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The Pathologies of Banking Business As Usual

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The Wolf of Wall Street's Jordan Belfort is the latest popular culture depiction of the "banker behaving badly" we love to hate. However, the Jordan Belforts of the world do not cause financial crises—the reality is far less sexy. This Article argues that financial crises are caused by ordinary financial industry personnel engaging in everyday behavior that is not fraudulent, but nonetheless has the potential to generate huge social problems in the quest for short-term profits. In particular, this Article focuses on the destabilizing potential of complex innovation and leverage—two pathologies of banking business as usual. This Article argues that criminal law, private litigation and command-and-control regulation are all limited in their ability to restrain these non-fraudulent but destabilizing behaviors, and so we must also address the prevailing "Wall Street" culture that promotes these behaviors with little regard for their social costs.

Many proponents of financial regulatory reform have ignored the issue of industry culture—perhaps because the problem often seems intractable. Instead, most reform efforts have tinkered around the edges of destabilizing behaviors, with the tacit understanding that the industry will constantly arbitrage regulations in an endless cat-and-mouse game. However, we need not be entirely fatalistic about financial industry culture: there is a large empirical literature that demonstrates that people often do make sacrifices for the public good, and this Article is the first to use this "pro-social" literature to inform proposals for financial industry reform.

It would be pretty shallow to attribute the cultural pathologies of Wall Street at their roots to bad people working there. The trouble, instead, is

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that the structural conditions of the financial industry have fostered certain cultural norms. If you are designing policies to fix Wall Street, you need to take into account how they will shape that culture.[1]

INTRODUCTION

Our popular culture is replete with real and fictional examples of bankers behaving badly. From Wall Street's Gordon Gekko to The Wolf of Wall Street's Jordan Belfort, from Milken to Madoff, our society loves to hate flamboyant financiers who lie, cheat and steal their way to success—and then get their comeuppance in the form of a criminal conviction. It is not surprising, then, that the American public is angry that none of the bankers who caused the financial crisis of 2007–2008 (the "Financial Crisis") were sent to jail.[2] After all, because the financial system is the

1. Jonathan Chait, *Barack Obama, Ta-Nehisi Coates, Poverty and Culture*, N.Y. MAGAZINE, Mar. 19, 2014, http://nymag.com/daily/intelligencer/2014/03/obama-ta-nehisi-coates-poverty-and-culture.html.

2. *See, e.g.*, Matt Taibbi, *Why Isn't Wall Street in Jail?*, ROLLING STONE, Mar. 3, 2011, at 44, which pithily sums up the situation as "[e]verything's [expletive], and nobody

primary provider of credit to the broader economy,[3] the failure of financial institutions and markets during the Financial Crisis generated broader economic recessions,[4] increased unemployment, eviscerated pensions, increased the rate of household bankruptcies, and even damaged personal health.[5] However, as this Article will explore, financial crises are caused by behavior that is much more mundane and widespread than the flashy frauds we see in the movies.

This is in many ways an inconvenient conclusion. It would be easier if we could classify the individual sources of financial instability as dishonest or untrustworthy villains—"bad apples" are relatively few and far between, and their bad behavior is relatively easy to identify and punish. In reality, however, financial crises result from everyday activities performed by large swathes of the financial industry in an attempt to maximize short-term profits. In particular, reliance on large amounts of leverage, as well as financial innovation that exacerbates complexity—two pathologies of banking business as usual—are rarely dishonest or sensational, but evince a lack of concern for how society will suffer when the financial system is destabilized. However, neither criminal law nor private litigation is particularly adept at addressing these pathologies, and traditional financial

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goes to jail" (quoting a former Senate investigator).

3. "This strong connection between financial markets and real economic activity, particularly when financial markets cease to function, is what has made so many of the crises . . . such spectacular historic events." CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENCE: EIGHT CENTURIES OF FINANCIAL FOLLY xliv (2009). Banks are the "backup source of liquidity to all other institutions, financial and nonfinancial." E. Gerald Corrigan, *Summary of Are Banks Special?*, FEDERAL RESERVE BANK OF MINNEAPOLIS (Jan 1, 1983), *available at* https://www.minneapolisfed.org/publications/annual-reports/are-banks-special. "Banks enable people to borrow money, and, today, by operating electronic-transfer systems, they allow commerce to take place without notes and coins changing hands. They also play a critical role in channeling savings into productive investments. . . . [M]any businesses rely on the banks to fund their day-to-day operations." John Cassidy, *What Good is Wall Street?*, THE NEW YORKER, Nov. 29, 2010, at 49-50.

4. The Financial Crisis spurred what has been called the "Great Recession" which started in December 2007, and officially ended in June 2009. Even after the Great Recession officially ended, the United States economy remained sluggish. Catherine Rampell, *The Recession Has (Officially) Ended*, N.Y. TIMES BLOG (Sept. 30, 2010, 1:50 p.m.), http://economix.blogs.nytimes.com/2010/09/20/the-recession-has-officially-ended/?_r=0.

5. *See, e.g.*,Mona Fiuzat et al., *United States Stock Market Performance and Acute Myocardial Infarction Rates in 2008–2009 (from the Duke Databank for Cardiovascular Disease)*, 106 AM. J. CARDIOLOGY, 1545, 1545-49 (2010) (showing a correlation between the stock market performance in 2008-2009 and heart health); Aaron Reeves et. al., *Increase in State Suicide Rates in the USA During Economic Recession*, 380 THE LANCET 1813, 1813-14 (2012), *available at* http://www.sciencedirect.com/science/article/pii/S0140673612619102 (shedding light on America's mental health problems as a consequence of the recession).

regulation also has its limits—if the law can't make financial industry personnel eschew destabilizing behaviors, then they will only do so if they view themselves as stewards of financial stability who are willing to make some sacrifices for the greater good. Unfortunately, while it is not unreasonable to expect more than a purely self-interested mentality from the financial industry—it is, after all, "a heavily subsidized industry that carries out major quasi-governmental functions and is fully dependent on government business and support for its current scale of operations"[6]—regrettably, financial industry culture does not currently reflect the privileged and quasi-public role that financial institutions play in society. (This Article shall use the short-hand "failure of indirect other-regarding behavior" to describe situations where the financial industry demonstrates a failure of empathy by not considering the negative externalities that harm people with whom they have no direct connection).[7]

This Article therefore asserts that we must also explore proposals to reform financial industry culture. While financial industry personnel are often considerate of others in their non-work life, more self-interested, short-termist norms have displaced norms of indirect other-regarding behavior in many of their workplaces.[8] Part of this Article's purpose, then, is to explore policies that would allow the other-regarding norms that drive individuals *outside* of the workplace to fulfill their promise as potential modifiers of destabilizing behavior *within* the workplace. The intention is to use a number of strategies to create a social context wherein the prevailing norm is for financial institution personnel to give some consideration to the negative externalities of their actions, with the consequence that deviating from that norm for the purpose of making short-term gains will expose the deviator to censure and opprobrium from their peers within the firm and industry, and damage their own self-concept as stewards for the financial system.

Of course, a more other-regarding industry culture is not a panacea for financial stability. Individual judgments by industry personnel about what behaviors best balance self-interest and other-regarding norms will often differ, and given the complexity and uncertainty inherent in the financial system, even well-intended actions will sometimes fail to create the most

6. Lawrence G. Baxter, *Capture Nuances in Financial Regulation*, 47 WAKE FOREST L. REV. 537, 563 (2012); *see also* Mehrsa Baradaran, *Banking and the Social Contract*, 89 NOTRE DAME L. REV. 1283, 1339 (2013).

7. For a discussion of systemic risk and instability as negative externalities, see Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQ. L. 649, 671 (2001).

8. *See infra* text accompanying notes 35-37 (suggesting that Wall-Street culture favors short-term profitability above all else).

optimal conditions for financial stability.[9] Despite this potential for inconsistency and mistakes, however, there is inherent value in "engender[ing] a culture in which firms continually question[] the impact of their activities on others."[10] Even in the presence of cognitive errors, destabilizing behavior is less likely when financial industry participants are willing to consider the externalities of their actions, rather than focusing myopically on self-interest.

As a first step towards reforming financial industry culture, this Article explores a series of complementary reforms directed at business schools and financial institution corporate governance (focusing particularly on boards of directors and compliance and risk-management functions). It also explores how financial industry self-regulation might be harnessed to create a prevailing industry culture which values avoiding social harm. To be clear, this Article is not arguing for complete abnegation of self-interest by the financial industry, nor is it arguing for the elimination of risk-taking: either outcome would be undesirable, as well as a fool's errand. Instead, this Article advocates for a change in culture such that financial industry participants "behave as if [society's] comfort and welfare were, if not necessarily at the top of their 'to-do' list, still worth consideration."[11] The proposed reforms are designed to stress the magnitude of the benefits of financial stability for the broader public (so that the financial industry feels that sacrifices made are worthwhile), and increase contacts between the financial industry and the broader public (to help erode the existing in-group versus out-group orientation that makes the financial industry less likely to value the well-being of the broader public).[12] Some of the proposals are designed to instill a better understanding of financial instability as a phenomenon that is at least partially caused by the financial industry's activities, rather than an automatic and inevitable part of the business cycle for which the financial industry bears no responsibility.

All of these proposals will require the buy-in of authority figures (business school professors, financial institution board members or senior management, as the case may be) to succeed. They are also predicated on

9. *See infra* text accompanying notes 155-163 (discussing the complexity of the financial system).

10. Dan Awrey, William Blair & David Kershaw, *Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation*, (London Sch. Of Econ., Legal Studies Working Paper No. 14/2012, 2012), *available at* http://ssrn.com/abstract=2157588.

11. LYNN STOUT, CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE 7 (2010).

12. Onnig H. Dombalagian, *The Expressive Synergies of the Volcker Rule*, 54 B.C. L. REV. 469, 498 (2013); Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757, 763 (2005).

the understanding that it is both possible and appropriate for the actions of financial sector personnel to be informed by more than just self-interest. As such, accepting the value of this Article's proposals entails at least a partial rejection of the "self-interest" part of the neoclassical economic assumption that all persons act only to maximize rational self-interest. To this end, this Article relies on the wealth of empirical research that supports the existence of a universal norm of indirect other-regarding behavior that directs us to consider the effects of our actions on others beyond our immediate counterparties.[13] In cultures as varied as "Orma cattle herders in Kenya" and "Lamalara whale-hunters in Indonesia", researchers have found that people will sometimes make sacrifices for the greater good,[14] and the expectation that people will empathize with the plight of others, and refrain from harming others, is even stronger than the expectation that people will actively assist others.[15] That is not to say that self-interest is irrelevant to people's motivations—only that people are often willing to make small sacrifices for the greater good. If the sacrifice demanded is too large, however, self-interest is likely to carry the day.[16] As such, while the reforms proposed in this Article are conceptually separate from proposals that have been made to align the incentives of financial institution personnel with the interests of the public in long-term stability (these incentive-based proposals appeal entirely to the actor's self-interest), the two types of proposals are necessarily complementary. Incentives must be structured such that there is not too much personal cost involved in avoiding the pathologies of banking business as usual: cultural reform is more apt for the fine-tuning of behaviors once there are no longer overwhelming incentives to act in a particular poor way.

The remainder of this Article will proceed as follows. Section I will explore in more detail the pathologies of banking business as usual. It considers two particularly important pathologies in the abstract—namely, the use of leverage, and certain types of complexity-inducing financial innovation—as well as utilizes more concrete examples from the Financial Crisis, and the more recent scandal relating to JPMorgan's "London

13. Coughlin notes that "[t]he socio-economic literature is replete with examples of how models that assume the pursuit of narrow self-interest simply do not work as well as those that provide a more complete and more realistic portrayal of human motivation." Richard M. Coughlin, *Whose Morality? Which Community? What Interests? Socio-economic and Communitarian Perspectives*, 25 J. SOCIO-ECONOMICS 135, 140 (1996). Much of this research is summarized in STOUT, *supra* note 11, at 75-93.

14. The research on other-regarding behavior recognizes that incentives play a role in driving behavior, although it contradicts the assumption that we only ever act to maximize self-interest. STOUT, *supra* note 11 at 82.

15. Zak, *infra* note 21, at 267; Solomon, *infra* note 24, at 20.

16. STOUT, *supra* note 11, at 99.

Whale" trading losses, to explain how behavior that is self-interested, but stops short of fraud, is the usual culprit in times of financial instability. Section II explores a range of business school and institutional governance reforms designed to inculcate a more other-regarding culture in the financial industry. Section III emphasizes the need for such cultural reform by demonstrating that strategies typically used to combat financial misconduct—including criminal prosecution and private litigation—are ill-suited to addressing non-fraudulent destabilizing behaviors. Section III also explores the limitations of command-and-control regulation (particularly its susceptibility to arbitrage), and the difficulties inherent in precisely aligning the incentives of the financial industry with society's interests in financial stability. While rules and incentives remain important tools for engendering financial stability, this Article argues that they should be complemented by policies that promote cultural reform.

I. THE PATHOLOGIES OF BANKING BUSINESS AS USUAL

Broadly speaking, two meta-narratives have emerged as explanations for the Financial Crisis. One narrative sees the Crisis as the confluence of appropriately self-interested actions by individuals who were simply confounded by complexity and cognitive failures[17]: buyers and sellers of financial products all failed to appreciate the risks that were being taken in the lead up to—and eventually precipitated—the Financial Crisis. This first account of the Crisis asserts that destabilizing behaviors were problematic, but cannot be addressed by cultural reform (and should not be punished) because they resulted from purely cognitive errors with no attendant moral culpability.[18] Counterpoised against this first narrative is the "moral failure" narrative, which asserts that the institutions buying and selling financial products *did* appreciate the risks that were being taken in the lead-up to the Crisis, but were happy to maximize their own self-interest by consciously duping their counterparties.[19]

This Article argues for a middle path—neither cognitive nor moral failures should be considered in isolation. While it is true that market participants will never have perfect information or be able to make perfect decisions about something as complex as the financial system,[20] it is also

17. Arnold Kling, *The Financial Crisis: Moral Failure or Cognitive Failure?*, 33 HARV. J.L. & PUB. POL'Y 507, 507-09 (2010); Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209, 1210 (2011).

18. Kling, *supra* note 17, at 507-09.

19. Langevoort, *supra* note 17, at 1210-11.

20. *Id.* at 1210.

true that they will rarely be *entirely* ignorant of what is going on in that system. Instead, market participants will usually be making *partially* informed decisions, and some type of moral judgment will need to supplement that decision-making in order to fill the informational and cognitive void.[21] In particular, moral norms function as a lens through which information is viewed and assessed—risks are sometimes underappreciated as unimportant, not only because the decision-maker had difficulty comprehending those risks, but also because the consequences of those risks would be borne largely by other people if they came to fruition.[22] Moral and cognitive failures are thus intertwined, and must be analyzed as such.

This Article seeks to explain how the moral and cognitive failures of the financial industry intertwine to generate financial instability. In order to do so, it must engage with a preliminary under-theorized question: what precisely is meant by "moral norms" and "morality" in the financial stability context? There is not just one normative standard that governs the behavior of the financial industry: as Jodi Short has identified, "[c]orporate financial conduct . . . is subject to multiple and potentially conflicting normative systems."[23] This Article therefore takes on the task of unpacking some of the moral normative systems that currently apply to Wall Street personnel. While there are centuries of religious and philosophical literature that explore the boundaries of morality, this Article will leave such religious and philosophical debates to those better qualified to engage in them.[24] Instead, this Article is informed by ethnographical research on

21. "[M]orals are not a creation of reason, but a second tradition independent from the tradition of reason, which helps us adapt to problems which exceed by far the limits of our capacity of rational perception". Paul J. Zak, *Values and Value: Moral Economics*, *in* MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY, 259, 259 (Paul J. Zak ed., 2008) (quoting Friedrich von Hayek); *see also* Susan A. Bandes, *Emotions and Risk Regulation*, *in* 62 STUDIES IN LAW, POLITICS, AND SOCIETY 219, 220 (Bettina Lange et al. eds., 2013).

22. In the behavioral economics literature, this is known as "incentive bias": "In this case, the actor knows or has good reason to know that the facts are a certain way, but deliberately ignores the facts, suppresses information, or distorts analysis out of a conscious intention to promote the actor's own interests." 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, 817 (2010).

23. Jodi L. Short, *Competing Normative Frameworks and the Limits of Deterrence Theory: Comments on Baker and Griffith's Ensuring Corporate Misconduct*, 38 LAW & SOC. INQUIRY 493, 501 (2013).

24. Some scholars have evinced a distaste for confusing the religious aspects of morality with law: there is a sense, for some, that "to make a personal statement about the immorality of a particular type of securities transaction is to confuse oneself with God." John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 HOFSTRA L. REV. 1015 (2001) (discussing Manne's

the norms that are particular to and prevalent in the financial industry,[25] as well as a large body of empirical research by ethnographers, anthropologists and neuroscientists on moral norms that tend to apply universally around the world and across cultures.[26] People tend to feel ashamed when they violate the moral norms that exist in their culture, and as such, these universal moral norms can be powerful regulators of behavior, even in the absence of formal enforcement mechanisms.[27]

Research on universal moral norms has identified that humans generally expect compliance with norms relating to recognition of property rights and prohibitions on murder, rape and certain other forms of violence.[28] There are also certain universal moral norms that are highly salient to financial regulation. One is honesty,[29] and a broad literature has emerged that explores how honesty is essential to economic interactions between people.[30] Another universal moral norm that is highly salient to—but almost entirely unexplored in the context of—financial regulation, is the norm of indirect other-regarding behavior.[31] This norm directs us to consider the effects of our actions on others beyond our immediate counterparties (in economic parlance, the externalities of our actions), as

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work). However, morality need not be religious: there is a long tradition of moral philosophy outside of the religious traditions, incorporating the works of Aristotle, Hobbes, Adam Smith, Hume, Kant, and Rawls, to name just a few. *See* Robert C. Solomon, *Free Enterprise, Sympathy and Virtue*, *in* MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY, *supra* note 22, at 16 (providing a reasonably brief review of the views of these thinkers, in the context of corporations and free enterprise).

25. KAREN HO, LIQUIDATED: AN ETHNOGRAPHY OF WALL STREET (2009).

26. Lynn A. Stout, *Taking Conscience Seriously*, *in* MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY, *supra* note 21, at 157, 162 [hereinafter Stout, MORAL MARKETS]; Zak, *supra* note 21, at 259, 273.

27. Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 909 (1996)

28. Stout, MORAL MARKETS, *supra* note 26, at 162.

29. "The norms embodied in this legal regime include honesty, fair dealing, and investor protection." Short, *supra* note 23, at 501.

30. *See, e.g.*, TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD (2006) (arguing that the lack of trust and honesty in the financial industry has detrimental consequences on the economy and suggesting that Americans can reverse the trend by "demand[ing] of their leaders and of each other more honesty and less cynicism, more trust and less doubting").

31. "Even with spatial and temporal distance, others' emotions are felt in ourselves and influence our behavior." Zak, *supra* note 21, at 267; "Universal moral values . . . reflect . . . direct concern for the concrete welfare of other living, breathing humans in one's community. At this level, morality is both an important concept and a widely shared one." Stout, MORAL MARKETS, *supra* note 26, at 163. This more expansive notion of indirect other-regarding behavior becomes particularly important when people have no choice as to participation in a system: they can choose not to deal with people they deem dishonest or untrustworthy, but it is much more difficult to opt out of an entire financial system and economy that are callous to their needs.

opposed to the norm of honesty, which tends to be assessed by its impact on others with whom we have some type of direct connection (i.e. honest people tell the truth to others).[32]

Honesty is recognized as being essential to economic interactions: if an actor is perceived to be lacking in honesty, others will not have the confidence to engage in transactions with that actor without expensive verification mechanisms.[33] While these increased transaction costs are certainly important for individual transactions, they can also become significant from a systemic perspective when instances of dishonest behavior become so prevalent (or are perceived to have become so prevalent) that transaction costs are increased for everyone, even where both counterparties *are* honest. In such a systemic context, failure to think more expansively about externalities (in this case, the increased transaction costs for "others" resulting from a systemic lack of confidence precipitated by one's dishonest actions)[34] violates the norm of indirect other-regarding behavior.

Regrettably, this norm of indirect other-regarding behavior appears to have been displaced, or at least to have mutated, in the prevailing culture of Wall Street today.[35] One landmark ethnographic study of Wall Street institutions has found that the employees of such institutions are motivated almost entirely by short-term profits,[36] which "generat[es] pressure to . . . ignore the societal impact of their risk-taking."[37] This does not necessarily demonstrate a complete lack of concern for everyone: to the extent that risky behavior drives up short-term institutional profits, it could be said to

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32. Tamar Frankel, *Trust, Honesty and Ethics in Business*, 31-32 FIN. & COMMON GOOD (BIEN COMMUN) 87, 88 (2008), http://www.tamarfrankel.com/support-files/financeandcommongood.pdf.

33. Ronald J. Colombo, *The Role of Trust in Financial Regulation*, 55 VILL. L. REV. 577, 579 (2010).

34. James A. Fanto, *Surveillant and Counselor: A Reorientation in Compliance for Financial Firms* 20 (Brooklyn Law Sch. Legal Studies, Working Paper No. 358, 2013), *available at* http://ssrn.com/abstract=2321317.

35. Cultures can evolve in ways that suppress universal moral norms like empathy and guilt. Frankel, *supra* note 32, at 89.

36. Karen Ho's ethnography of Wall Street bankers depicts an industry that has a laser-like focus on short-term market movements, rather than on long-term consequences for those outside of the markets. (cited in Langevoort, *supra* note 17, at 1233). More recently, an independent report on Barclays found that "[t]he culture that emerged [at the bank] tended to favor transactions over relationships, the short term over sustainability and financial over other business purposes." Mark Scott, *Report Faults 'at All Costs' Attitude at Barclays That Encouraged Risk*, N.Y. TIMES, Apr. 4, 2013, at B2, *available at* http://dealbook.nytimes.com/2013/04/03/report-faults-at-all-costs-attitude-at-barclays (quoting Anthony Salz, former head of the law firm Freshfields Bruckhaus Deringer).

37. Awrey et al., *supra* note 10, at 20.

be aligned with norms of promoting shareholder value[38] (although there is a strong case that diversified financial institution shareholders are better served by financial stability than by outsized profits from those financial institutions).[39] Members of the financial industry often demonstrate concern for their peers within the industry as well.[40] However, when financial industry personnel engage in risky behavior for the single-minded purpose of increasing short-term profits, this evinces a lack of regard for people who are neither their peers nor shareholders in the financial institution, but who will (in the form of lost jobs and eviscerated retirement funds) bear the brunt of any financial instability caused by that institution.[41] To be clear, it is not the risk-taking in and of itself that is objectionable (after all, the financial industry came into being for the purpose of facilitating the prudent taking and managing of risks). Instead, Wall Street behavior diverges from norms of indirect other-regarding behavior in its failure to consider the negative externalities of its risk-taking—particularly the consequences for those who have no direct relationship with the institution in question.

A. Complexity and Leverage

This Part will explore the process of financial innovation, and the use of very high leverage: two important examples of financial activities that generate large profits in the short-term, but which pose potentially huge problems for financial stability. Whilst some amount of innovation, and some level of leverage, is integral to the proper functioning of the financial system, it is difficult to delineate in advance the ideal amounts of each. Innovation can facilitate broader economic growth by improving capital intermediation and risk management,[42] and some level of leverage is

38. "A second normative system governing behavior in the contemporary corporation is the maximization of shareholder value, narrowly conceived as wealth and often operationalized as short-term, quarter-to-quarter gains." Short, *supra* note 23, at 501. However, the quest for short-term profits can also be viewed more cynically as a pure promotion of personal self-interest. *Id.* at 504.

39. *See infra* note 199 and accompanying text (arguing that diversified shareholders are harmed more by systemic events than lower institutional profits).

40. If a culture evolves so that a person's peer group endorses their act, even if it violates broader social norms, then that person is more likely to be comfortable breaching those norms. Sunstein, *supra* note 27, at 940.

41. "[T]he pain [resulting from financial instability] usually does not fall proportionately on those who made the mistakes in the first place". Stephen B. Young, *Moral Capitalism and the Great Financial Meltdown of 2008*, 33 FLETCHER F. WORLD AFF. 129, 139 (2009).

42. Hilary J. Allen, *A New Philosophy For Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173, 218-19 (2013) [hereinafter Allen, *New Philosophy*].

essential to financial institutions' abilities to provide liquidity and intermediate capital.[43] But excessive amounts of either activity can destabilize our financial system.

Financial innovation is potentially problematic because of its contribution to the increasing complexity of the financial system. This complexity renders the system increasingly opaque to reasoned human cognition, making it more difficult to make thoughtful judgments about where risk lies. Furthermore, the numerous linkages between financial institutions and products function as feedback loops that can speed up and amplify the transmission of shocks throughout the financial system.[44] This increased speed further hampers the exercise of reasoned human judgment, necessitating reliance on shortcuts like cognitive heuristics and computer models, which tend to dismiss low-probability but high-consequence tail risks.[45] Thus, when something unanticipated goes wrong (which may be as innocent as a fat finger error) the shock can reverberate through the system before anyone (regulators or market participants) can exercise reasoned human judgment about how to respond. In place of reasoned judgment, correlated reliance on similar shortcuts can lead to the panicked herd behavior (particularly the destructive fire sales of financial assets) that precipitates financial instability.[46]

Innovation of complex new financial products thus poses risks for financial stability.[47] This is so even when the institutions that develop these products honestly disclose the inherent risks to investors: the new products

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43. RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 40 (5th ed. 2013).

44. Allen, *New Philosophy*, *supra* note 42, at 218-19. This is particularly the case when there is a long chain of intermediaries involved, which increases reliance on short-term funding (each link in the chain must use increasingly cheaper funding to make the transaction viable, and funding generally becomes cheaper when it is short-term, because of the lowered chance that something can go wrong in the brief period of exposure). Increased reliance on short-term funding renders the financial system more fragile. Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. (forthcoming 2015).

45. "Individuals tend to ignore low probability catastrophic events." Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1488 (1993). This very human tendency is exacerbated by over-reliance on computer-based mathematical models like "Value at Risk" or "VaR", which tend to downplay tail risks. *See generally* 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).

46. Allen, *New Philosophy*, *supra* note 42, at 219.

47. "In today's financial marketplace, the biggest and potentially least understood systemic risks come from large-scale trading in highly complex derivatives, structured products, and other instruments of risk transfer used for sophisticated speculation and arbitrage." Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 478 (2011).

still add complexity and interconnectedness to the financial system, increasing the amount and obscuring the allocation of risk in the system as a whole.[48] Some take the position that this is the necessary price to be paid for progress,[49] but in fact there are many reasons to be skeptical of the benefits of financial innovation: innovation often serves the short-term interests of the firms who supply the innovations, rather than addressing any genuine societal needs for improved capital intermediation and/or risk management functions.[50] To the extent that financial institutions develop complex financial products with little social utility in order to generate large fees (particularly when these products are rushed out without full appreciation of the risks they entail), financial innovation can be viewed as a failure of indirect other-regarding behavior. There is a similar failure if an unnecessarily complex innovation has been engineered in order to confuse regulators, or to arbitrage regulatory requirements. Despite being undesirable, however, such innovations are by no means illegal.[51]

Financial innovations are often developed as a way of introducing new and unregulated types of leverage into the system.[52] When financial institutions rely heavily on leverage,[53] it increases their profits in good times, but makes them very vulnerable to external shocks. If such a shock occurs, highly-leveraged institutions will likely need to sell their assets quickly,[54] and this can depress asset prices system-wide, forcing other institutions to also deleverage by selling their assets (Brunnermeier has described this vicious cycle as a "fire sale externality").[55] Falling asset

48. Allen, *New Philosophy*, *supra* note 42, at 218-21.

49. *See, e.g.*, ROBERT E. LITAN, THE BROOKINGS INSTITUTION, IN DEFENSE OF MUCH, BUT NOT ALL, FINANCIAL INNOVATION (Feb. 17, 2010), *available at* http://www.brookings.edu/~/media/research/files/papers/2010/2/17%20financial%20innovation%20litan/0217_financial_innovation_litan.pdf.

50. Dan Awrey, *Complexity, Innovation, and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. 235, 262 (2012).

51. Regulatory arbitrage is "a perfectly legal planning technique used to avoid . . . regulatory costs." Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 229 (2010).

52. *See, e.g.*, Geanakoplos' discussion of how the innovation of the credit default swap created a new and almost limitless source of leverage in the financial system. John Geanakoplos, *The Leverage Cycle*, 24 NBER MACROECONOMICS ANN. 2009, 1, 6 (2009).

53. The less equity funding used to fund activities, the higher the debt funding and thus the higher the leverage. Andrew W. Lo & Thomas J. Brennan, *Do Labyrinthine Legal Limits on Leverage Lessen the Likelihood of Losses? An Analytical Framework*, 90 TEX. L. REV. 1775, 1780 (2012).

54. "As different managers experience similar effects, they are likely to react in the same way by each selling assets, causing greater price volatility and prompting further sales. The result is a cascading decline in value, with greater coordination impairing each firm's ability to manage its own risk exposure." Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323, 326-27 (2011).

55. Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-*

prices can damage confidence and cause financial institutions to become insolvent—with broad consequences for the availability of credit and payment systems to the economy as a whole.[56]

Given these externalized costs of high leverage and instability, society is best served by financial institutions reducing their leverage profile. To this end, international regulatory capital standards (the most recent iteration of which is known as "Basel III") have been developed that require banks to maintain a minimum amount of equity (as opposed to debt) funding.[57] Basel III's standards are complicated, but essentially they require banks to fund a minimum amount of their "risk-weighted assets" with equity or equity-like instruments, which are better able to absorb losses than debt.[58] Banks are able to arbitrage these regulatory capital rules, though, to allow them to hold lower amounts of equity than are required by the "spirit" of Basel III. For example, over the years banks have innovated new products like trust preferred securities and contingent convertible bonds to satisfy regulatory capital requirements, notwithstanding that these innovative instruments are inferior to common equity in their ability to absorb any losses that the issuing financial institution may incur.[59] In addition, different types of non-bank institutions (often referred to as "shadow banks") have evolved since the advent of regulatory capital rules that provide banking-like services without having to comply with Basel III's standards.[60]

The banks that are required to comply with Basel III can also arbitrage those standards by manipulating the way they calculate their risk-weighted assets. A bank can transfer its assets "off-balance sheet" so that they are excluded from its calculation of risk-weighted assets, or a bank can use proprietary internal models to assign low risk-weightings to its assets.[61] These techniques allow banks to report that they have fewer assets, with lower risk-weightings, which allows them to fund themselves with more

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2008, 23 J. OF ECON. PERSP. 77, 94 (2009).

56. Allen, New Philosophy, *supra* note 48, at 183.

57. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (2011).

58. The Basel III international standards on capital adequacy (which are in the process of being implemented in most advanced economies) effectively require banks to fund at least 7.0% of their risk-weighed assets with common equity, and to fund another 3.5% of their risk weighted assets with equity-like instruments. There are more stringent requirements for global systemically important banks. *Id.* at 27-28.

59. Hilary J. Allen, *Let's Talk About Tax: Fixing Bank Incentives to Sabotage Stability*, 18 FORDHAM J. CORP. & FIN. L. 821, 844-866 (2013) [hereinafter Allen, *Let's Talk About Tax*].

60. *Id.* at 882-83.

61. *Id.* at 832.

debt and less equity and thus increase their leverage (the amount of equity funding required is expressed as a percentage of risk-weighted assets).[62] Doing so is rarely fraudulent: because accounting methodologies and the attribution of risk to highly complex, often illiquid, financial assets are inherently subjective, and reflect the combined judgments of many different people working in a financial institution, it is very difficult to say that the results are not plausibly honest. However, even though this type of arbitrage is legal, if a lack of concern for how others might be affected by the fruition of an institution's risks results in consistently low reports of risk-weighted assets (and thus minimizes the amount of equity that the institution has available to absorb losses), then this evinces a failure of indirect other-regarding behavior.[63]

B. The Pathologies of the Financial Crisis

Unnecessarily high complexity and leverage, as well as some other failures of indirect other-regarding behavior, were key drivers of the Financial Crisis. This Part will illustrate this idea with actual examples from the Financial Crisis. However, this Part will start by examining someone who did *not* cause the Financial Crisis: Bernie Madoff. Many people invested with Madoff in the years before the Financial Crisis, trusting that he was an honest money manager producing reasonable (if somewhat implausibly consistent) returns.[64] When Madoff could no longer attract new investors during the Financial Crisis, it became apparent that he was operating a Ponzi scheme, and that he had defrauded investors of an estimated $64.8 billion.[65] Madoff was charged with eleven felony counts, including securities, mail and wire fraud; he subsequently pled guilty to all

62. Vanessa Le Leslé and Sofiya Avramova, *Revisiting Risk-Weighted Assets* 7 (IMF Working Paper 12/90, 2012).

63. It should also be noted that while the Basel III standards are helpful, they do not come close to eliminating the externalities caused by financial institution leverage. Basel III does not apply to most non-bank financial institutions, and even when it comes to banks, many economists dispute that the minimum levels of equity funding mandated by Basel III are sufficient. For example, Admati and twenty other prominent economists have argued that banks should be required to fund at least 15% of their *total* (i.e. not risk-weighted) assets with common equity. Admati et al., *Healthy Banking System is the Goal, Not Profitable Banks*, FINANCIAL TIMES, Nov. 9, 2010, *available at*, http://www.ft.com/intl/cms/s/0/63fa6b9e-eb8e-11df-bbb5-00144feab49a.html#axzz3PtCHWUlj. Given the limitations of the Basel III standards, society is largely forced to depend on financial institutions' own judgments about what level of leverage is appropriate, and instability is much more likely if those judgments are entirely self-interested.

64. Felicia Smith, *Madoff Ponzi Scheme Exposes the Myth of the Sophisticated Investor*, 40 U. BALT. L. REV. 215, 229 (2010).

65. *Id.* at 226.

charges, and was sentenced to 150 years in prison for his dishonest and criminal behavior.[66] While Madoff's failures of honesty and trustworthiness were devastating for those who had invested with him, they did not really compromise the stability of the financial system more broadly.[67] At worst, Madoff's fund—and the numerous other Ponzi schemes that have come to light in the last few years—may have contributed to a general sense that the financial markets were unfair and therefore not deserving of confidence,[68] but these Ponzi schemes can more accurately be described as being *exposed by* financial instability, rather than causing it.

The sheer scope of the Financial Crisis suggests that it could not have been caused entirely by the actions of a few "bad apples."[69] Instead, the actions that caused the greatest harm in the Financial Crisis were in many cases not fraudulent (or if they were fraudulent, the real harm that they caused went far beyond harm to the people who were deceived and cheated). The more plausible narrative of the Financial Crisis is that the financial industry had a self-interested culture that encouraged many people, who would probably consider themselves very honest and trustworthy,[70] to disregard the externalities of their actions. This point is perhaps best illustrated by considering the mortgage-backed securitization ("MBS") bubble that precipitated the Financial Crisis.

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66. *Id.*at 215, 221-22.

67. Indeed neither Madoff's nor any other Ponzi scheme even rates a mention in the FCIC Report on the causes of the Financial Crisis. That is not to say that the failure of Madoff's fund did not cause any negative externalities: in particular, many universities and non-profit organizations were devastated by losses resulting from Madoff's fraud. *Id.* at 232. The point being made is that the externalities caused by interruptions to university and non-profit activities did not include any consequences for financial stability.

68. *Id.* at 231.

69. Persaud notes that "We must continue to clamp down on fraud and ethical abuses and promote transparency, but this is not enough to avoid crises." Avinash Persaud, *Macro-Prudential Regulation: Fixing Fundamental Market (and Regulatory) Failures*, CRISIS RESPONSE (The World Bank Grp., Wash., D.C.), July 2009, at 7, *available at* http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/Note6.pdf. In a similar vein, Coffee has stated in relation to the Enron scandal that "No doubt, there were some rogues and some particularly bad boards. Yet the most reliable evidence, when properly read, suggests that Enron and related scandals were neither unique nor idiosyncratic; rather, pervasive problems arose that undercut existing systems of corporate governance." Symposium, *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 270 (2004).

70. "Personal greed perhaps, a lack of sufficient scrutiny of the company's affairs, an insensitivity or an indifference to public opinion, these charges could be leveled against some corporate leaders, but few, thankfully, are guilty of deliberate fraud or wickedness. At worst they were only playing the game according to the rules as they understood them." Charles Handy, *What's a Business For?, in* MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY 329 (Paul J. Zak ed., 2008).

In the late 1990s, the market for non-traditional residential mortgages began to grow in earnest.[71] Mortgage lenders engaged mortgage brokers to market these non-traditional mortgages to borrowers, but the mortgage brokers were in no way incentivized to ensure that borrowers could repay their mortgages. In fact, they were often rewarded through use of a commission known as a "yield spread premium" to steer borrowers towards more expensive mortgages.[72] The mortgage lenders were unconcerned about the borrowers' ability to repay, because those lenders did not retain any of the risk that the mortgages might default: the mortgages were immediately sold to Wall Street firms (which relied heavily on leverage to purchase these and other assets). The Wall Street firms were unconcerned about underwriting standards for the mortgages, because they immediately packaged the mortgages into complex MBSs and then sold them to investors.[73] Even when Wall Street firms kept MBSs on their books, they were still unconcerned about the quality of the underlying mortgages because they had engineered the MBSs (and layered credit default swaps on top of them) in a way that purported to reduce—or even eliminate—the default risk inherent in the individual underlying mortgages.[74]

Because the real risks inherent in these MBSs were obscured by complex financial engineering (and because regulators acquiesced in the view that MBSs were not risky investments), investors were not compensated for the risk they were acquiring, and the securities were "over-issued relative to what would be possible under rational expectations."[75] The demand for MBSs generated demand for more and more mortgages, with the result that mortgages were issued to even riskier borrowers who did not necessarily understand the terms of the exotic mortgages they were entering into, and who (in many cases) could not hope to be able to repay the mortgages if the values of their homes were to fall. This drove up real estate prices, and made the MBSs backed by those mortgages even riskier. This securitization process thus inflated both a real estate bubble and a bubble in MBSs themselves, and there were systemic reverberations when these bubbles popped, precipitating the Financial Crisis. In particular, the markets lost confidence in financial institutions

71. These mortgages included subprime mortgages for borrowers with weak credit, and for all types of borrowers, riskier mortgages with exotic features that allowed for negative amortization. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 88, 102 (2011) [hereinafter, the "FCIC Report"].

72. *Id.* at 90.

73. Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2040-41 (2007).

74. FCIC Report, *supra* note 71, at 42-35.

75. Nicola Gennaioli, Andrei Shleifer and & Robert Vishny, *Neglected Risks, Financial Innovation, and Financial Fragility*, 104 J. FIN. ECON. 452, 454 (2012).

that had large exposure to MBSs (or to credit default swaps used to hedge exposure to MBSs), like Lehman Brothers, Bear Stearns, Citibank, and AIG. Because these firms relied so heavily on short-term debt to fund their usual operations, once they lost the confidence of their funders, they quickly lost the ability to carry on business. The U.S. Government then stepped in to assist these institutions (with the notable exception of Lehman Brothers), but was unable to inspire confidence sufficient to immediately restore the normal workings of the financial system. The result was a credit crunch that stalled broader economic growth.

So which moral failings were at work here?[76] Individual mortgage brokers who marketed predatory loans *did* have personal relationships with potential mortgagors, and they abused the trust reposed in them when they engaged in dishonest sales tactics that hid risks from those mortgagors.[77] These types of behaviors could therefore properly be characterized as fraudulent, and they have often been the subject of criminal sanctions and private lawsuits.[78] But not only did many brokers disregard the interests of those they dealt with directly, they also disregarded the impact of their activities on society more broadly. In fact, by marketing these predatory loans, mortgage brokers were artificially inflating home prices, thereby fuelling a destabilizing asset bubble that would eventually hurt everyone when it popped. However, it is quite plausible that most mortgage brokers did not comprehend the systemic harm that their activities, when aggregated with similar behavior by other mortgage brokers, might do to financial stability more generally. If it is true that mortgage brokers did not understand the impact of their activities on society more broadly, then we cannot characterize their actions as a failure of indirect other-regarding behavior – in such an instance, it is fair to say that there is a pure cognitive failure rather than any moral failure.[79]

While it would be harder for the Wall Street firms, which made the mortgages and packaged them into MBSs,[80] to assert that they were

76. While this Article is focused on the financial industry's contribution to instability, the U.S. federal financial regulatory agencies should not entirely escape blame for the MBS bubble. *See* Part IV.C *infra* (discussing how financial regulators failed to take steps that might have mitigated the Crisis).

77. Kevin T. Jackson, *The Scandal Beneath the Financial Crisis: Getting a View from a Moral-Cultural Mental Model*, 33 HARV. J.L. & PUB. POL'Y 735, 762 (2010).

78. The Department of Justice has made available on its website a sample of documents relating to civil and criminal mortgage fraud prosecutions. *See, e.g.*, *Sample Documents*, U.S. ATTORNEY'S OFFICE E. DIST. PA., http://www.justice.gov/usao/pae/Mortgage_Task_Force/sampledocs.html (last visited May 9, 2015).

79. Where there is a purely cognitive failure, changing cultural norms to encourage more other-regarding behavior will have no impact.

80. By the time of the Financial Crisis, many of the lenders that made the mortgage loans had been subsumed into Wall Street conglomerates. FCIC Report, *supra* note 71, at

completely ignorant of the potential externalities of their actions, it is nonetheless true that many on Wall Street underappreciated the risks inherent in MBSs. This was in large part a result, however, of a conscious strategy by these same Wall Street firms to create opaquely complex financial products (MBSs had been specifically engineered as securities with only a low probability of default, and humans have a natural tendency to underestimate the risk—often referred to as "tail risk"—of low-probability, but potentially high-impact, events).[81] Furthermore, many did try to alert Wall Street to the problems with MBSs: voices warned about the securitization bubble prior to the Financial Crisis,[82] and significant short positions were taken against MBSs (and securities backed by other, more complex assets connected with the mortgage markets).[83] The problem was that these warnings about financial instability were largely ignored, in part because of moral failings. The financial industry's desire for short-term profits, and disregard for externalities borne by those outside of the financial system, ensured that the MBS machine continued to churn on even when there were clear warnings of the MBS market's destabilizing potential.

Wall Street's attitude was epitomized by a new acronym "IBGYBG" (short for "I'll be gone, you'll be gone"), coined in the heat of the MBS bubble to describe deals that "brought in big fees up front while risking much larger losses in the future."[84] This lack of moral compunction with respect to the MBS market was also on display in a quote from Armand Pastine, a Managing Director of a CDO issuer, reported in May of 2005: he stated, "[t]o suggest that CDO managers would pull out of an economically viable deal for moral reasons — that's a cop-out".[85] That Pastine repudiated morality does not mean that he was not also affected by

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88-89.

81. *See supra* note 45 (citing materials for the proposition that individuals tend to ignore low probability catastrophic events).

82. Engel & McCoy, *supra* note 73; Raghuram G. Rajan, *Has Financial Development Made the World Riskier?*, *in* THE GREENSPAN ERA: LESSONS FOR THE FUTURE, A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY, JACKSON HOLE, WYOMING, AUGUST 25-27, 2005 (Alan Greenspan ed., Fed. Reserve Bank of Kan. City 2005).

83. *See* Michael Lewis, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010) (presenting an extremely entertaining account of the people who bet against the MBS bubble).

84. FCIC Report, *supra* note 71, at 8.

85. Allison Pyburn, *CDO Investors Debate Morality of Spread Environment*, ASSET SECURITIZATION REPORT, May 9, 2005, at 1. It should be noted, though, that there were some bond managers who took "the high road . . . ." PIMCO, for example, announced that it would withdraw from the MBS market because the rates being paid on bonds were insufficient to compensate investors for the risk inherent in such bonds, given the lack of historical performance data for subprime mortgages, and credit ratings that were too lax. *Id.*

cognitive failures. In a statement ripe with hubris, Pastine also noted his (disastrously incorrect) view that "some of the investors are underestimating the stamina and resiliency of the residential mortgage market in the U.S. — particularly in light of the new products available to more residential consumers along the entire credit spectrum."[86] Nonetheless, Pastine's complete disregard for morality in the context of financial business is indicative of a broader cultural issue. He, and many others, thought it was preposterous to even consider the moral implications of mortgage-backed securitization.

Admittedly, when Pastine was quoted in May of 2005, the MBS bubble had reached such frenzied proportions that the profits to be made by participating would have been difficult to give up, even if industry personnel had felt some moral disquiet about the danger the bubble posed for financial stability—as Chuck Prince famously said, "[a]s long as the music is playing, you've got to get up and dance".[87] But earlier in the decade, when the MBS market was less frothy, dancing was less of a necessity: it is not unreasonable to suggest that financial institutions should have adopted a more circumspect and prudent approach to the creation, promotion and purchase of MBSs at that stage, which would have mitigated the growth of the bubble in the long-run.[88] However, the financial industry was so focused on short-term profits (especially the fee income associated with the mortgage backed securitization process) that it did not consider the long-term consequences of its activities for financial stability.[89]

In the wake of the Financial Crisis, some members of the financial industry have recognized their failures of indirect other-regarding behavior.[90] By and large, however, the gravity of the Financial Crisis has

86. *Id.*

87. Dealbook, *Citi Chief on Buyouts: 'We're Still Dancing'*, N.Y. TIMES, July 10, 2007, *available at* http://dealbook.nytimes.com/2007/07/10/citi-chief-on-buyout-loans-were-still-dancing/?_r=0.

88. Financial intermediaries assist in the creation of asset bubbles: they promote the products because of the fee income associated with those products, and there is little check on the quality or quantity of products issued because the financial intermediary has no skin in the game. *See* Young, *supra* note 41, at 138 (discussing factors that lead to asset bubbles). Pistor has emphasized that instability becomes built-in to the system at the time of contracting, so that is the key point at which other-regarding behavior is most important. Katharina Pistor, *A Legal Theory of Finance*, 41 J. COMP. ECON., 315, 327 (2013),.

89. *See* Kling, *supra* note 17, at 508 (discussing the misalignment of incentives in the financial industry that led to the Financial Crisis).

90. In the aftermath of the Financial Crisis, Bank of America CEO Brian Moynihan testified that "[o]ver the course of the crisis, we, as an industry, caused a lot of damage. Never has it been clearer how poor business judgments we have made have affected Main Street." FCIC Report, *supra* note 71, at 389.

not inspired the moral contrition that one might have expected. In fact, many in the industry have come to see themselves as being persecuted for failures of indirect other-regarding behavior that they view as simply being part of their job.[91] Furthermore, financial innovation and use of high levels of leverage continue largely unabated. The financial industry's failures of other-regarding behavior cannot be blamed entirely on a pre-Crisis bubble mentality. They reflect deep-seated cultural problems that have persisted even through the Financial Crisis and the recession that followed.[92]

The industry's lack of remorse has no doubt exacerbated the public desire for some form of reprisal, but while some MBS-related fraud has been prosecuted in the aftermath of the Financial Crisis,[93] almost no criminal charges have been levied against financial institutions—or their senior managers—for actually causing the MBS bubble.[94] Particularly galling for many is the fact that no executive of Lehman Brothers has been charged with any crime. This was not for want of trying: prosecutors appear to have expended great effort in investigating potential leads.[95] But while Lehman Brothers' management and employees certainly exhibited failures of indirect other-regarding behavior (for example, by using high

91. As a hyperbolic example of this mentality, in an interview with the Wall Street Journal, Robert Benmosche of AIG stated: "[t]he uproar over bonuses 'was intended to stir public anger, to get everybody out there with their pitch forks and their hangman nooses, and all that–sort of like what we did in the Deep South [decades ago]. And I think it was just as bad and just as wrong.'" Leslie Scism, *AIG's Benmosche and Miller on Villains, Turnarounds and Those Bonuses*, WALL ST. J. (Sept. 23, 2013, 2:32 PM), http://blogs.wsj.com/moneybeat/2013/09/23/aigs-benmosche-and-miller-on-villains-turnarounds-and-those-bonuses/tab/print/.

92. *See infra* Part II.C (discussing pathologies since the Financial Crisis).

93. The Department of Justice reported that in 2012, for example, 107 criminal defendants were charged with fraud relating to homeowners distressed by the Financial Crisis. Press Release, Dep't of Justice, Financial Fraud Enforcement Task Force Members Reveal Results of Distressed Homeowner Initiative, (Oct. 9, 2012), http://www.justice.gov/opa/pr/2012/October/12-ag-1216.html.

94. *No Crime, No Punishment*, N.Y. TIMES, Aug. 26, 2012 at SR10, *available at* http://www.nytimes.com/2012/08/26/opinion/sunday/no-crime-no-punishment.html.
The criminal prosecution of two former Bear Stearns hedge fund managers for securities fraud was the highest profile criminal case arising out of the Crisis, but they were acquitted. Zachery Kouwe and Dan Slater, *2 Bear Stearns Fund Leaders Are Acquitted*, N.Y. TIMES, Nov. 11, 2009 at A1, *available at* http://www.nytimes.com/2009/11/11/business/11bear.html. Even if the hedge fund managers had been found guilty, their crime would have been deceiving their investors, rather than contributing to financial instability by exacerbating a bubble in complex mortgage-backed financial products. Press Release, U.S. Attorney's Office for the E. Dist. of N.Y., Two Senior Managers Of Failed Bear Stearns Hedge Funds Indicted On Conspiracy And Fraud Charges (June 19, 2008), http://www.justice.gov/usao/nye/pr/2008/2008jun19.html.

95. Ben Protess & Susanne Craig, *Inside the End of the U.S. Bid to Get Lehman*, N.Y. TIMES, Sept. 9, 2013, *available at* http://dealbook.nytimes.com/2013/09/08/inside-the-end-of-the-u-s-bid-to-punish-lehman-executives/.

levels of leverage to purchase illiquid complex assets like MBSs),[96] there was little evidence of behavior that was actually fraudulent. As Jed Rakoff has noted, "If the Great Recession was in no part the handiwork of intentionally fraudulent practices by high-level executives, then to prosecute such executives criminally would be 'scapegoating' of the most shallow and despicable kind."[97] The one potentially shady practice identified by Anton Valukas, the Lehman Brothers' Examiner, was Lehman's use of the "Repo 105" accounting manoeuver to "temporarily remove $50 billion of assets from its balance sheet at first and second quarter ends in 2008 so that it could report significantly lower net leverage numbers than reality."[98] Ultimately, though, prosecutors concluded that this accounting practice was technically legal.[99] Regardless, the Repo 105 transactions were not destabilizing in and of themselves, but were used to hide destabilizing actions (like highly-leveraged purchases of MBSs) that had already been taken.[100]

Notwithstanding the dearth of criminal proceedings, an infinite array of civil claims has been filed in connection with the MBS bubble.[101] These include claims alleging predatory conduct by mortgage lenders towards mortgagors;[102] securities fraud claims alleging that financial institutions made misleading and deceptive statements to investors in connection with the sale of MBSs;[103] securities fraud claims brought by shareholders in

96. Examiner's Report of Anton R. Valukas at 22, *In re* Lehman Bros. Holdings, 439 B.R. 811 (Bankr. S.D.N.Y. 2010) (Nos. 08-13555, 08-13888).

97. Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REVIEW OF BOOKS, Jan. 9, 2014, at 4.

98. Examiner's Report, *supra* note 96, at 19.

99. Protess & Craig, *supra* note 95.

100. *See* Examiner's Report, *supra* note 96, at 22.

101. This paragraph does not provide an exhaustive list of the types of claims that have been brought. One of the more creative claims filed with regard to the MBS bubble alleged that "subprime foreclosures constituted a public nuisance caused by defendant financial institutions' securitization practices". See Christopher J. Miller, *"Don't Blame Me, Blame the Financial Crisis": A Survey of Dismissal Rulings in 10b-5 Suits for Subprime Securities Losses*, 80 FORDHAM L. REV. 273, 275 (2011) for a discussion of *City of Cleveland v. Ameriquest Mortg. Sec., Inc.*, 615 F.3d 496 (6th Cir. 2010). For a more comprehensive account of Crisis-related litigation, see David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1469 (2014) (discussing the characteristics and kinds of crisis-related litigation using Citigroup's suit against Wells Fargo as an example).

102. For example, in October 2012, a class action was filed by the ACLU alleging that Morgan Stanley had disproportionately targeted African Americans borrowers with high-cost and high-risk residential mortgages. Jessica Silver-Greenberg, *A.C.L.U. Filing Suit Over Loans*, N.Y. TIMES, Oct. 15, 2012, at B1, *available at* http://www.nytimes.com/2012/10/15/business/aclu-to-sue-morgan-stanley-over-mortgage-loans.html.

103. For a discussion of claims brought by the SEC in connection with misleading statements made to MBS investors, see Peter J Henning, *Mixed Results for S.E.C. in*

financial institutions alleging misleading and deceptive statements (for example, that the institutions misrepresented the strength of their mortgage underwriting standards or their exposure to subprime mortgages);[104] and claims alleging breach of fiduciary duties by financial institution boards for failing to monitor their institution's risk exposures.[105] Some of these claims have succeeded, but many have proven unsuccessful because of difficulties in establishing scienter and causation,[106] and because of courts' reluctance to hold financial institution boards liable for failing to monitor business risk.[107] Even if more of these claims had succeeded, however, they would

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Financial Crisis Cases, N.Y. TIMES (Nov. 19, 2012), http://dealbook.nytimes.com/2012/11/19/mixed-results-for-s-e-c-in-financial-crisis-cases/. The SEC's settlement with Goldman Sachs over the CDO referred to as "ABACUS 2007-AC1" is illustrative: the SEC filed a complaint against Goldman Sachs alleging that "marketing materials for ABACUS 2007-AC1 'were false and misleading because they represented that ACA selected the reference portfolio while omitting any mention that Paulson, a party with economic interests adverse to CDO investors, played a significant role in the selection of the reference portfolio.'" Jonathan Fisher, Claire Cregan, James di Giulio & Jodi Schutze, *Economic Crime and the Global Financial Crisis*, 5 LAW & FIN. MKT. REV. 276, 278 (2011). Fannie Mae and Freddie Mac, the largest MBS investors in the U.S., have also "accused the banks of duping the housing giants into buying $200 billion of mortgage securities that ultimately imploded during the financial crisis". Jessica Silver-Greenberg, *Banks Seek to Overturn Judge's Ruling in a Mortgage Case*, N.Y. TIMES , Mar. 28, 2013, at B10 *available at* http://dealbook.nytimes.com/2013/03/27/banks-seek-to-overturn-judges-ruling-in-critical-mortgage-case/.

104. For a rare example of a successful suit in this vein, see *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp.2d 1132 (C.D. Cal. 2008). Courts have generally dismissed such claims. *See* Hurt, *infra* note 290, at 267 (discussing how the Southern District of New York has not seen a large number of successful suits against financial institutions).

105. These claims are usually framed as failure of the board's duty to oversee or monitor the financial institution. *See, e.g.*, *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009) ("[A]lleging that directors breached their fiduciary duties by failing to adequately protect corporation from exposure to subprime lending market, and alleging that directors engaged in waste."). However, other types of fiduciary duty claims (including breach of the duty of care) have also been (unsuccessfully) alleged in the wake of the Crisis. *See, e.g.*, *In re* The Goldman Sachs Grp., Inc. S'holder Litig., 2011 WL 4826104 (Del. Ch. 2011) ("[A]lleging that [directors] breached their fiduciary duties by failing to properly analyze and rationally set compensation levels for corporate employees, by committing waste, . . . and by failing to adequately monitor the corporation's operations."). For a discussion of these claims, see Hurt, *infra* note 290 at 275–79.

106. One survey of 10b-5 claims brought in the wake of the Financial Crisis found that "Scienter has been the major hurdle for plaintiffs in financial crisis-related suits under Section 10b and Rule 10b-5: in the cases examined, only one court that found the plaintiff's scienter allegations sufficient ultimately dismissed the complaint for failure to plead loss causation." Miller, *supra* note 101, at 304. For a discussion of the difficulties associated with establishing liability for consumer claims relating to securitized mortgages, see Kathleen C. Engel & Thomas J. Fitzpatrick IV, *Complexity, Complicity, and Liability Up the Securitization Food Chain: Investor and Arranger Exposure to Consumer Claims*, 2 HARV. BUS. L. REV. 345 (2012).

107. *See* Symposium, *A Board's Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717, 739

have enforced only the interests of mortgagors, MBS investors, or financial institution shareholders. The brunt of the collapse of the financial system was borne by people who had never even heard of MBSs, and who may not have had mortgages or even bank accounts,[108] let alone shares in financial institutions.[109]

C. Pathologies Since the Financial Crisis

The preceding discussion focused on moral failings in the lead-up to the Financial Crisis. Some have argued that the Financial Crisis was the proverbial "100 Year Storm", and thus unrepresentative of how the financial industry usually works.[110] Others thought that the Financial Crisis was a product of a broken Wall Street culture, but hoped that the magnitude of the Financial Crisis would prompt a change in that culture. Unfortunately, it appears that potentially destabilizing behaviors, as well as the financial industry's failure to consider the interests of society, persist and are endemic. The losses suffered by JPMorgan's Chief Investment Office ("CIO") in 2012 (known colloquially as the "London Whale" episode) are case in point.

By way of background, the CIO, which was created to invest the bank's excess deposits, started trading credit derivatives in 2006[111] (the stated purpose of the CIO's credit derivatives portfolio was to "hedge" or

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(2009) ("[E]valuating the board's success at monitoring business risk would . . . unleash the dangers of hindsight bias.").

108. In 2011, 8.2% of households had no bank accounts – many of these were lower income and unemployed households. FED. DEPOSIT INS. CORP., 2011 NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 3-4 (2012).

109. For an anecdotal description of the impact of the Financial Crisis on lower income and unemployed households, see Ronald A. Wilson, *The View From South Tucson: How the Economic Crisis Affects Defendants in My Courtroom*, 48 JUDGES J. 14 (2009).

110. For example, in testimony before the Financial Crisis Inquiry Commission, Goldman Sachs CEO Lloyd Blankfein stated "After the shocks of recent months and the associated economic pain, there is a natural and appropriate desire for wholesale reform. We should resist a response, however, that is solely designed around protecting us from the 100-year storm." Lloyd C. Blankfein, Chairman and CEO, The Goldman Sachs Grp., Inc., Testimony Before the Financial Crisis Inquiry Commission 12 (Jan. 13, 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0113-Blankfein.pdf.

111. STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS. 113TH CONG., JPMORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES 3 (2013) [hereinafter, Senate Report]. The most commonly traded form of credit derivative is a credit default swap, or CDS, which provides protection with respect to default risk on an underlying debt instrument, such as a bond. Other, more complicated types of credit derivatives, reference indices of debt instruments instead of a single debt instrument. *Id.* at 30-34.

offset JPMorgan's other credit risks in the long-term).[112] In the first quarter of 2012, the CIO was directed to reduce its risk-weighted assets – instead of doing so by selling off the riskiest derivative assets in its portfolio, the CIO opted to retain those assets and enter into additional risky derivatives designed to offset its existing derivative assets (thus increasing the size and risk of the total portfolio, and nullifying the hedging benefit of the derivatives already in its portfolio).[113] The portfolio started to lose value rapidly, even as its size was being expanded: in March 2012 alone, $40 billion of credit derivatives were purchased for the portfolio, and the portfolio reported $550 million of losses.[114] The CIO had a number of risk limits in place that were intended to alert the CIO if the derivatives and other assets it held became too risky, and these risk limits were breached at least 330 times in the first four months of 2012. However, these breaches were either ignored, or the risk limits were themselves adjusted to allow the portfolio to be operated as before.[115] Trading was finally halted in late March, but losses continued to grow – by the end of 2012, the portfolio was reported as having lost $6.2 billion in total.[116]

Fortunately, the losses occasioned by the CIO's trades were insufficiently large to have any systemic effect. However, the Senate report into the CIO's losses appreciates the true systemic significance of the episode: "The bank's actions not only exposed the many risk management deficiencies at JPMorgan Chase, but also raise systemic concerns about how many other financial institutions may be disregarding risk indicators and manipulating models to artificially lower risk results and capital requirements."[117] While cognitive failures were certainly at work here – JPMorgan would not have continued its trading strategy if the traders and their managers didn't think that the trades would eventually become profitable – willfully misvaluing investments and ignoring risk limits is symptomatic of an industry culture that, despite the lessons of the Financial Crisis, continues to exalt short-term profit to the potential detriment of long-term stability. As we have seen repeatedly, this lack of regard for others cannot be attributed only to "bad apples" or "rogue traders".[118] Instead, the traders within the CIO (including Bruno Iksil, the so-called "London Whale") consummated their trades openly and with the blessing of some of the bank's most senior managers, all of whom were

112. *Id.* at 4, 12.
113. *Id.* at 3.
114. *Id.* at 4.
115. *Id.* at 7.
116. *Id.* at 4.
117. *Id.* at 8.
118. *Id.* at 14.

therefore complicit in ignoring the breaches of risk metrics by the CIO's credit derivatives portfolio. For example, for four days in January 2012, the portfolio breached the acceptable Value-at-Risk limit not only for the portfolio, but for the whole bank, and the breach was reported all the way up to Jamie Dimon, CEO of JPMorgan.[119] Yet the CIO continued its trading strategy unchastened until late March. As the Senate report puts it, JPMorgan (which actually has the reputation of being one of the most careful of the Wall Street firms)[120] has a "culture in which risk limit breaches were routinely disregarded, risk metrics were frequently criticized or downplayed, and risk evaluation models were targeted by bank personnel seeking to produce artificially lower capital requirements."[121]

JPMorgan appears to have displayed some dishonesty here: the Senate report recounts at length the ways in which the bank misinformed investors and the public about its losses.[122] In terms of financial stability, however, the more culpable behavior is JPMorgan breaching internal risk protocols rather than how subsequent losses were reported to investors and the public. Once a highly-leveraged financial institution sustains sufficient losses, it is likely to lose the confidence of, and thus short-term funding from, other financial institutions: the experience of Bear Stearns and Lehman Brothers shows that once confidence is lost, financial institution failure can be precipitous, and contagious.[123] Internal risk protocols are designed to stop an institution from incurring such losses in the first place, and thus protect both the institution and the system as a whole. Public disclosures regarding losses occasioned by risky conduct will do nothing to reduce those losses, and such disclosures may in fact precipitate institutional failure by damaging confidence in the institution. Thus, as far as financial stability is concerned, the moral failing here was not one of dishonesty in public disclosures, but a failure to appreciate the potential consequences for others of JPMorgan making investments that its own internal systems had identified as too risky.

Although JPMorgan's *public* disclosure failures were not problematic from a financial stability perspective, hiding information about the CIO's risks and losses from JPMorgan's regulators (primarily the OCC) could have proved destabilizing. Regulators rely on real-time information from large institutions to make judgment calls about the risks faced by such

119. *Id.* at 7.

120. *See* Henry T. C. Hu, *Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601, 1671-1672 (2012) ("Dimon and JPM were so respected that they were at the vanguard of the financial services industry to fend off the impact of Dodd-Frank.").

121. Senate Report, *supra* note 111, at 7.

122. *Id.* at 14.

123. Allen, *Let's Talk About Tax*, *supra* note 59, at 864-65.

institutions, and the financial system as a whole. Because JPMorgan was not entirely forthcoming in its dealings with regulators,[124] the OCC had limited information on which to determine whether regulatory intervention was required. It is appropriate, then, that the Attorney-General, the Manhattan U.S. Attorney and the FBI Assistant Director-In-Charge,[125] as well as the SEC,[126] have charged two JPMorgan derivatives traders with fraudulent valuations, false filings and the keeping of false books and records. In a similar vein, the SEC reached a settlement with JPMorgan, which extracted civil penalties as well as a rare admission of wrongdoing for "misstating financial results and lacking effective internal controls to detect and prevent its traders from fraudulently overvaluing investments to conceal hundreds of millions of dollars in trading losses."[127] Nonetheless, these charges only address the outward trappings of JPMorgan's outsized risk-taking, rather than the risk-taking itself. That risk-taking, which evinced a failure of indirect other-regarding behavior, remains unpunishable by criminal sanctions—it could only have been addressed by the OCC taking steps to enforce its prudential regulations against JPMorgan.

Unfortunately, the OCC's performance left much to be desired in this instance: "[t]he increase in the [CIO derivatives portfolio's] size and risk triggered a breach of the CIO's and bankwide [sic] VaR limits, which the bank disclosed to the OCC in routine risk reports at the time, but which did not trigger an agency inquiry."[128] It seems that it was easier for the OCC to simply acquiesce in JPMorgan's conduct,[129] rather than taking more aggressive actions that would have been unpopular with JPMorgan in the short-term but upheld the regulators' obligation to preserve financial stability for others.[130] The OCC's conduct in this situation suggests that

124. Senate Report, *supra* note 111, at 8-9 ("[T]he bank was not forthcoming and even provided incorrect information" about the CIO's derivatives portfolio.). *Id.* at 14 ("In a quarterly meeting in late January 2012, the bank told the OCC that it planned to reduce the size of the SCP, but then increased the portfolio and its attendant risks.").

125. Press Release, U.S. Attorney for the S. Dist. of N.Y., Attorney Gen., Manhattan U.S. Attorney, and FBI Assistant Director-In-Charge Announce Charges Against Two Derivatives Traders In Connection With Multi-Billion Dollar Trading Loss At JPMorgan Chase & Company (Aug. 14, 2013).

126. Press Release No. 2013-154, Sec. Exch. Comm'n., SEC Charges Two J.P. Morgan Traders with Fraudulently Overvaluing Investments to Conceal Losses (Aug. 14, 2013).

127. Press Release No. 2013-187, Sec. Exch. Comm'n., JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013).

128. Senate Report, *supra* note 111, at 9.

129. When the OCC tried to investigate JPMorgan's conduct in the past, they were criticized by JPMorgan as "being overly intrusive". *Id.* at 14.

130. *Id.* at 10 ("JPMorgan Chase's ability to dodge effective OCC oversight . . . demonstrates that bank regulators need to conduct more aggressive oversight with their

regulatory failings, in addition to industry failings, persist post-Financial Crisis.

II. ADDRESSING FINANCIAL INDUSTRY CULTURE

The previous section illustrated that financial instability is a product of both cognitive failures and failures of indirect other-regarding behavior. A large post-Crisis scholarship has already examined the relevant cognitive failures in depth: this Section focuses instead on ways of changing the norms that characterize financial industry culture,[131] in order to promote more other-regarding behavior.

To date, much of the legal scholarship on norms has followed the law and economics paradigm. For example, McAdams' much-cited esteem theory of norms relies on a rationally self-interested calculus by an actor about how he or she is perceived. Self-interest is viewed as encompassing reputational utility as well as material interests, and McAdams posits that "the initial force behind norm creation is the desire individuals have for *respect* or *prestige*, that is, for the relative *esteem* of others."[132] The law and economics literature thus focuses on using "reputation, expressive effects, shaming and social sanctioning"[133] to create norms and change behavior.[134]

Unfortunately, the prescriptions of law and economics hold little promise for affecting a broad shift in the financial industry's norms with respect to destabilizing activities. For example, while unrestrained leverage and financial innovation can prove to be destabilizing, judicious

existing tools and develop more effective tools to detect and stop unsafe and unsound derivatives trading.").

131. William C. Dudley, President, Fed. Reserve Bank of N.Y., Enhancing Financial Stability by Improving Culture in the Financial Services Industry: Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry, (Oct. 20, 2014) ("Culture [within a financial institution] relates to the implicit norms that guide behavior in the absence of regulations or compliance rules—and sometimes despite those explicit restraints. Culture exists within every firm whether it is recognized or ignored, whether it is nurtured or neglected, and whether it is embraced of disavowed. Culture reflects the prevailing attitudes and behaviors within a firm. It is how people react not only to black and white, but to all of the shades of grey. Like a gentle breeze, culture may be hard to see, but you can feel it. Culture relates to what 'should' I do, and not to what 'can' I do.").

132. Richard H. McAdams, *Origin, Development and Regulation of Norms*, 96 MICH. L. REV. 338, 342 (1997) (emphasis added).

133. Yuval Feldman, *Behavioral Ethics Meets Behavioral Law and Economics*, *in* THE OXFORD HANDBOOK OF BEHAVIORAL ECONOMICS AND LAW 213, 225 (2014).

134. McAdams, *supra* note 132, at 355 ("If many people agree that a behavior deserves disapproval, if there is an inherent risk the behavior will be detected, and if this agreement and risk are well-known, then the pattern of disapproval itself creates cost to the behavior. When sufficiently large, these cost produce a norm against the behavior.").

amounts of these activities are necessary to the proper functioning of the financial system.[135] Consequently, it is very difficult to delineate *ex ante* the levels of such activities that we want to permit, and those we do not. Without clear rules about what is and is not acceptable, problematic behavior "cannot be articulated, publicized, and detected with the clarity and consistency that is necessary to marshal the public to shun offenders".[136] Dombalagian makes a similar point in the context of the Volcker Rule (a provision of Dodd-Frank which limits—but recognizes some beneficial aspects of—proprietary trading by banking entities): "both the Rule itself and the rules promulgated thereunder attest to the difficulty of defining the kind of conduct promoted, tolerated or discouraged under the putative norm."[137] In the absence of clarity, public shaming cannot be harnessed to create industry-wide norms regarding destabilizing activities.

Within a financial institution that was truly committed to indirect other-regarding behavior, there would be more scope for the forging of norms through reputational utility. An institution can be more prescriptive about the types of activities that are and are not permitted within that institution, and an employee who deviates from these rules for the purpose of making short-term gains might run the risk of opprobrium and blame from his peers within the firm[138] (as well as the risk of being disciplined or fired). Financial activities, however, are constantly evolving, and internal firm activities restrictions might not always be able to be as prescriptive as we might like. More importantly, large financial institutions currently tend to herd together in performing destabilizing but immediately profitable activities,[139] and an individual financial institution that forgoes profit in order to improve stability without the protection of the herd risks punishment from its shareholders.[140] What is most needed, then, is an industry-wide norm of indirect other-regarding behavior, rather than activity- and institution-specific norms.[141] The aim of this Section is to

135. *See supra* text accompanying notes 42-43.

136. Dombalagian, *supra* note 12, at 499.

137. *Id.* at 500.

138. Sunstein, *supra* note 27, at 945 ("[Experimental work] shows that agents are willing to cooperate, and hence to solve collective action problems without coercion, if most people are seen as cooperators; in such circumstances the social meaning of noncooperation is greed or selfishness.").

139. Brett McDonnell, *Don't Panic! Defending Cowardly Interventions During and After a Crisis*, 116 PENN. ST. L. REV. 1, 13 (2011) ("Should the strategy fail, everyone will be in the same boat and individual managers will get little blame.").

140. William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 720-721 (2010).

141. Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1197 (2010) (arguing that the financial industry needs to make "excessive risk takers . . .

explore ways of reorienting the governing norms of the financial industry as a whole in ways that do not rely on censure and shaming from the general public.

New bodies of research have emerged that critique the law and economics scholarship and recognize that rational self-interest is not the only motivator of behavior.[142] This research demonstrates that internal motivators, as well as social context, are important drivers of behavior, and that shaming is not the only way to motivate cultural change. As such, educational and institutional reforms can improve financial stability if they succeed in causing financial industry participants to internalize norms of indirect other-regarding behavior,[143] so that such norms "come to mind in decision-making because they are part of [a financial industry employee's] identity, [and] they thus contend with, and even suppress, other motivations, such as the self-interest that may characterize his or her business identity and that of the business group."[144]

One such body of literature that contradicts the law and economics approach is known as behavioral ethics.[145] Developed primarily by management scholars, behavioral ethics is concerned with two different levels of cognitive processing:[146] System 1 relates to intuitive processes, whereas System 2 is characterized by conscious thought and reasoning.[147] Behavioral ethicists conclude that while we may often automatically and unconsciously act in our own self-interest (as a result of the intuitive processes of System 1),[148] we are also motivated by an innate desire to view ourselves as moral creatures.[149] As such, if norms of indirect other-regarding behavior are internalized and kept salient, deliberative System 2 cognition can override the self-interest sought by System 1.[150] (It is even

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stand out from the herd instead of leading everyone else over the precipice.").

142. Feldman, *supra* note 133, at 15-16 ("[S]ocial norms change behavior mostly by subconscious effects that are not associated with the costs and benefits of following social norms.").

143. Fanto, *supra* note 34, at 45.

144. *Id.* at 42-43.

145. Feldman, *supra* note 133, at 15-16 (arguing that behavioral ethics takes the view that self-interest is a subconscious motivator, whereas law and economics expects a more rational and conscious calculation of costs and benefits in determining what constitutes self-interest).

146. *Id.*

147. On Amir & Orly Lobel, *Stumble, Predict, Nudge: How Behavioral Economics Informs Law and Policy*, 108 COLUM. L. REV. 2098, 2110 (2008).

148. Feldman, *supra* note 133, at 4.

149. Nina Mazar, On Amir & Dan Arierly, *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, 45 J. MKTG. RES. 633, 634 (2008) ("[I]t has been shown that people typically . . . have strong beliefs in their own morality, and that they want to maintain this aspect of their self-concept.").

150. Fanto, *supra* note 34, at 34.

possible that norms of other-regarding behavior may become part of System 1's instinctual response. Some research indicates that in social contexts, being seen as cooperative and esteemed by one's peers is in one's self interest, and so cooperating with accepted norms becomes automatic).[151] While the behavioral ethics literature expresses a concern that System 2 might sometimes be deployed after the fact to rationalize and justify automatic self-interested behavior, rather than preventing it in the first place,[152] even this would be an improvement over the financial industry's status quo. At present, there is no need for industry personnel to even rationalize their self-interested actions, and thus their activities are not impeded by any cognitive dissonance whatsoever.

An alternative challenge to traditional law and economics is posed by the prosocial literature, which finds that that while self-interest is certainly a relevant motivator, innate other-regarding norms also inform our behavior so long as incentives and cultural factors are not stacked too heavily against such norms.[153] Summarizing the empirical findings regarding when prosocial behavior is more (and less) likely, Stout has developed the following model for creating the optimal conditions for people to act in the interests of others, simply because it is the right thing to do:

> *Unselfish prosocial behavior toward strangers, including unselfish compliance with legal and ethical rules, is triggered by social context, including especially:*
>
> *instructions from authority;*
> *beliefs about others' prosocial behavior; and*
> *the magnitude of benefits to others.*
>
> *Prosocial behavior declines, however, as the personal cost of acting prosocially increases.*[154]

This section's discussion of educational and industry reforms will be primarily informed by Stout's model.

To be clear, even once internalized, other-regarding norms provide no precise prescription for how financial industry personnel should act.[155]

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151. Feldman, *supra* note 133, at 8.

152. The concern is that people "do harm when it serves their self-interest and at the same time feel good about it". *Id.* at 19.

153. *See supra* notes 13-16 and accompanying text.

154. STOUT, *supra* note 11, at 99 (emphasis in original).

155. This is inevitable, given that something as complex as financial stability does not lend itself to "ascertainably correct solutions." Bandes, *supra* note 21 at 220.

Different people might have different conceptions of what is in others' best interests, and some might think that financial stability should be subservient to other public interests.[156] For example, arguments have been made that the MBS bubble was actually *caused* by other-regarding behavior, in the sense that it was inspired by the Community Reinvestment Act and other policies aimed at making home ownership more accessible—at the expense of financial stability.[157] In fact, the evidence is reasonably clear that these arguments are incorrect and that affordable housing policies were not responsible for causing the Financial Crisis.[158] Nonetheless, if the promotion of home ownership had been the true animus of the financial industry in the lead-up to the Financial Crisis, this Article would not be in a position to say that the industry had demonstrated any failure of indirect other-regarding behavior in connection with the MBS bubble: this Article does not purport to say *how* people should evaluate others' best interests, only that they *should* evaluate others' best interests.

This does not mean, however, that exhortations towards indirect other-regarding behavior are completely indeterminate or lacking in content. One clear guideline is that it is unacceptable for financial industry personnel to focus *entirely* on their short-term self-interest, or on the short-term self-interest of the institution that employs them. Another clear guideline is that financial industry personnel should start from the presumption that there is societal benefit to complying with regulation and cooperating with regulators, instead of automatically adopting a zero-sum stance and assuming that all regulation should be arbitraged.[159] The final

156. Saule T. Omarova, *Bankers, Bureaucrats and Guardians: Towards Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621, 669 (2012); Bandes, *supra* note 21, at 227.

157. Peter J. Wallison, *Dissenting Statement*, FIN. CRISIS INQUIRY COMM'N (2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_wallison_dissent.pdf; Phil Gramm & Mike Solon, *The Clinton-Era Roots of the Financial Crisis*, WALL ST. J., Aug. 12, 2013, http://www.wsj.com/articles/SB10001424127887323477604579000571334113350.

158. For a methodical debunking of Wallison's arguments, see DAVID MIN, CTR. FOR AM. PROGRESS, WHY WALLISON IS WRONG ABOUT THE GENESIS OF THE U.S. HOUSING CRISIS: RESPONDING TO WALLISON'S LATEST DEFENSE OF HIS FLAWED FINANCIAL CRISIS INQUIRY COMMISSION DISSENT, (2011), http://www.americanprogress.org/wp-content/uploads/issues/2011/07/pdf/ min_wallison.pdf.

159. William C. Dudley, President and C.E.O., Fed. Reserve Bank of N.Y., Ending Too Big To Fail, Remarks at the Global Economic Policy Forum (Nov. 7, 2013) (noting that regulatory reform alone "may not solve another important problem evident within some large financial institutions—the apparent lack of respect for law, regulation and the public trust."); Fanto, *supra* note 34, at 5 (noting that "a compliance approach that changes the perspective of firm employees so that they *consider policies behind the rules*, which include the long-term stability of the financial system and customer confidence in the markets, would help employees understand the potential dangers of certain financial products and

clear guideline is that, given the gravity of the social consequences of financial instability, the promotion of financial stability should always at least figure in the other-regarding behavior calculus for financial industry personnel (even if it is ultimately decided that there is some more deserving goal that trumps financial stability).

Within this framework, financial industry personnel may come to different conclusions about how best to minimize the destabilizing externalities of their activities,[160] and about whether and when financial stability should be subservient to other goals. Differing opinions on these issues are not necessarily a bad thing: Professors Romano and Whitehead have written at length about how regulation that correlates behavior can prove destabilizing,[161] and encouraging industry personnel to make their own other-regarding judgments might mitigate this destabilizing correlation. In some circumstances, though, financial industry personnel may turn out to be just plain wrong in their assessments and their cognitive errors, despite the best other-regarding intentions, may end up destabilizing the financial system.[162] This possibility of error does not mean, however, that attempts to engender more indirect other-regarding behavior in the financial industry are pointless. Holding the potential for cognitive errors equal, it stands to reason that destabilizing behavior will be less likely in circumstances where externalities are considered than in circumstances where they are not. And this is likely understating the case for indirect other-regarding behavior: too intense a focus on short-term self-interest is likely to limit a cognitive assessment of the risks involved in a given activity,[163] and so the potential for cognitive errors is likely higher in the absence of other-regarding behavior.

It is, of course, a monumental task to change an industry's culture to render it more other-regarding, and the reforms suggested in this Article are only first steps in trying to achieve this goal. The silver lining, however, is that for many people, the norms of short-term self-interest that guide the financial industry are adopted later in life, in graduate education or on the

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services" (emphasis added)).

160. Allen, *New Philosophy*, *supra* note 42, at 203 ("the complexity of the financial system . . . is such that precise answers *cannot* be achieved").

161. Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture*, 31 YALE J. ON REG. 1 (2014); Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323 (2011).

162. It is impossible to perfectly calibrate activities in a way that both allows for growth, and ensures that no risks are taken that would imperil the stability of the financial system. Brett H. McDonnell, *Of Mises and Min(sky): Libertarian and Liberal Responses to Financial Crises Past and Present*, 34 SEATTLE U. L. REV. 1279, 1310 (2011).

163. *See supra* note 22 and accompanying text (discussing incentive bias and underappreciated risk).

job, and are generally compartmentalized to that education or job.[164] While some individuals are by nature more self-interested than others,[165] if financial industry culture as a whole is made more other-regarding, then that could lessen the attraction for those individuals to join the financial industry.[166] To the extent that norms of short-term self-interest are learned, they can be unlearned,[167] notwithstanding how deeply ingrained they are currently in financial institution culture. There is no single policy solution that can revolutionize financial industry culture in this way: such an endeavor requires a multi-pronged approach that confronts different aspects of business education and financial institution operations. The remainder of this Section will therefore explore a variety of proposals for complementary reforms.

A. Business School Reform

Since the 1960s, when neoclassical economics became the touchstone of business education,[168] morality and values have been largely excluded from the core business school curriculum.[169] Although many business schools offer ethics and behavioral economics courses that challenge the position that we are all rational self-interested actors, traditional neoclassical economic modeling continues to hold sway in core business classes. These core classes thus tend to dismiss consideration of values, which are "hard to define, hard to measure, and seemingly at odds with the calculating rationality that was the starting point for traditional economic modeling."[170] Given this context, it is perhaps not surprising that research

164. Richard Painter, *The Moral Responsibilities of Investment Bankers*, 8 U. ST. THOMAS L.J. 5, 18-19 (2010).

165. This Article does not tackle the issue of whether the financial industry tends to attract employees who are somehow less moral than the average person. It focuses instead on how financial industry culture causes individuals to put aside the other-regarding inclinations that they *do* have.

166. Dudley, *supra* note 131 ("[T]he degree to which an industry attracts risk-takers is not pre-ordained, but reflects the prevailing incentives in the industry. After all, risk-takers have options.").

167. Moral norms that guide behavior can be learned and unlearned. George A. Akerlof & Rachel E. Kranton, *Identity and the Economics of Organizations*, 19 J. ECON. PERSPECTIVES 9, 12 (2005).

168. JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET 103 (2011).

169. Herbert Gintis & Rakesh Khurana, *Corporate Honesty and Business Education: A Behavioral Model*, *in* MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY 300 (Paul J. Zak ed., 2008).

170. Oliver R. Goodenough, *Values, Mechanism Design and Fairness*, *in* MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY 228, 228 (Paul J. Zak ed., 2008); *see also* Long Wang, Deepak Malhotra & J. Keith Murnighan, *Economics Education*

indicates that those with economic and financial training tend to be more selfish and less other-regarding than other members of society.[171] If, however, business education is responsible for repressing natural inclinations towards other-regarding behavior, then we have a very good idea about where to start fixing financial industry culture (and even when incoming students already show a strong propensity towards self-interest, business school education can help mitigate this).[172]

To these ends, a number of scholars have called for an overhaul of business education that stresses the importance of trust, honesty, decency, accountability, fairness and the common good, rather than having business schools teach that compensation is the only important motivator.[173] This is intended to return business education to its pre-1960s roots as informed by "a rhetoric of social duty that framed business education as having a higher aim than mere 'moneymaking.'"[174] As part of such an overhaul, ethics should be integrated into core business school classes so that students are given some guidance as to how to make other-regarding choices in context, rather than ethics being relegated to stand-alone courses that are often dismissed as a waste of time.[175] Some sense of history of financial booms and busts (and the contribution that the financial industry has made thereto) should also be incorporated into core business school courses: people are more likely to engage in other-regarding behaviors if the magnitude of perceived benefits to others is large,[176] so it is important that business school students learn about how the financial industry can exacerbate the ups and downs of the business cycle (particularly through its use of

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and Greed, 10 ACAD. MGMT. LEARNING EDUC. 643, 643-47 (2011) (commenting on how economics training assumes self-interest maximization and de-emphasizes social consequences).

171. For a discussion of this research, see Stout, MORAL MARKETS, *supra* note 26, at 168-70; *see also* Jackson, *supra* note 77, at 750-52. Of course, this finding may be partially explained by self-selection: more selfish individuals may be drawn to business school. To that end, Thomas J. Peters' proposal that elite business schools "apply a simple admissions rule: anyone from an ultra-privileged background needs to have done something of significant social value to be admitted," may assist. Jodi Kantor, *Class Is Seen Dividing Harvard Business School*, N.Y. TIMES, Sept. 9, 2013, http://www.nytimes.com/2013/09/10/education/harvard-business-students-see-class-as-divisive-an-issue-as-gender.html.

172. Robert A. Giacalone & Mark D. Promislo, *Broken When Entering: The Stigmatization of Goodness and Business Ethics Education*, 12 ACAD. MGMT. LEARNING EDUC. 86, 95-96 (2013).

173. Gintis & Khurana, *supra* note 169, at 300-01; Jackson, *supra* note 77, at 758; Zingales, *infra* note 264.

174. RAKESH KHURANA, FROM HIGHER AIMS TO HIRED HANDS: THE SOCIAL TRANSFORMATION OF AMERICAN BUSINESS SCHOOLS AND THE UNFULFILLED PROMISE OF MANAGEMENT AS A PROFESSION 91 (2007).

175. Zingales, *infra* note 264.

176. STOUT, *supra* note 11, at 99.

leverage), and the human cost of financial instability.[177] In the absence of such instruction, students may assume that the business cycle is entirely independent of their actions,[178] and thus that prosocial behavior is irrelevant. Furthermore, if financial stability is framed as the desired status quo rather than as a transitional phase of the business cycle, deviations from financial stability are more likely to be viewed as a loss to be avoided.[179]

Given that prosocial behavior is often triggered by instructions from authority,[180] it is key that the ethics and history components of the business school curriculum are taught by business school deans and prominent faculty members.[181] Other-regarding behaviors could also be encouraged by offering some type of clinic in business schools, where students provide less-privileged members of society with services like financial counseling or retirement planning. Once students graduate and start working in the financial industry, it has been observed that "[a] strong in-group versus out-group cultural orientation [often exists which encourages] the maintenance of a highly aggressive, opportunistic stance toward outsiders":[182] distance between those in the financial industry and those ultimately impacted by the industry's decisions makes it difficult to establish an other-regarding, stability-minded culture.[183] By creating relationships during business

177. McDonnell, *supra* note 139, at 27 ("As memories of bad times dim, banks and businesses become willing to take on more risk."); *see also* FOX, *supra* note 168, at 319. Historical material would have the added benefit of familiarizing students with the mistakes that caused those past crises, hopefully making it less likely that those mistakes will be repeated.

178. HO, *supra* note 25, at 11 ("[T]he construction of booms and busts are simply conflated with 'the market' and are not understood as arising from the particular workplace models, corporate culture, and organizational values of Wall Street financial institutions (investment banks in particular) or the specific and personal experiences of those who work for them.").

179. Compelling research has found that people prefer avoiding losses to making gains. As such, framing a problem as a loss can have a significant impact on how people respond to that problem. Cass R. Sunstein, *Moral Heuristics*, 28 BEHAV. & BRAIN SCI. 531, 535 (2005).

180. STOUT, *supra* note 11, at 99.

181. Gintis & Khurana, *supra* note 169, at 324 ("[B]usiness school faculties and deans have an institutional responsibility to socialize students to a model of behavior that inspires them to respect other institutions in society, especially the basic units of family and community, and to inspire students to accept the responsibilities and obligations that come with occupying society's most powerful positions.").

182. Langevoort, *supra* note 17, at 1216.

183. STOUT, *supra* note 11 at 101. The increasing specialization of, and lengths of chains of intermediation within, the financial industry have led to ever-greater attenuation between the decisions made by individual industry employees and those impacted by their decisions. Awrey et al., *supra* note 10, at 14 ("[T]he anonymity within large, complex organizations; technologies enabling 'faceless' communication across great distances, and

school between students and those outside of the financial sector, a business school clinic program (which could be complemented by an ongoing pro bono requirement for the financial industry) could be effective in ensuring that financial industry personnel see people who are impacted by their decisions, but do not themselves have control over the levers of financial stability. Consequently, students would view these individuals as sufficiently connected to them to be worthy of their consideration.[184] Not only would these programs put a face on the "other" the financial industry should be regarding, they also have the potential to change the financial industry's perspective on money. Realizing that a few hundred dollars can mean a world of difference to some people might shatter the blasé indifference that can come from constantly seeing strings of zeroes flash across a computer screen with little perceptible consequence.[185]

B. Corporate Governance Reform

It is clear that it will take time for any changes made in business education to percolate into the financial industry.[186] Because of the importance of instructions from authority in establishing what is and is not acceptable behavior,[187] there is a very real concern that more seasoned industry veterans, weaned on a philosophy of pure self-interest, will "haze" any other-regarding behavior inculcated in business schools out of new financial industry employees. To that end, reforming business education will not work on its own; it must be coupled with efforts to change industry culture from within.

To date, most attempts to reform risk-taking in financial institutions have focused on compensation incentive structures. There are many papers that have already explored how banker pay incentivizes short-termism and a "heads we win, tails you lose" attitude amongst bank employees.[188] This

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the commoditization of business transactions and relationships might all be expected to decrease moral intensity.").

184. Research suggests that violations of the norm of other-regarding can to some extent be excused when the "other" is perceived to be outside of the actor's in-group. Stout, MORAL MARKETS, *supra* note 26, at 162; Zak, *supra* note 21, at 262.

185. This would encourage a better appreciation of the magnitude of the benefit of financial stability, as per part (iii) of Stout's model. STOUT, *supra* note 11, at 99.

186. *See* Gintis & Khurana, *supra* note 169, at 302 (describing the anti-corruption socialization campaigns in Hong Kong schools as an example of the delayed impact of education campaigns on social norms).

187. STOUT, *supra* note 11, at 99.

188. The most prominent of these papers being Bebchuk & Spamann, *infra* note 325. For a focus on the compensation of traders, rather than executives, see Simone M. Sepe & Charles K. Whitehead, *Paying for Risk: Bankers, Compensation, and Competition* (Cornell Law Faculty Working Papers, Paper No. 114, 2014).

Article will not retread that ground. Instead, this Article draws attention to how difficult it is to fine-tune the alignment of incentives with desired risk taking; the multiplicity of differing proposals for compensation reform attests to this idea.[189] This Article also notes that these complex proposals invite arbitrage, which could have unintended and unforeseen destabilizing consequences. Thus, while this Article recognizes the value of attempts to better align compensation incentives with society's interest in financial stability, it stresses the importance of exploring broader cultural reform proposals as well.[190]

Importantly, desired outcomes can sometimes be achieved without the micro-manipulation of incentives; people often obey internalized moral norms without material incentives to do so because they want to maintain a positive conception of themselves as moral human beings.[191] Short notes that "[n]ormatively motivated decisions are often characterized precisely by their disregard of the material costs and benefits of the action."[192] As such, if people within the financial industry were to see themselves as having a social responsibility to avoid financial instability, they would be more willing to forgo short-term financial gain in order to maintain their

189. *See, e.g.*, Bebchuk & Spamann *infra* note 325, at 253; FINANCIAL STABILITY FORUM, FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES 2 (2009); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long Term*, 26 YALE J. ON REG. 359 (2009); U.K. PARLIAMENTARY COMMITTEE ON BANKING STANDARDS, *infra* note 280, at 8-9; Sepe & Whitehead, *supra* note 188. Bruner notes that "the combined thinking [on how to structure compensation to balance risk and financial rewards] of seven financial regulators, comprising fifty pages of the *Federal Register*, amounts to little more than a directive to reduce risk-taking. How, exactly, is that to be done? 'We don't know,' our regulators implicitly reply. 'You figure it out.'" Christopher M. Bruner, *Concepts of Corporate Purpose in Post-Crisis Financial Firms*, 36 SEATTLE U. L. REV. 527, 558 (2013).

190. It is also worth considering whether hard caps on financial industry compensation should be implemented, given that "the increasing presence of money and wealth in the immediate surroundings tends to prompt more selfishness." Langevoort, *supra* note 17, at 1240. In a related vein, Sepe & Whitehead make several proposals aimed at taming market pressures to reward traders with extremely high salaries. Sepe & Whitehead, *supra* note 188. Although the EU's decision to cap bank bonuses has been criticized by the Squam Lake Group for failing to properly address bankers' risk-taking incentives, the cap may nonetheless be valuable if it allows room for norms of other-regarding behavior to flourish. Martin N. Baily et al., *Aligning Incentives at Systemically Important Financial Institutions* (Columbia Bus. Sch Working Paper No. 13-18, 2013), *available at* http://ssrn.com/abstract=2239895 (critizing EU's decision to cap bank bonuses). A reduction in compensation could also discourage naturally self-interested people from gravitating to the financial industry in the first place.

191. "[T]o maintain their positive self-concepts, people will comply with their internal standards even when doing so involves investments of effort or sacrificing financial gains." Mazar et al., *supra* note 149, at 633.

192. Short, *supra* note 23, at 505.

self-concept as a steward for the financial system (and regulations and regulators would have less work to do).[193] Incidentally, such a shift toward other-regarding behavior and sense of societal purpose might also increase job satisfaction in the industry.[194] This section will therefore explore reforms that can assist in creating an environment in which such other-regarding behavior can flourish.

1. Board Reforms

At present, the boards of financial institutions are primarily concerned with the interests of their shareholders.[195] Financial stability, however, would be best served by authorizing such boards to consider the interests of non-shareholder stakeholders.[196] While prioritizing the interests of such stakeholders would certainly be a departure from the prevailing theories of corporate governance,[197] special governance rules for financial institutions

193. ZAK, *supra* note 21, at 264; STOUT, *supra* note 11, at 212; Fanto, *supra* note 34, at 28.

194. Disaffectedness and cognitive dissonance can arise when natural inclinations towards other-regarding behavior are shut out of the workplace: "Researchers have . . . found a connection between self-reported happiness and ethical behavior." STOUT, *supra* note 11, at 241. Unfortunately, the current ethos of the financial industry might be summarized as "a "lose-lose" proposition, either wealth and irresponsibility or integrity and failure." Solomon, *supra* note 24, at 36. An op-ed written by former Goldman Sachs employee Greg Smith has come to epitomize the disaffectedness that many financial industry employees feel:

> culture was always a vital part of Goldman Sachs's success. It revolved around teamwork, integrity, a spirit of humility, and always doing right by our clients. The culture was the secret sauce that made this place great and allowed us to earn our clients' trust for 143 years. It wasn't just about making money; this alone will not sustain a firm for so long. It had something to do with pride and belief in the organization. I am sad to say that I look around today and see virtually no trace of the culture that made me love working for this firm for many years. I no longer have the pride, or the belief. . . . I truly believe that this decline in the firm's moral fiber represents the single most serious threat to its long-run survival. . . . I don't know of any illegal behavior, but will people push the envelope and pitch lucrative and complicated products to clients even if they are not the simplest investments or the ones most directly aligned with the client's goals? Absolutely. Every day, in fact.

Greg Smith, *Why I Am Leaving Goldman Sachs*, N.Y. TIMES, Mar. 14, 2012, at A27.

195. ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 126 (2013).

196. Financial institution shareholders often push those institutions to generate profits from high-risk activities that can prove destabilizing. Bruner, *supra* note 189, at 552-53, 557-559.

197. The prevailing theory of corporate governance is that "public corporations 'belong' to their shareholders, and they exist for one purpose only, to maximize shareholders' wealth. Shareholder wealth, in turn, is typically measured by share price—meaning share price

are not entirely unprecedented: a number of courts have opined that bank directors owe duties to a broader range of constituents than do directors of non-bank corporations.[198] In any event, a systemic failure will impact diversified shareholders more than the profitability of any one institution,[199] so financial stability is actually in the best interests of most financial institution shareholders. As such, financial institution boards can justifiably prioritize financial stability, even though doing so could detrimentally impact the institution's share price.

There are therefore strong justifications for allowing the boards and managers of financial institutions to consider issues of financial stability in their deliberations. Awrey, Blair and Kershaw have proposed a "Take Externalities Seriously" initiative, which would require financial institutions to implement controls and processes:

> (1) to ensure that the identification and avoidance of socially excessive risk taking is embedded in corporate culture; (2) to identify and monitor potential socially excessive (i.e. systemic) risks generated by a firm's activities; (3) to better understand a firm's exposure to systemic risk; and (4) to determine how best to minimize these risks on an ongoing basis.[200]

In particular, Awrey et al. propose that financial institutions should be required to have a senior ethics committee on the board of directors that would oversee monitoring and reporting of socially-excessive risk-

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today." LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS AND THE PUBLIC 2-3 (2012). However, the assumption that corporations are legally required to maximize shareholder value is in many respects an ideological position that is susceptible to challenge. *Id.* at 3-4.

198. Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47 (2010-11).

199. John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 40-41 (2013).

200. Awrey et al., *supra* note 10, at 33. To be clear, while corporate governance initiatives are intended to encourage better behavior from within the industry, they will not take root or succeed without some external regulation backing them up. Regulators would therefore need to require financial institutions to implement the necessary board committees and compliance mechanisms, and should judge fulfillment of such requirements by the level of the financial institution's commitment to raising awareness of, and establishing norms that seek to avoid, the negative externalities of financial institution activities. Awrey et al., *supra* note 10, at 33. In addition, the SEC's Regulation S-K could be amended to require financial institutions that are listed in the United States to publicly disclose the steps they are taking to improve financial stability by reducing externalities. This would require financial institutions to develop clear compliance plans, and the public dissemination of such plans could build up to the creation of best practices for institutions to follow.

taking.[201] Such an initiative could, for example, empower boards to prioritize lower leverage and longer-term funding options for the institution's trading operations, notwithstanding that these may generate less profit for shareholders in the short-term. Similarly, it could support policies to abandon the development of complex new products that demonstrate limited social utility, even though the products might generate large fees for the institution in the short-term (or at least implement policies that require that a single individual retain day-to-day responsibility for the entire life-cycle of the new financial product).[202]

If, as per Awrey et al.'s proposal, consideration of externalities is going to fall heavily on financial institution boards, it is worth giving some thought to the composition of those boards—particularly the boards of the large, systemically important financial institutions ("SIFIs") that have the greatest potential to destabilize the financial system.[203] Dodd-Frank already requires that the boards of SIFIs establish risk committees with specified levels of independence and expertise,[204] but this Article will explore more radical changes. One policy that might institutionalize other-regarding voices on SIFI boards would be to require such institutions to dedicate a critical mass of board seats to publicly-elected or administratively-appointed figures representing the public's interest in financial stability.[205] Such public directors could "restrain[] self-interest run amok in the corporate inner circles . . . [as well as] counter the natural inclination of those at the summit of the corporate hierarchy to form self-

201. Awrey et al., *supra* note 10, at 34.

202. Research suggests that *immoral* behavior is encouraged by "break[ing] up decisions into parts so most individuals were only responsible for moving the decision forward and could not claim ultimate responsibility for an action." ZAK, *supra* note 21, at 261; *see also* Amir & Lobel, *supra* note 147, at 2134-35. This type of thinking informs the recommendation of the U.K. Parliamentary Commission on Banking Standards, which recommends that a new "Senior Persons Regime" be implemented so that "key responsibilities within banks are assigned to specific individuals, who are made fully and unambiguously aware of those responsibilities and made to understand that they will be held to account for how they carry them out." U.K. PARLIAMENTARY COMMITTEE ON BANKING STANDARDS, *infra* note 280, at 8-9.

203. This Article focuses on larger, systemically significant firms, rather than on smaller, local institutions providing traditional retail banking products and services, because the former are far more likely to endanger systemic stability. Omarova, *supra* note 47, at 456-57.

204. Dodd-Frank Wall Street Reform & Consumer Protection Act § 165(h), 12 U.S.C. § 5346 (2010).

205. In the broader corporate context, Fanto has explored at length the rationale for, and the logistics of, requiring corporations to have a critical mass of public directors on their boards. *See* James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435, 490-540 (2004)(discussing the importance of corporate boards comprising a critical mass of public directors).

contained groups that are characterized by groupthink and other negative group dynamics."[206] In many respects, this type of proposal mimics McDonnell and Schwarcz's proposal that "regulatory contrarians" be embedded in financial regulatory agencies[207]— these "board contrarians" would be an other-regarding voice forcing the rest of the board members to "interact during the decision-making process with [people] with differing backgrounds and biases, and . . . publicly defend their positions."[208] As noted above, courts have already recognized that bank directors can represent interests beyond those of their shareholders,[209] and legislation like Dodd-Frank already authorizes enhanced supervisory and prudential standards for SIFIs.[210] A requirement that the public interest be represented on SIFI boards finds support in these precedents.

Admittedly, in large financial institutions, boards have limited oversight over the day-to-day actions of senior managers and other employees. It is thus key that those managers and employees also take responsibility for the externalities that their actions could cause.[211] A more other-regarding board can set an example for how others should conduct themselves,[212] but merely setting an example is unlikely to be enough. As per Stout's model, clear instructions from authority are a key element in creating a more prosocial culture,[213] and any other-regarding example set by the board will have little effect if managers give contrary instructions to employees to prioritize self-interest. The next Subpart will therefore consider more granular reforms, in an attempt to encourage certain key financial institution employees to feel that more prosocial behavior is required of them and of their colleagues.

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206. *Id.* at 494.

207. Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629 (2011).

208. *Id.* at 1647.

209. *See supra* note 198 and accompanying text (describing that several courts have held that bank directors owe duties to stakeholders other than shareholders).

210. *See, e.g.*, Dodd-Frank Wall Street Reform & Consumer Protection Act § 115, 12 U.S.C. § 5325 (2010) (authorizing increased prudential supervisory standards for SIFIs).

211. "All actors, from the board down to the trader, need to know that when there is a conflict between regulatory objectives and the pursuit of value that it is lawful and legitimate to prioritize fair treatment or the avoidance of potential externalities." Awrey et al., *supra* note 10, at 42; *see also* Sepe & Whitehead, *supra* note 188 (discussing the destabilizing potential of the activities of traders and other financial institution employees).

212. Michelle Harner, *Corporate Culture and ERM* 2 (U. Md. Legal Studies Research Paper, Paper No. 2013-34, 2013), *available at* http://ssrn.com/abstract=2289432.

213. STOUT, *supra* note 11, at 99.

2. Reform of Compliance and Risk-Management Functions

While this Article argues that all financial sector employees need to engage in other-regarding behavior, much of the grunt work associated with minimizing industry externalities will fall on compliance personnel (who provide advice and training on compliance with regulations and professional and ethical standards)[214] and risk-managers (who assess the firm's risk exposure and communicate their findings to senior management).[215] However, given that compliance personnel and risk-managers do not directly generate profits for their employers, they often lack clout within the firm.[216] As such, the reforms discussed in this Subpart will only succeed if senior management ensures the primacy and independence of the risk-management and compliance functions.[217] From an institutional design perspective, compliance and risk-management personnel should report directly to senior management, instead of reporting to the heads of business units who may resent their "profit-killing" efforts.[218] Increases in compensation for compliance and risk-management personnel would also communicate to the firm the importance that management places on these functions. Regulators could encourage these reforms by taking such institutional design matters into account when discharging their supervisory task of assessing the adequacy of the financial institution's management structure.[219]

With support from senior management, compliance departments could aid in the creation of a more other-regarding culture by developing codes of ethical conduct that stress the importance of considering externalities – these should be highly publicized, and compliance should be rewarded and non-compliance addressed.[220] To assist with enforcement, compliance

214. Fanto, *supra* note 34, at 16-19.

215. Rene M. Stulz, *Risk Management Failures: What Are They and When Do They Happen*, 20 J. APPLIED CORP. FIN. 39, 39 (2008).

216. *See* David M. Driesen, *Legal Theory Lessons From the Financial Crisis*, 40 J. CORP. L. 55, 72 (2014) ("[F]irms tend to pay more attention to its traders' views . . . because trading serves as a profit center.").

217. *See* Fanto, *supra* note 34, at 21.

218. *See* FINANCIAL STABILITY FORUM, *supra* note 189, at 2. (discussing the importance of independence and authority for risk-management personnel). In a similar vein, the U.K. Parliamentary Commission on Banking Standards has advocated for "individual and direct lines of access and accountability to the board for the heads of the risk, compliance and internal audit functions and much greater levels of protection for their independence . . . ." U.K. Parliamentary Committee on Banking Standards, *infra* note 280, at 10.

219. For a synopsis of the risk assessment processes of financial regulators, see Mehrsa Baradaran, *Regulation by Hypothetical*, 67 VAND. L. REV. 1247, 1275-76 (2014).

220. Michelle Harner, *Corporate Culture and ERM*, DIRECTOR NOTES (The Conference Bd., New York, N.Y.), July 2013, at 2-3 . Compliance with these codes is more likely if the

personnel could be directed to implement policies that allow for whistleblowing with respect to persons who fail to comply with the codes[221] (perhaps by taking outsize trading risks or by speciously valuing firm assets).[222] The purpose of these codes goes beyond creating a basis for disciplinary action, however: they are also intended to serve an educative function by promoting a culture where compliance with the norm of indirect other-regarding behavior is seen as a primary motivator, and the shared responsibility of *all* financial institution employees.[223] In particular, these educative efforts should stress that being a steward for financial stability is an important responsibility specifically conferred on those who work in the financial industry – thus maintaining the sense of prestige and importance that seems to motivate many in the industry.[224]

Risk-management personnel can also play an important role in mitigating negative externalities caused by financial institution activities, but they will need to reorient their perspective somewhat in order to do so. At present, risk managers focus on the potential losses of the firm (or a division of the firm),[225] but they could also be directed to assess – to the best of their knowledge – any risks being created for the financial system as a whole.[226] Information about these risks would then be reported to senior management, who ideally would then make decisions aimed at minimizing

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codes are coupled with policies that designate individuals to oversee the entire life-cycle of a financial product or trading portfolio. *See supra* note 203.

221. Harner discusses the possibility of implementing such processes in Michelle Harner, *The Potential Cost and Value of ERM*, Director Notes (The Conference Bd., New York, N.Y.), Mar. 1, 2013, at 3.

222. *See, e.g.*, *supra* Part II.C (discussing examples of destabilizing behaviors by JPMorgan in 2012).

223. *See* Fanto, *supra* note 34, at 18-19. Bandes notes that norm-creation is a dynamic and social process, rather than an individualized one. Bandes, *supra* note 21, at 225.

224. The literature on changing social norms suggests that such efforts will be more successful if they reinforce rather than undermine the identities of their peers. Short, *supra* note 23, at 506. In her ethnography of Wall Street, Ho emphasizes that many in the industry view themselves as bearing the vital and difficult burden of purveying the capital "that forms the foundations and enables the growth and expansion of our largest corporations and public and private works." Ho, *supra* note 25, at 27. This sentiment seems to inform Goldman Sachs' CEO Lloyd Blankfein's infamous statement that banks are "doing God's work." Dealbook, *Blankfein Says He's Just Doing 'God's Work'*, N.Y. TIMES, Nov. 9, 2009, http://dealbook.nytimes.com/2009/11/09/goldman-chief-says-he-is-just-doing-gods-work/.

225. As Admati and Hellwig have noted, "the banks' interests in measuring and managing risks are not the same as the public interest in having a safe financial system . . . ." ADMATI & HELLWIG, *supra* note 195, at 184.

226. Of course, firms are not able to assess *all* of the systemic risks they are creating, as to do so would also require knowledge of their competitors' strategies and how the various institutions' strategies would interact. As such, the role of regulators in monitoring systemic risks remains vital. Allen, New Philosophy, *supra* note 42, at 184.

such systemic risks (for example, by divesting assets deemed too risky, rather than layering them with complex derivatives as occurred in the London Whale episode).[227] Importantly, this reconceptualization of the risk-management function as systemic risk monitor would require changes in the risk-management toolbox as well as a change in perspective.

"Value-at-risk" (usually known as "VaR") models are the risk assessment models currently favored by most financial institutions. A number of criticisms, however, have been leveled at these models from a systemic risk perspective. They are used to estimate, within a given confidence level, the amount of money a firm, (or a business unit or a portfolio) could lose on any given day.[228] However, they are significantly limited in that they focus on a firm's risk in isolation,[229] and also, because they presume that historical data is somewhat predictive of what will happen in the future, tend to discount low-probability "tail events" that fall outside of their historical data set.[230] But it is these very tail events, during which it becomes clear that the firm's risks are correlated and tightly coupled with the risks of other financial institutions,[231] which threaten financial stability and are likely to generate the externalities that this Article is seeking to mitigate. Although new and improved types of modeling techniques have been developed (for example, Monte Carlo models have been designed to more realistically simulate correlation amongst risks),[232] even these more sophisticated models are subject to limitations in terms of their ability to predict the likelihood of a tail event occurring.[233]

In addition, the usual critiques of the risk-modeling technologies discussed above fail to discuss the problems that quantitative modeling techniques pose for other-regarding behavior. Even the more sophisticated results generated by Monte Carlo simulations "lack . . . human intuition."[234] Because the experience of empathy for others involves limbic regions of the brain associated with emotional responses,[235] to the extent that

227. *See supra* text accompanying note 111 (discussing the London Whale incident).

228. Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*,45 U. MICH. J.L. REFORM 55, 69 (2011).

229. See, for example, Gerding, *supra* note 45, at 169-86 (discussing some of the weaknesses of risk models).

230. Johnson, *supra* note 228, at 71.

231. *Id.* at 72.

232. *Id.* at 72-73.

233. Driesen notes that the accuracy of Monte Carlo models is dependent upon knowledge of the distribution of probabilities of certain outcomes – knowledge that is absent when dealing with complex systems like the financial system. Driesen, *supra* note 216, at 78.

234. Johnson, *supra* note 228, at 73.

235. Zak, *supra* note 21, at 266.

processes are automated through mathematical models and no longer filtered through the human brain, any empathy that might have colored such judgments is lost. As such, this Article argues that risk-managers should not be permitted to rely exclusively or unthinkingly on quantitative modeling in assessing their risks.[236] Scenario analysis and creative thinking, performed by humans as well as computers, should become an integral part of the risk-management function.[237]

C. Reform of Self-Regulation

The previous two Subparts have explored certain externally-mandated reforms intended to inculcate a new culture in financial institutions. There are limits on what externally-mandated reforms can achieve, however.[238] As per Stout's model, prosocial behavior flourishes in environments where there are instructions from authority to act prosocially and beliefs that others are acting prosocially. If the financial industry is disdainful of external regulations (which it certainly seems to be at present),[239] then industry participants may not view such external regulations as legitimate instructions from authority, nor will industry participants believe that others are complying with those instructions.[240] Instead, norms of other-regarding behavior are most likely to flourish under a regime of self-regulation. A self-regulatory authority is likely to have more credibility with the industry than an external regulator,[241] and because self-regulation is intended to reflect the industry's own standards, rather than externally imposed regulation, it is more likely to engender beliefs that prosocial, pro-

236. Stulz has expressed a similar sentiment: "I conclude that the probabilities of large losses are measured very imprecisely and that, as a consequence, companies should rely less on estimates of such probabilities and pay more attention to the implications of large losses for their survival." Stulz, *supra* note 215, at 39.

237. For a discussion of how stress tests, war games, and other scenario analyses can reduce excessive risk-taking, see Nizan Geslevich Packin, *It's (Not) All About The Money: Using Behavioral Economics to Improve Regulation of Risk Management in Financial Institutions*, 15 U. PA. J. BUS. L. 419, 479-81 (2013).

238. Omarova, *supra* note 47, at 475.

239. *See also* Donald C. Langevoort, State of Mind and the Global Financial Crisis 17 (2013) (unpublished manuscript) (available at http://luc.edu/media/lucedu/law/centers/investor/pdfs/langevoort.pdf) (discussing the psychological and cultural dimensions of the financial crisis).

240. Fanto has noted that regulatory compliance could well be viewed by many broker-dealers as "something external, and not reflective of their own self-identity and self-definition, which are centered on their productive securities activities and the business groups where they conduct these activities." Fanto, *supra* note 34, at 21; *see also* Dombalagian, *supra* note 12, at 498.

241. Education and persuasion by peers and insiders is more likely to be effective in changing norms. Short, *supra* note 23, at 506.

stability behavior is both expected and carried out by others in the industry. Theoretically at least, self-regulation shows significant promise for improving industry culture[242] and could potentially displace some of the stricter legal rules that run the risk of crowding out moral norms of other-regarding behavior.[243]

However, financial industry self-regulation would have to be significantly reconceptualized to achieve a focus on financial stability. In the United States, financial self-regulation has traditionally been very prescriptive and addressed things like competency and character – particularly in the context of relationships between industry personnel and clients.[244] While this type of self-regulation sometimes requires professionals "to act beyond their self-interest[]" when acting for clients,[245] it does not address behaviors that generate instability and thus harm a broader group of persons with whom the professional has no direct connection.[246] Given the difficulty in delineating destabilizing behaviors with any precision, it would be impossible to create any kind of prescriptive industry code or compliance manual that sought to deal with such destabilizing behaviors, and as such, any industry self-regulation would have to leave significant discretion to industry participants (particularly compliance departments) in determining what activities should be permitted.

Unfortunately, this leaves us with something of a Catch-22. While industry self-regulation is probably the best way to create a more other-regarding culture, the amount of discretion required in a financial stability self-regulatory regime ensures that self-regulation that is not backed by a genuine cultural change will effectively be deregulatory (or perversely result in more selfish behavior, because the rubber stamp of self-regulation has the potential to cause members of a profession to abdicate responsibility for their own moral obligations).[247] So how can the powers

242. This discussion is premised on the understanding that self-regulation would work together with, rather than entirely supplant, traditional command-and-control regulation. For a discussion of the division of labor between government and industry self-regulation in the financial stability context, see Omarova, *supra* note 47, at 438-42.

243. Fanto, *supra* note 34, at 31-32.

244. Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 536, 538 (2002). This type of self-regulation has evolved to address the significant opportunities for malfeasance that arise when firm employees are dealing with cash and personal property. Fanto, *supra* note 34, at 20.

245. Andrew F. Tuch, *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101, 111 (2014).

246. *See* Omarova, *supra* note 47, at 438 (discussing systematic risk created by the financial services industry).

247. David DeSteno, *Good Groups Can Lead to Bad Apples*, PSYCHOLOGY TODAY, July

that be in the financial industry be convinced to spearhead a more other-regarding culture? Omarova, drawing analogies from the nuclear power and chemical industries, has concluded that a more other-regarding financial industry culture will only develop if the industry sees itself as a " 'community of fate' whose future prosperity depend[s] upon its ability to impose collective self-restraint on its members' profit-seeking activities in the name of public safety."[248] Essentially, unless there is a credible threat to financial institutions' existence or profitability, industry leaders will not agitate for cultural change.

The financial industry might feel an existential threat if senior managers of financial institutions genuinely believed that they would not be able to partake of government assistance in the event of a future crisis. But, in reality, this type of threat is not credible. Even though Dodd-Frank asserts that there will be no more bailouts,[249] bailouts are likely to remain a political necessity in times of crisis, and financial institutions know this.[250] The only threat that is likely to motivate financial institutions, then, is the fear of significant regulatory interference,[251] especially if such regulation has the potential to significantly reduce profits.[252] Along these lines, William Dudley, the President and CEO of the Federal Reserve Bank of New York reportedly unnerved some in the industry when he said in a recent speech:[253]

> [I]f those of you here today as stewards of these large financial institutions do not do your part in pushing forcefully for change across the industry, then bad behavior will undoubtedly persist. If that were to occur, the inevitable conclusion will be reached

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13, 2011, http://www.psychologytoday.com/blog/out-character/201107/good-groups-can-lead-bad-apples.

248. Omarova, *supra* note 47, at 443, 446.

249. The preamble to the Act describes it as an Act "to protect the American taxpayer by ending bailouts. . . ." Dodd-Frank Wall Street Reform and Consumer Protection Act 12 U.S.C. Preamble (2010).

250. Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439 (2011).

251. Omarova, *supra* note 47, at 453. Examples of such regulatory changes include breaking up the big banks, or introducing a precautionary review procedure for financial institution trading strategies and product development. For a discussion of the former, see SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 214-17 (2010). For a discussion of the latter, see Saule T. Omarova, *License To Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63 (2012).

252. Omarova, *supra* note 47, at 486-87.

253. Peter Eavis, *Regulator Tells Banks to Clean Up Bad Behavior or Face Downsizing*, N.Y. TIMES, Oct. 20, 2014, http://dealbook.nytimes.com/2014/10/20/regulator-tells-banks-to-clean-up-bad-behavior-or-face-downsizing/.

> that your firms are too big and complex to manage effectively. In that case, financial stability concerns would dictate that your firms need to be dramatically downsized and simplified so they can be managed effectively.[254]

Despite Dudley's strong words, though, the political power of financial institutions suggests that, at least at present, there is no real credible threat of significant regulatory reform. Inevitably, we are left with the notion that a wholesale change in financial culture cannot be achieved until the political winds shift after the next financial crisis.[255] This Article thus argues strenuously that the momentum of the next crisis must not be squandered: the response to that crisis must ensure that the leaders of financial institutions genuinely fear that if they do not adopt far-reaching self-regulatory reform and inculcate a more other-regarding culture, then they will face laws that impose significant structural reform on them. In the interim, however, the externally-mandated reforms explored in Parts A and B of this Section should be pursued as potentially effective (albeit more limited) means of improving financial industry culture.

III. LIMITATIONS OF OTHER MEANS OF ADDRESSING THE PATHOLOGIES

Changing an industry's culture is an enormous undertaking. It is not surprising, then, that many proponents of financial reform prefer to focus on the more discrete tools of criminal prosecutions, private litigation, regulatory supervision and regulatory enforcement to promote financial stability. However, as this section will explore, these traditional tools are limited in what they can achieve when dealing with behavior that is not fraudulent, but evinces a disregard for the consequences of financial instability for others. Accordingly, this Section emphasizes that broader cultural reform is a necessary complement to the more traditional approaches to financial stability regulation.

This section also helps explain why financial institutions (and their employees) are rarely punished for causing financial instability. Criminal law and private litigation, for example, are limited in their ability to punish destabilizing behaviors largely because of the difficulties associated with

254. Dudley, *supra* note 131.

255. Depressingly, we probably will not have to wait too long for this: JPMorgan CEO Jamie Dimon testified his belief that financial crises will occur every five to seven years. Sewell Chan, *Voices That Dominate Wall Street Take a Meeker Tone on Capitol Hill*, N.Y. TIMES, Jan. 14, 2010, at B5.

establishing moral culpability and causation.[256] Financial instability arises not from the actions of one person or firm, but as a result of the aggregation and interaction of actions by a very large number of actors, magnified by correlations and feedback loops.[257] Once a crisis has occurred, it is very difficult to pinpoint who is actually responsible for causing the instability, and what proportion of the fault lies at their door.[258] In addition, many people who suffer as a result of financial instability do so not because they contracted with a financial institution, but because they are unable to get credit or lose their job as a result of the general economic malaise that follows a financial crisis. It is very difficult to demonstrate with any precision that one person or firm is responsible for these individualized harms.

With regard to the difficulty of establishing moral culpability, there will be some situations where complexity and cognitive failures entirely prevent financial institution personnel from appreciating the potential of their activities to damage financial stability and thus harm others.[259] In such situations, any cause of action that requires a demonstration of moral culpability will certainly fail. However, this Article has already made the case that most destabilizing behaviors entail both cognitive and moral failures. Moral failures – in the form of failures of indirect other-regarding behavior – often contribute to financial instability, but they are different in kind from the more direct failure of dishonesty on which most white collar criminal prosecutions are predicated.[260] Because neither the law nor society at large expects complete abnegation of self-interest – indeed, some level of self-interest is necessary to survival[261] – it is very difficult to identify with any precision the tipping point at which acceptable self-interest becomes an immoral failure of other-regarding behavior.

This is *a fortiori* the case in the context of collective action problems (like over-leveraged participation in asset price bubbles, and the corresponding fire sales that occur on the downside of the leverage

256. *See supra* note 106 and accompanying text (discussing causation and the scienter requirement in 10b-5 claims).

257. Awrey et al., *supra* note 10, at 33-34.

258. David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1433 (2014).

259. *See* Langevoort, *supra* note 17, at 1218-20.

260. STUART P. GREEN, LYING, CHEATING AND STEALING: A MORAL THEORY OF WHITE COLLAR CRIME 149 (2007).

261. "Total self-restraint may also be destructive to markets." Frankel, *supra* note 32, at 92; "Self-interest . . . has its place as a factor shaping human behavior, but this place is alongside the moral forces that bind the individual to the community." Richard M. Coughlin, *Whose Morality? Which Community? What Interests? Socio-economic and Communitarian Perspectives*, 25 J. SOCIO-ECONOMICS 137 (1996).

cycle),[262] when individuals have such strong incentives to act in a self-interested way that it is difficult to label their behavior as immorally self-interested, notwithstanding that their collective behavior generates suboptimal outcomes for everyone.[263] While the financial industry generally appreciates that financial stability is best served by *not* using leverage to bid up the price of assets beyond any reasonable assessment of their value or dumping assets in fire sales that are destructive of asset values system-wide,[264] once these types of behaviors become prevalent, it can become too costly for financial industry personnel not to participate. However, as Hockett has identified, financial stability-related collective action problems often worsen over time, with each round of self-interested action taking society further away from the desired goal of financial stability.[265] In the earliest rounds of a collective action problem, the disparity between self-interest and other-regarding behavior is not as pronounced, and it could thus be reasonable to expect a small sacrifice from the financial industry (in the form of other-regarding coordination) that would nip the incipient collective action problem in the bud.[266] Again, however, it is difficult to identify the point at which the collective action problem becomes so bad that it is no longer reasonable to expect people to make sacrifices for the sake of coordination.

The remainder of this section will explore in greater detail why criminal law and private litigation are so ill-suited to holding people accountable for failures of indirect other-regarding behavior. It will also explain why, while regulation should certainly play an important role in addressing destabilizing behavior, its efficacy is limited to some extent. Finally, it will briefly explain why market discipline is not helpful in addressing destabilizing behaviors.

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262. Robert Hockett, *Recursive Collective Action Problems: The Structure of Procyclicality in Financial Markets, Monetary Systems, Macroeconomies and Formally Similar Contexts*, 3 J. FIN. PERSP. (forthcoming 2015) (available at http://ssrn.com/abstract=2239849).

263. *Id.*

264. Of course this presumes some level of cognitive awareness of the consequences of collective action problems. It is difficult to predict the exact consequences of such problems *ex ante*, but Zingales notes that people who have studied economics and finance are generally able to identify the outcome that is in the collective best interest of all persons involved. Luigi Zingales, *Do Business Schools Incubate Criminals?*, BLOOMBERG VIEW (July 16, 2012), http://www.bloombergview.com/articles/2012-07-16/do-business-schools-incubate-criminals-.

265. Hockett, *supra* note 262.

266. "[W]e can expect most people will be willing to make at least a small personal sacrifice . . . in order to behave prosocially." STOUT, *supra* note 11, at 117.

A. Criminal Law

To some extent, the dearth of criminal prosecutions in the wake of the Financial Crisis is a result of the evidentiary difficulties (and political economies) associated with prosecuting white-collar crimes.[267] However, this Article asserts that the bigger issue is that many of the behaviors that destabilized the financial system and caused the Financial Crisis do not fit into our traditional frameworks for criminal liability. While this Article appreciates that, at a gut level, many people want to see someone held accountable for the misery occasioned by the Crisis,[268] it asserts that many of the destabilizing behaviors that brought the world economy to its knees are, and should remain, unpunishable.

Federal criminal law, in its current form, is not designed to address non-fraudulent destabilizing behavior. Federal wire, mail and securities fraud statutes all have scienter requirements that purport to require some type of dishonest mental state: wire fraud requires a defendant to have "devised or intend[ed] to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises."[269] The crime of mail fraud has similar elements.[270] The prohibition on securities fraud makes it unlawful to either "employ any device, scheme, or artifice to defraud"; "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading"; or "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person"; in each case in connection with the purchase or sale of a security.[271] By focusing on deception, the plain language of each of these fraud statutes indicates that it does not apply to honest but self-interested

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267. For a discussion of these issues, see Geoffrey M. Gilchrist, *The Special Problem of Banks and Crime*, 85. U. COLO. L. REV. 1, 1 (2014) ("the non-prosecution of bankers is often explained by lack of evidence or the difficulty of white-collar prosecutions generally."); Rakoff, *supra* note 97, at 4 (proving fraudulent intent by executives has been very difficult); Zaring, *supra* note 258, at 1435-37 (discussing the pros and cons of using white collar crime to regulate corporate misconduct). This Article does not enter into the debate on whether the Department of Justice has been too lenient in prosecuting fraud committed in connection with the Financial Crisis. The point made by this Article is that the most dangerous destabilizing behaviors do not constitute fraud, and are not properly the subject of any criminal prohibition.

268. The public often desires the "closure and certainty" provided by criminal punishment. Miriam Baer, *Choosing Punishment*, 92 B.U. L. REV. 577, 636 (2012).

269. 18 U.S.C. § 1343.

270. 18 U.S.C. § 1341.

271. 17 C.F.R. 240.10b-5.

behavior.[272] Although courts have in some instances interpreted the scienter requirement for these fraud provisions as being satisfied by mere recklessness,[273] such decisions "swim against a considerable tide of cases insisting on knowledge or intent for white-collar and regulatory crime offenses carrying significant prison sentences."[274]

Given that existing federal criminal law does not squarely address destabilizing behavior that lacks a deceitful mental state, this raises the question of whether a criminal offense *should* be created for this kind of behavior (perhaps with a shorter prison sentence than crimes committed with knowledge or intent). Although there is much scholarly debate about why society chooses to criminalize behavior, there is some consensus around the "retributivist" view, which posits that actions are criminalized because society has an interest in seeing morally culpable behavior punished.[275] It follows from the retributivist reasoning that imposing "punishment on people who were not at fault, or . . . in a way that was disproportionate to their fault, would be unjust."[276] In other words, criminal punishment should only be doled out when offenders deserve such punishment because they have acted in a morally culpable way.[277] In criminal fraud cases, for example, the moral failure that is usually cited as "deserving" punishment is dishonesty.[278] Because of the impossibility of clearly demonstrating the moral culpability inherent in a failure of indirect other-regarding behavior,[279] this Article posits that that the perpetrators of

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272. Other criminal offenses that pertain particularly to financial institutions and their employees also tend to cover dishonest acts, rather than honest but destabilizing activities. For example, when Congress enacted 12 U.S.C. § 1833a to give prosecutors more latitude in pursuing bank misconduct, it only included crimes that involved some type of element of dishonesty. All of the new criminal offenses introduced by Dodd-Frank similarly target direct, identifiable and dishonest conduct, like disclosure failures and failure to register. *See* Tiffany M. Joslyn, *Criminal Provisions in the Dodd-Frank Wall Street Reform & Consumer Protection Act*, NEW FED. INITIATIVES PROJECT, (The Federalist Soc'y for Law & Pub. Policy Studies, Wash., D.C.), Dec. 10, 2010, http://www.fed-soc.org/doclib/20101210_NFIPCrimProvisionsinDoddFrank.pdf (containing a catalogue of Dodd-Frank's new crimes).

273. Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L. J. 511, 557-58 (2011).

274. *Id.* at 560.

275. Paul H. Robinson & John M. Darley, *The Utility of Desert*, 91 NW. U. L. REV. 453, 455 (1997).

276. GREEN, *supra* note 260, at 22.

277. Green argues that white collar offenses constitute crimes when the impugned behavior can be characterized as cheating, deception, stealing, coercion and exploitation, disloyalty, promise-breaking, and disobedience. *Id.* at 53-127. All of these types of moral wrongfulness can be subsumed under the heading of dishonesty.

278. *Id.* at 149. Although it should be noted that "criminal philosophy has yet to distill, in a concrete and usable fashion, an objective means for identifying the . . . nature of conduct that 'deserves" punishment.'" Baer, *supra* note 268, at 596.

279. *See supra* text accompanying notes 259-261. Practically speaking, criminal

non-fraudulent destabilizing behaviors do not deserve to be punished with criminal penalties.

Some disagree with this conclusion, and argue for the imposition of criminal offenses that penalize financial institution employees who honestly, but recklessly disregard financial stability.[280] Criminal recklessness offenses typically include elements that reflect a cognizant disregard for societal norms about what is risky: those who ignore the potential consequences of those risks for others are seen as deserving punishment.[281] However, in the complicated context of the financial system, there exists no broad social consensus about the types of risk-taking that violate social norms *at the time such risks are taken*[282] (although with the benefit of hindsight, we can usually say which risks turned out badly).[283] Norms about financial risk-taking are not sufficiently precise *ex ante* that reckless failure to comply with such norms evinces a disregard for others that "deserves" to be criminalized.[284]

There are also other, non-retributivist rationales that have been advanced for criminalizing behavior – amongst these, deterrence is of particular relevance to this Article (given that it seeks ways of preventing destabilizing behavior).[285] Optimal deterrence theory posits that when

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prosecutors are better suited to navigating black-and-white issues like lying and cheating than this more nuanced concept of failure of indirect other-regarding behavior by way of undue risk taking. Baer, *supra* note 268, at 635-36.

280. For example, the U.K. Parliamentary Commission on Banking Standards recently proposed new criminal offence for reckless mismanagement of financial institutions. PARLIAMENTARY COMMISSION ON BANKING STANDARDS, CHANGING BANKING FOR GOOD, 2013-14, H.C. 175-I, at 10 (U.K.).

281. Jed S. Rakoff, *Conjoining "Recklessness" in Securities Fraud Cases to Moral Culpability*, 44 LOY. U. CHI. L. J. 1447, 1456 (2013). The Model Penal Code provides that:

> A person acts recklessly with respect to a material element of an offense when he consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation.

MODEL PENAL CODE § 2.02(2)(c) (2011).

282. Rakoff, *supra* note 281, at 1453.

283. For a discussion of hindsight bias, see Mitu Gulati, et al., *Fraud By Hindsight*, 98 NW. U. L. REV. 773, 775 (2004).

284. Buell notes that in the criminal context, we cannot "easily justify ex ante vagueness, with large gaps to be filled in terms of specific behaviors entirely ex post." Buell, *supra* note 273, at 521.

285. Criminalizing behavior is usually justified by one or more of the following rationales: "deterrence, incapacitation, rehabilitation and desert." Paul H. Robinson, *Criminal Law Scholarship: Three Illusions*, 2 THEORETICAL INQUIRIES IN L. 287, 290 (2001). It should be noted, though, that some are skeptical about the deterrence justification for

faced with a criminal sanction, a potential offender will calculate the likelihood of detection and the cost of being punished if detected, weigh these against the benefits of transgression, and make a rational decision as to whether or not it is worthwhile to engage in the activity.[286] Unfortunately, a lack of clarity about what is and is not acceptable behavior constrains the efficacy of any deterring sanction,[287] and destabilizing behaviors defy the creation of clear criminal sanctions. Many potentially destabilizing behaviors are necessary – at least to some degree – to the proper functioning of the financial system. They should not be the subjects of an outright criminal ban.[288] Instead, it is the self-interested misuse of these activities that we wish to prevent, but this Article has already explored in depth the difficulty in delineating a bright-line *ex ante* rule as to the self-interest that is acceptable, and the self-interest that we wish to deter.[289] As such, criminal law will not function as an effective deterrent of non-fraudulent, but destabilizing, financial activities.

B. Private Litigation

In some contexts, "civil liability for extremely poor judgment . . . has filled gaps that the criminal law leaves behind."[290] But private litigation is also largely unsuitable for punishing non-fraudulent behavior that has a diffuse impact on society at large. Most of the people who suffer in the negative economic conditions that follow financial crises will be prevented from bringing claims against the financial institutions that have generated the instability, because to establish standing, "the plaintiff must establish injury-in-fact; [and] the plaintiff must show a connection between the injury and the conduct alleged."[291] The law generally does not view pure

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criminalizing behavior: Baer argues "[d]eterrence may well be invoked as a justification for punishment, but lay intuitions about culpability and moral outrage appear to outweigh the factors that ought to matter most under a deterrence-based scheme." Baer, *supra* note 268, at 588.

286. Short, *supra* note 23, at 496. Optimal deterrence theory does not enjoy universal support, however - it has been criticized on behavioral economic grounds, which call into question whether people actually make accurate assessments of the likelihood and costs of punishment. *Id.* at 496-97. These concerns are even more salient when dealing with something as complex as financial risk-taking, further undermining the case for deterrence in this context.

287. *Id.* at 505.

288. *See supra* text accompanying notes 42-43 (discussing the necessity of some level of innovation and leverage).

289. *See supra* text accompanying notes 261-266 (discussing the necessity of some level of self-interest).

290. Christine Hurt, *The Duty to Manage Risk*, 39 J. CORP. L. 253, 257 (2014).

291. Heidi Mandanis Schooner, *Private Enforcement of Systemic Risk Regulation*, 43

economic loss as a compensable injury,[292] so the injury-in-fact element is an insurmountable hurdle for most potential plaintiffs in this context.[293] Furthermore, this Article has already explored how difficult it is to attribute causation of financial instability to any one financial institution,[294] and so the requirement to show a causal connection between injurious conduct and injury will also prevent most potential plaintiffs from having standing.

It is possible that financial institutions and their employees might nonetheless be deterred from engaging in destabilizing behavior if they faced a real threat of litigation from those who *do* have standing, notwithstanding that any damages awarded in such claims would not come close to encompassing the full amount of harm externalized by financial institutions in a crisis.[295] As the law currently stands, though, even individuals who are likely to have standing (either because they are shareholders in a financial institution, or because they have transacted directly with a financial institution) face major challenges in punishing destabilizing behaviors. For example, civil common law fraud claims require some demonstration of actual dishonesty (in the sense that the maker of the statement knew or believed the statement to be false).[296] Securities fraud claims[297] only require a demonstration of recklessness (a lesser standard of culpability than dishonesty),[298] but as the previous Part explored, recklessness is very difficult to establish in a context where there is no *ex ante* societal consensus about which levels of financial risk-taking are acceptable, and which are not.[299] As such, fraud claims have limited applicability to destabilizing behaviors, and are often used to address attempts to cover-up previous destabilizing behaviors (once the damage has

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CREIGHTON L. REV. 993, 1009 (2010).

292. Armour & Gordon, *supra* note 199, at 15.

293. Courts have also ruled that there is no implied private right of action to enforce prudential regulations. Schooner, *supra* note 291, at 1008-09. Schooner has argued that a "qui tam" process should be implemented that would allow private plaintiffs to enforce macroprudential regulations against financial institutions. *Id.* at 1011-17. This proposal is intriguing, and has the potential to improve enforcement of existing macroprudential regulations. However, by definition, it will only address behaviors that have been identified *ex ante* as problematic for financial stability—it would not impact what financial institutions do in the space beyond regulation.

294. *See supra* text accompanying notes 256-258.

295. *See* Armour & Gordon, *supra* note 199, at 36 (discussing the limitations of tort remedies in the context of systemic harm).

296. RESTATEMENT (SECOND) OF TORTS § 526 (1977).

297. These claims are brought pursuant to 17 C.F.R. 240.10b-5.

298. The Supreme Court has noted, without expressly deciding the issue, that all circuit courts have allowed plaintiffs to plead that a defendant acted recklessly. Tellabs, Inc. v Makor Issues & Rights, Ltd. 551 U.S. 308, 319-20 (2007). Of course, plaintiffs can also plead that the defendant acted intentionally.

299. *See supra* text accompanying notes 282-284.

been done), rather than the behaviors themselves.[300] Alternatively, a plaintiff could try to fit destabilizing behaviors into the negligence law framework, but such claims will only succeed if negligent conduct is a "substantial factor in bringing about the harm."[301] Proving such causation is likely to be very difficult, given that financial instability generally arises from the collective actions of an entire industry.[302]

One private cause of action that might seem to hold some promise for addressing financial instability would be a breach of fiduciary duty suit against financial institution directors, alleging failure to monitor destabilizing behaviors.[303] However, the Delaware courts (and most major U.S. financial institutions are incorporated in Delaware) tend to be very deferential to boards, and have ruled that boards will only be subject to oversight liability when there is "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists".[304] This is very difficult to prove, with the result that plaintiffs rarely succeed in establishing oversight liability.[305] Furthermore, courts have typically held that such a duty to monitor applies to legal and compliance risks, but not to business risks.[306] This approach largely precludes holding boards liable for flawed oversight of risk-management policies. It is, of course, open to the courts (or legislators) to reinterpret fiduciary duties to include a duty to monitor risk-management decisions,[307] but it is very unlikely that they will do so: that would be tantamount to abandoning the long-standing "business judgment rule" presumption with respect to financial risk-taking.[308] Furthermore, even assuming that courts were willing to effectively abrogate the business judgment rule in this context, it is not clear that doing

300. See, for example, the securities fraud claims that have been brought against JPMorgan in the wake of the London Whale episode, discussed in the text accompanying note 126.

301. RESTATEMENT (SECOND) OF TORTS § 431 (1977).

302. In one case arising out of the Financial Crisis, the jury agreed that some kind of wrong had been perpetrated, but were unable to identify any one person as the single party responsible. SEC v. Stoker, 865 F. Supp. 2d 457 (S.D.N.Y. 2012); Rakoff, *supra* note 281, at 1456.

303. These claims are known as "Caremark claims," after the case *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996). Such types of claims have been characterized as a last resort. Hurt, *supra* note 290, at 269.

304. *In re* Caremark Int'l Inc. Deriv. Litig. 698 A.2d at 971.

305. Armour & Gordon, *supra* note 199, at 33.

306. Hurt, *supra* note 290, at 282.

307. For example, Armour & Gordon have proposed that "those controlling a systemic firm fac[e] liability *to their firm* for conflicts of interest or negligence as regards decisions capable of contributing to systemic risk." Armour & Gordon, *supra* note 199, at 29.

308. *Id.* at 289-90.

so would be advisable. Such a duty to ensure prudent risk-management would require courts "to determine what amount of risk-taking is excessive for a given firm at the point of time the decision was made":[309] just as with recklessness,[310] such a determination invites hindsight bias and a confusion of bad outcomes with bad acts.

C. Command-and-Control Regulation

Given that the private causes of action in our legal system are ill-suited to punishing the pathologies of banking business as usual, this Part will examine the role that command-and-control financial regulation can play. Financial regulators seem the most appropriate candidates to identify *ex ante* activities that are likely to be destabilizing and to take steps to either control or prohibit those activities. An institution's failure to comply with such regulations can then be punished with civil sanctions,[311] even if it cannot be proved that the consequences of the offending actions were actually destabilizing, or morally culpable. I have previously written regarding the benefits of such proactive legislation,[312] but I nonetheless recognize its limits: given the complexity of the financial system, it would be impossible for regulators to anticipate, catalogue and regulate *ex ante* every type of behavior that could prove destabilizing.[313] Even if regulators could do so, there are still resource constraints that limit their ability to supervise financial institutions and enforce their regulations.[314] Furthermore, such regulations would remain susceptible to arbitrage by financial institutions (at least for so long as those institutions were motivated purely by norms of short-term self-interest). Finally, regulators are not always paragons of public service—their willingness to promote financial stability is also limited at times.

In the lead-up to the Financial Crisis, for example, financial regulators failed to take steps to protect consumers from unsavory lending practices, which would have reduced the number of residential mortgage loans made, taking some air out of the real estate and MBS bubbles. In particular, the Federal Reserve failed to use its power under the Home Ownership and Equity Protection Act to create uniform federal mortgage lending rules to

309. *Id.* at 260.

310. *See supra* text accompanying notes 282-284.

311. The available regulatory sanctions include civil penalties, cease-and-desist orders, orders for suspension, removal and prohibition, as well as less formal regulatory pressure. Schooner, *supra* note 291, at 1005-1006.

312. Allen, *New Philosophy*, *supra* note 42.

313. Armour & Gordon, *supra* note 199, at 27.

314. Dudley, *supra* note 131; Schooner, *supra* note 291, at 1001.

prohibit predatory lending practices,[315] and the OCC and OTS sought to preempt any state efforts to reign in consumer abuses by banks.[316] Essentially, the regulators prioritized bank profitability over how banks dealt with their customers.[317] To some extent this can be attributed to cognitive failure by the banking regulators: they failed to fully appreciate that ignoring consumer protection would lead to poor quality mortgages, which would then be securitized with ramifications both for the safety and soundness of individual institutions, and for the economy as a whole.[318] But banking regulators had been alerted to these issues. Consumer advocates continually complained to the regulators, and within the Federal Reserve Governor Gramlich was a vocal advocate for improving oversight over consumer protection issues.[319] Furthermore, in 2007, Professors Engel and McCoy made explicit the destabilizing potential of these failures of consumer protection.[320] The regulators' decision to ignore these warnings can be partially attributed to moral failings: either because regulators had unconsciously internalized the self-interested worldview of the financial industry,[321] or because regulators sought a conflict-free life by avoiding complaint from the financial sector,[322] they chose to allow consumer abuses

315. The Home Ownership and Equity Protection Act, enacted in 1994, gave the Federal Reserve the power to enact industry-wide rules to reign in abusive mortgage practices. The rules promulgated by the Fed in 2001 only covered 1% of all mortgages. In fact, the Fed did not use its HOEPA authority to issue rules that required most lenders to ensure the borrower's ability to repay until 2008, after the subprime bubble had already burst. FCIC Report, *supra* note 71, at 77–94.

316. *Id.* at 96, 112.

317. *See* Heidi Mandanis Schooner, *The Role of Central Banks in Bank Supervision in the United States and the United Kingdom*, 28 BROOK. J. OF INT'L L. 411, 427 (2003) ("[T]he Federal Reserve's . . . regulatory role remains focused on safety and soundness and not on other goals of financial regulation, such as consumer protection.").

318. *See generally Hearing on "Consumer Protections in Financial Services: Past Problems, Future Solutions" Before the. S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 11-23 (2009) (statement of Patricia A. McCoy, George J. & Helen M. England Professor of Law, Univ. of Conn. Sch. of Law); *see also* Arthur E. Wilmarth, Jr., *The Financial Service Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FIN. L. 881, 926 (2012); Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143, 152 (2009).

319. FCIC Report, *supra* note 71, at 95.

320. Engel & McCoy, *supra* note 73.

321. For a discussion of cognitive capture of regulators, see Willem H. Buiter, *Central Banks and Financial Crises*, MAINTAINING STABILITY IN A CHANGING FINANCIAL SYSTEM: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY 495, 601 (Fed. Res. Bank of Kan. City, 2009); James Kwak, *Cultural Capture and the Financial Crisis*, *in* PREVENTING CAPTURE: SPECIAL INTEREST INFLUENCE IN REGULATION, AND HOW TO LIMIT IT (Daniel Carpenter & David A. Moss eds., 2013).

322. With regard to the desire of regulators to avoid criticism and political intervention, see DAVID ANDREW SINGER, REGULATING CAPITAL: SETTING STANDARDS FOR THE

to continue.

Even after problematic behavior has occurred, regulators have not consistently addressed institutional wrong-doing: there has been much criticism of the SEC, for example, for not bringing "failure to supervise" actions against the large financial institutions in the wake of the Financial Crisis.[323] And as the JPMorgan "London Whale" episode illustrates, unreliable regulatory supervision of institutions persists even after the Crisis.[324] Given these demonstrated limitations of financial regulators and command-and-control regulation, it would be imprudent to rely *exclusively* on them to ensure financial stability.

D. Incentives Regulation

Another potential regulatory avenue for addressing destabilizing behavior is to structure incentives (including by way of compensation reform, and the implementation of Pigouvian taxes) to encourage better behavior amongst financial industry personnel.[325] This Article has already explored some of the difficulties inherent in using incentives regulation to improve financial stability.[326] Essentially, the concern is that it is very difficult to precisely calibrate incentives to produce the desired behavior[327]—particularly because of the difficulty of identifying, in advance, the benchmark level of desirable risk-taking for financial institutions that should be incentivized—and incentives that are not perfectly targeted can have unintended harmful consequences.[328] There is

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INTERNATIONAL FINANCIAL SYSTEM 22 (2007).

323. *See* Aruna Viswanatha, *Analysis: SEC Targets Low-Level Bankers, Spares Top Execs*, REUTERS (Nov. 15, 2011), http://www.reuters.com/article/2011/11/15/us-sec-enforcement-idUSTRE7AE2BN20111115. "Failure to supervise" actions are brought by the SEC pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934, for an individual's failure to comply with the obligation under Section 15(b)(4)(E) "reasonably to supervise, with a view to preventing violations of [the securities laws], another person who commits such a violation, if such other person is subject to his supervision." 15 U.S.C. § 78o(b)(4)(E). It should be noted, however, that such "failure to supervise" actions would not cover inordinate risk-taking, as this is not a violation of the securities laws.

324. *See supra* text accompanying notes 128-130.

325. *See, e.g.*, with respect to compensation, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010). For a discussion of Pigouvian taxes in the financial sector, see Douglas A. Shackelford, Daniel N. Shaviro & Joel Slemrod, *Taxation and the Financial Sector*, 63 NATIONAL TAX JOURNAL 781 (2010).

326. *See supra* text accompanying notes 189-190.

327. *See supra* note 189 and accompanying text.

328. For example, corporate governance reforms that sought to align managers' interests with stockholders' interests by granting managers more equity-based compensation, inadvertently caused mangers to be much more short-termist in their outlook. STOUT, *supra* note 11, at 250.

also a risk that when incentives-based regulation appeals only to the self-interest of financial industry personnel (for example, by subjecting their bonuses to clawbacks if losses subsequently materialize),[329] the penalties involved can be interpreted simply as a "cost of doing business." Experimental studies have found that the introduction of penalties can refocus individuals' attention on those penalties, to the exclusion of any concern for others that might have otherwise motivated their behavior.[330]

This Article therefore emphasizes the importance of supplementing (and in some cases, substituting) incentives regulation and command-and-control regulation with policies that aim to maximize people's natural inclinations towards other-regarding behavior. The intention is not to understate the importance of rules and incentives in engendering financial stability—moral norms alone cannot regulate the financial system. Rather, this Article asserts that policymakers should aim to calibrate a cocktail of (i) command-and-control type rules, (ii) incentives and (iii) policies that encourage indirect other-regarding behavior, in the way that seems best calculated to engender financial stability. Part of this task entails recognizing which type of tool is best suited to which type of problem; norms of indirect other-regarding behavior are the best tool available for addressing the pathologies of banking business as usual.

E. Market Discipline

Finally, it is worth briefly considering whether private market discipline can play a role in circumscribing undesirable destabilizing behaviors. Unfortunately, in the financial markets, self-interested market discipline cannot force financial institutions to stop taking socially undesirable risks: "the social costs of bank failure extend far beyond losses to creditors," and so even if market discipline worked perfectly, "the contractual internalization of social costs would only be partial."[331] In practice, because of creditor apathy and the opacity of financial institution risk-taking, self-interested market discipline falls far short of achieving even this theorized partial internalization.[332] As such, purely self-interested

329. For an argument in favor of such clawbacks, see Brian Bell & John Van Reenen, *Bankers' Bonuses: Claw-back Clauses Are Critical*, VOXEU (May 3, 2010), *available at* http://www.voxeu.org/article/bankers-bonuses-claw-back-clauses-are-critical.

330. *See, e.g.*, Uri Gneezy & Aldo Rustichini, *A Fine is a Price*, 29 J. OF LEGAL STUD. 1 (2000) (discussing the effect of introducing a fine for parents who were late picking up their children from day care; counterintuitively, this resulted in an increased number of late collections); *see also* STOUT, *supra* note 11, at 191-92 ("By emphasizing external material incentives, the day-care centers crowded out 'internal' incentives like guilt and empathy.").

331. Armour & Gordon, *supra* note 199, at 14.

332. For a comprehensive discussion of the inability of market discipline to address

actions in the financial markets fail to prevent widespread instability.

CONCLUSION

This Article has provided a nuanced exploration of the pathologies of banking business as usual, and the moral and cognitive failures that drive them. It has demonstrated that when financial stability is at stake, the moral failure that must be addressed is a failure of indirect other-regarding behavior, rather than the failure of honesty that the law is more accustomed to addressing. Because neither criminal law nor private litigation are appropriate for addressing failures of indirect other-regarding behavior after the fact, and because it can sometimes be difficult for command-and-control regulation to prevent destabilizing activities *ex ante*, we are left with the (somewhat dispiriting) conclusion that the maintenance of financial stability sometimes rests on financial industry participants *choosing* to care about the externalities of their actions.

It is thus vitally important that proponents of financial reform consider ways of changing the prevailing Wall Street culture from one that is governed entirely by norms of short-term self-interest, to one that is tempered by norms of stewardship for financial stability. To date, attempts to address industry culture have largely been restricted to structuring incentives to align the industry's self-interest with society's interest in financial stability. However, it can be very difficult to determine *ex ante* the precise type of behavior that we want to incentivize and to tailor incentives accordingly. As such, it is vital that the debate on financial stability reform also be informed by the interdisciplinary research on other-regarding behavior that recognizes that in the right circumstances, people will engage in other-regarding stability-minded behavior simply because they view it as the right thing to do.

It may well be that true cultural change in the financial industry will not be feasible until after the next financial crisis—but the industry must be threatened with real reform then, or else it will have little impetus to become more other-regarding, and we will find ourselves in an exacerbated boom and bust cycle that disproportionately affects the most vulnerable members of society. We should not have to wait for a crisis, however, to implement the business education and governance reforms explored in this

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systemic risk, see David Min, *Understanding the Failures of Market Discipline*, 42 WASH. U. L. REV. (forthcoming 2015). For these reasons, there seems to have been little by way of discipline from bank creditors in the boom years leading up to the Financial Crisis. Anat Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive* 34 (Rock Ctr. for Corp. Governance at Stanford Univ. Working Paper Series, No. 161,,2013).

Article. These reforms are designed to improve the likelihood that financial institutions will take a more proactively other-regarding stance, and at least give some consideration to the potential externalities of their activities.