divestiture would also have cleansed the firms by separating the volatile from the safe business operations. Wallison (2010) argues that the Fed will continue to make the case for too big to fail bailouts after Dodd-Frank because it is overly cautious and protective of banks.[6] He argues that there will be a natural conflict (a "partnership") between the regulatory council and the big banks. Furthermore, because there will be this close working relationship, the large banks will be given protection from failure while smaller banks will simply be allowed to fail.

It is not certain that a 5 percent capitalization requirement for securitization under Dodd-Frank will be sufficient. Given the recent and continuing situation of foreclosures on subprime mortgages and the number of loans securitized, it probably isn't.

Also, banks have said privately that 5 percent is low enough not to make much difference (Jones and Askew, 2010). On September 12, 2010, global banking regulators agreed under Basel III to require banks to hold top-quality capital (equity or retained earnings) totaling 7 percent of their risk-bearing assets, an amount substantially higher than the 2 percent currently required. Because banking suffers from cyclical booms and busts, banks will be required to build up a separate "countercyclical buffer" of between zero and 2.5 percent when the credit markets are booming. The proposals will be put to the G-20 for endorsement. Criticisms of the proposal to increase bank capitalization requirements are, first, that banks will have too long (5-9 years) to meet these higher capitalization requirements, and, second, higher capitalization requirements might limit banks from making loans during the recession.

[6] Walliston first points out that Paul Volker at the Fed asked Bill Isaac at the FDIC in 1982 to bail out Penn Square Bank in the amount of $500 million after the bank had sold bad loans to bigger banks. He asserted Penn Square's failure would bring down bigger banks. Second, Richard Breeden at the SEC in 1990 was asked by the Fed to bail out Drexel Burnham Lambert, the fourth largest Wall Street Bank at the time, as it was headed for bankruptcy. Again, the fear was financial collapse. As noted *supra*, Alan Greenspan and others leaned on some large banks and financial firms to cover derivatives losses of a very large hedge fund, Long-Term Financial Management.

One may readily conclude that credit reporting agencies will be controlled well enough under Dodd-Frank.[7] The regulation is so controlling that they will have practically no autonomy at all. Congress in Section 932 went to extraordinary measures to improve and control competence, transparency, disclosure of risk, corporate governance, ethics, policy making, and regulatory compliance. The SEC and the new Office of Credit Ratings will control or have the right to review virtually every significant aspect of the credit rating agencies' activities. When the author gives his initial lecture to graduate business students in ethics, he provides them with a list of reasons a firm or profession should act ethically. Dodd-Frank provides a clear example that unethical firms face increased governmental regulation and a loss of autonomy.

The most significant provision in Dodd-Frank regulating the credit rating agencies is intended to provide a cure for conflict of interest existing because the agencies have sacrificed integrity and due diligence for the fee paid by the issuer. Ergo, application of the "other Golden Rule"—he who has the gold makes the rule. Congress created a clearinghouse for credit ratings. Rather than the issuer "cherry picking" the agency to get a favorable credit rating, the issuer will have the clearinghouse select the credit rating agency.

Section 932(t) requires each credit rating firm to be governed by a board of directors with at least half of the directors (minimum of two) being independent directors. At least one of the independent directors must be from a class of users of national credit ratings. Internal control systems must be maintained and monitored with annual reports to the SEC of adequacy and compliance of internal controls. The agencies must have written policies and procedures that cover, *inter alia*, credit rating methodologies. These must be reviewed and approved by the SEC. Furthermore, the agencies must show the SEC that its employees who do the ratings have satisfactory education and training in credit rating. Ethical considerations were emphasized in Dodd-Frank. A Chinese wall must be built between the agencies' rating activities and its marketing activities. The agencies must have codes of ethics and conflict of interest policies that are reviewable by the SEC. The SEC wants to know of any potential employee conflicts of interest by having present, past or future relationships with the issuers. The Office of Credit Ratings will be required to make annual inspections of the credit rating agencies to check rating methods and transparency. Finally, rules have been or will be promulgated to assure full disclosure and transparency. For example, due diligence evaluations, MBSs risks and assumptions, information relied on by the agencies, certifications by issuers that they have fully disclosed the risks in the asset-backed securities.

It is not certain whether or not the three big credit rating agencies will face more competition in the U.S. On the one hand, the extraordinary amount of regulation would depress any desire of an entrepreneur to enter the market. On the other hand, by having a federal clearing house assign issuances to the agencies, Congress has damaged the goodwill, to the extent any is left after the last two years, of the credit reporting agencies. Since a new firm could start fresh with new policies and procedures for operating a credit rating firm, without the worry of building a reputation for name recognition (i.e., building sizable goodwill), this could draw additional competition. The E.U. is seeking to have more competition in credit rating as an offset to the power of the big three credit rating agencies (Jones and Askew, 2010). Peter Bofinger, a member of the German Council of Economic Experts, calls for a government-run European ratings agency which the E.U. would have to establish and partially fund initially (Hawranek et al., 2010).

Even without the extensive federal regulation (or New York state regulation), the big three credit rating firms would have the incentive to be more diligent and ethical. Fallout from legal risk may last for years and could doom the companies. Law suits have already been initiated by attorneys general in California and Ohio against the agencies. There will no doubt be massive litigation against the agencies under state securities laws and under state tort law for misrepresentation to recover damages sustained by issuers, investors, shareholders, and state and state and local governments from negligence or fraud in the credit rating activities (Krusch, 2010; Ellsworth and Porapaiboon, 2009).

Whistleblower incentives and protection against retaliation are strong in Dodd-Frank (2010, Section 922) beefing up the provisions in the Sarbanes-Oxley Act of 2002 ("SOX"). It creates a new category of whistleblower providing a cash reward of 10 to 30 percent of the sanctions collected by the SEC, the specific amount being at the discretion of the SEC. For this reward, the whistleblower must provide the SEC with "original information", i.e., not already known to the SEC (Covington & Burling LLP, 2010). There are other limitations on receiving the reward, for example, felons, government investigators, and independent auditors, who are already under a duty to report findings to the SEC. The anti-retaliation provisions in Section 922 go farther than SOX's. SOX protects whistleblowers that provide information about certain violations of federal securities laws or various forms of fraud, including fraud against shareholders.

[7] In June 2008, all three credit rating agencies reached an agreement with the New York Attorney General to change its fee structure and to credit obligations to deal with excessive risk in securitizations (Ellsworth and Porapaiboon, 2009). First, the agencies will charge fees for various analytical tasks—not just the rating—and the agency will be paid regardless of which firm actually renders the rating. Second, the agency must disclose information about all securitizations submitted for their review. To avoid the negligent or fraudulent mortgage application review processes subprime lenders followed, the credit rating agencies will have to review individual mortgage lenders and the lenders' mortgage origination processes. Due diligence criteria must be developed by the agencies, and those criteria must be reviewed and reported on annually to prove they are independent when rating MBEs. Finally, the agencies must obtain a series or representations and warranties from investment banks and other parties about the loans underlying the MBEs (Ellsworth and Porapaiboon, 2009).

Dodd-Frank (2010, Section 922) covers reports required or protected by SOX, reports about violations of other laws subject to the SEC's jurisdiction, and reports to law enforcement officers about the commission of federal offenses. Section 922 provides extended whistleblower protection beyond SOX in that the statute of limitations to bring retaliation claims and the statute of repose on those claims are much longer. The employee has protection against retaliation for six years after the violation or three years after the employee learns of the facts about the retaliation, but in no event can a retaliation claim be brought after ten years after the date of the violation. A private right of action to sue the retaliator in a federal district court will be available to victims of retaliation. Section 926 allows the SEC to bar any Regulation D offering (Securities Act of 1933) by a felon or "bad actor".

WILL DODD-FRANK WORK WITHOUT ETHICAL PLAYERS?

Will the extensive regulatory scheme of Dodd-Frank be effective absent ethical players? The short answer is simply that matters couldn't get worse than they were. To the extent statutory and administrative rules now exist for the credit rating agencies and large banks will be limited in their ability to trade in risky derivatives (to the extent we don't know yet), the banking and securities business and legal environments have changed dramatically. A threshold question, however, is can government be effective regulators of the banking and securities industries? If the past is prologue, then probably it cannot.

Unless the SEC and the new Office of Credit Ratings write ineffective rules with excess exceptions and waivers that gut effectiveness or unless regulators and agents of these agencies are derelict in their duties, it should be a safe bet that the credit rating firms will not slip into the same mindset as before. The Congress effectively codified the credit rating agencies ethical duties, even their corporate social responsibility, into law. Thus, what a few years ago was "ought to do" has now become "must do". That said, the credit rating agencies and the issues have a history of collusion. One could foresee that issuers, like large investment banks, could lean on the agencies for lenient securities ratings. There are only three national rating agencies and the refusal of a large investment bank to use a rating agency for a legitimate or illegitimate reason could substantially restrict the agency's earnings. As for maintaining a code of ethics and a system of internal controls under Dodd-Frank, one is not necessarily comfortable with the results of SOX which also requires both of these.

When executives perpetrate fraud, they usually have underlings colluding with them to share common benefits—usually large bonuses. Dodd-Frank does not prohibit large profits nor does it prohibit large executive compensation. The regulatory scheme is compliance-oriented. If the members of the board are chosen by the executives or Chairman, there is no historical evidence that those directors, independent or not, will stand against excessive compensation. Transparency in executive compensation does not mean a return to reasonableness in the executive compensation levels. There is an adage of criminal defense attorneys: A grand jury will indict a ham sandwich if the prosecutor asks them to. The same can be said of corporate shareholders when asked to approve executive compensation. Seldom, if ever, have shareholders of a large corporation rejected a proposed executive compensation package. Claw-back provisions for executive compensation may help corporations and shareholders some when they pay out executive bonuses based on fraud, but claw-back provisions in SOX were not effective assurance of due diligence of executives in the financial and real estate industries. Thus, for credit rating agencies, it is a wait-and-see.

Trading high-risk derivatives (MBEs and CDOs) may or may not continue. Most likely they will be curtailed some but not as much as they could have been. Dodd-Frank gives some protection to commercial banks to restrict their dealings in derivatives, but what about foreign banks, investment banks, and local governments? It seems that a 5 percent credit risk retention policy is excessively lenient. A mortgage company may charge lender closing fees of 5 percent or recover the 5 percent in excessive interest in one year thereby negating the incentive not to speculate because of increased capitalization requirements. A securitizer obligated to capitalize only 5 percent would have little skin in the transaction. Considering that about $3.2 trillion of MBSs were sold, a substantial portion of those have already proven to be grossly overvalued as a yet undeterminable number of foreclosures take place. Again, Dodd-Frank concerns itself with process and compliance to rules and policies. As long as large banks and investment firms have sufficient capital for reserves and are not losing money on the risky derivatives, the market will value those MBSs and CDOs highly—high risk or not. The market will be more transparent, but the transparency of the market does not rid the economy of the "group think" or "herd mentality" as competitors seek the greatest profits. For example, Deutsche Bank is traded on the New York Stock Exchange and must comply with SOX.

Deutsche Bank, thus, maintains a corporate code of ethics containing whistleblower provisions and a policy of corporate social responsibility. The bank's executives had a fiduciary duty to the bank and its shareholders to act prudently and not to waste corporate assets. Even with all of these duties and safeguards, Deutsche Bank chose to invest heavily in the MBSs (approximately 2,000 packages consisting of millions of homes) apparently without considering the consequences other than the high profits that would have been created if the house of cards had not fallen (Pauly and Schulz, 2010). For the last couple of years the bank has been foreclosing on delinquent mortgages in the U.S., including about 600 large apartment buildings in Chicago in 2009 and about 5,000 houses in Cleveland. It was estimated that in the U.S. about 85-90 percent of all of the outstanding mortgages were ultimately controlled by four banks either as trustees or owners of a trust company. Deutsche Bank is one of the four holding about $3.7 billion of home loans according to the Federal Deposit Insurance Corporation ("FDIC"). Much worse for the bank was the 25 CDO deals totaling $20 billion, most of which collapsed helping to cause the financial crisis (Pauly and Schulz, 2010). Earlier in the author's career as a corporate lawyer, he learned a lesson about risk taking.

His air pollution control system firm was from time-to-time often asked to accept sales contracts containing unlimited consequential damages. The answer was always "no"; no contract was worth betting the existence of the company. Deutsche Bank bet its existence on the chance to make above normal profits on MBSs and CDOs because its executives ignored their fiduciary duty to the bank and to its shareholders. Today, the bank is lucky to be alive.

Mortgage lending was probably the area with the greatest ethical culpability that got worse and worse as the desire for more profits, bonuses, and notoriety blinded lenders and their employees. No federal regulation has been effective in preventing abuse of consumers. The Real Estate Settlement Procedures Act ("RESPA") and the Truth-In-Lending Act were supposed to provide full disclosure to home buyers of risks and charges. They have proven not to be effective in preventing mortgage lender abuse. The same could be said for the Federal Trade Commission Act and state consumer protection acts. Furthermore, as noted earlier, there is a chance that Title X of Dodd-Frank will never be put into effect given the political situation in the U.S. The provision in Dodd-Frank requiring an inquiry into the mortgage lending practices of firms that assign the mortgages to be securitized will probably have little consequence in reality. Fannie Mae and Freddie Mac changed its policies to allow 80-20 and 80-15-5 loans to be purchased from the mortgagees. To the extent that knowing how much equity has been provided by the buyer is a material fact for credit rating agencies, the inquiry is good. However, equity amounts can be manipulated; for example, a gift of the equity may be an undisclosed loan of the mortgagor. Also, falsification of records will not be admitted by mortgage lenders. Congress's failure to deal with Fannie Mae and Freddie Mac in Dodd-Frank significantly weakens any protections against abuses by mortgage lenders.

CONCLUSION

Dodd-Frank may attempt to legislate competency and transparency in financial decisions, but it is unlikely to succeed on its own. Governmental regulators have proven to be ineffective repeatedly. Furthermore, compliance supervision of internal controls and policies, as good and necessary as those controls and policies may be, requires a diligence on the part of regulators and a political desire to solve the problem. In the end diligence, integrity, trust, and discernment are ethical virtues a firm, its managers, and regulators must have to satisfactorily reduce the risk of injury to their stakeholders and the public. They either have these virtues or they don't. The absence of these virtues in practice led to the financial crisis just as surely as their absence led to the demise of Enron, WorldCom, Parmalot, and others. They cannot be legislated, but if the world is lucky and the regulators also practice these virtues, perhaps the new regulatory scheme of Dodd-Frank will be successful.

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