BANKERS BEHAVING BADLY? THE LIMITS OF REGULATORY REFORM

CLAIRE A. HILL*

> "I've managed to sell a few Abacus bonds to widows and orphans that I ran into at the airport, apparently these Belgians adore synthetic ABS CDO2."[1]

> "Structuring swaps transactions [of the sort Greece used to "hide" part of its debt] is one of those things which investment banks do. If countries like Greece buy swaps in order to hide their true fiscal status, then that's the country's fault, not the banks'. No self-respecting bank would decline such a transaction because they felt it was unfair to Eurostat."[2]

1. Introduction

We may finally be emerging from a "Great Recession." But the economy remains quite fragile. What bankers did was an important cause of the recession. They structured, sold and bought "toxic" securities, taking excessive risks with other people's money. Sometimes they did so recklessly, because they did not sufficiently understand the securities. Other times, they did understand the securities, and sold them to those who didn't, sometimes omitting much relevant information. Some evidence suggests that bankers knew the quality of mortgages being securitized was plummeting; indeed, given the dramatically increasing volume of mortgages being securitized, they had to at least suspect significant declines in quality. They also knew, or should have known, that the huge volume of mortgages being made could be having broader effects, including enormous and probably unsustainable housing price inflation. And they engaged in other problematic behavior, including the use, for themselves and for their clients, of techniques designed to conceal debt and otherwise improve financial appearance.

Regulation's ability to improve banker behavior is significantly hindered by a problematic banker ethos. The ethos allows, and to some extent encourages, both the externalization of risks and the search for loopholes. Importantly, the ethos doesn't just permit and encourage the behavior; the behavior becomes a source of pride and esteem. The ethos is industry-wide: this is not behavior of "rogues."[3]

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* Professor, James L. Krusemark Chair in Law, and Director, Institute for Law & Rationality, University of Minnesota Law School. Thanks to Brett McDonnell, Richard Painter, and Dan Schwarcz for very useful conversations and to the participants at the Symposium: Shadow Banking: Past, Present and Future, at Boston University School of Law. This paper discusses some ideas that will be expanded upon in a book on banker responsibility that I am writing with Richard Painter.

[1] This quote comes from an e-mail by Goldman Sachs investment banker Fabrice Tourre, which was described in Christine Harper, *Goldman's Tourre E-Mail Describes 'Frankenstein' Derivatives*, BLOOMBERG (Apr. 24, 2010), http://www.bloomberg.com/news/2010-04-24/-frankenstein-derivatives-described-in-e-mail-by-goldman-s-fabrice-tourre.html. Tourre had a key role in the Abacus deal, a transaction involving highly complex securities. The SEC alleged significant wrongdoing by Goldman in connection with Abacus; the charges were settled for $550 million, with Goldman neither admitting nor denying wrongdoing. Press Release, Sec. & Exch. Comm'n, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-123.htm.

[2] Felix Salmon, *The Greek Derivatives Aren't Goldman's Fault*, REUTERS (February 16, 2010), http://blogs.reuters.com/felix-salmon/2010/02/16/the-greek-derivatives-arent-goldmans-fault. The quote begins: "In other words, Eurostat knew that Greece, Italy, and others were planning this kind of deal even before they happened, thanks to their successful lobbying efforts with respect to ESA95, and it was inevitable that they would structure deals with investment banks doing exactly what they did. So while it's entirely fair to blame Greece for trying to hide its debt, and to blame Eurostat for letting it do so, I think that blaming Goldman is harder. It was surely not the only bank involved in these transactions, and the swaps were simple enough to be shopped around a few different banks to see which one could provide the best deal." *Id.*

[3] Rogues for this purpose include Joe Jett, Nick Leeson and Jerome Kerviel. Jett, then of Kidder Peabody, figured out a system to trick the firm's computers into recording as profitable trades that were not. Leeson made huge unauthorized bets that failed and then doubled down, managing to sink a several-hundred-year-old bank, Barings Bank, in the process. Kerviel also made such bets, costing Société Générale $6.7 billion. Thomas Kaplan, *Traders Gone Rogue: A Greatest-Hits Album*, N.Y. TIMES DEALB%K (Sep. 15, 2011, 8:02 AM), http://dealbook.nytimes.com/2011/09/15/traders-gone-rogue-a-greatest-hits-album/?ref=josephjett.

For regulation to succeed, it needs to address – really, change – this ethos. This ethos also needs to be addressed using extra-legal means, such as law used expressively. Ideally, social norms against such behavior would develop; short of that, norms that now encourage the behavior would lose force or even disappear. In this article, I mostly provide an account of the ethos at issue. I discuss some of law's limits in dealing with it. Finally, I argue for a different approach: a greater emphasis on banker responsibility, a subject which I discuss in more detail in a book I am writing with Richard Painter.

The existence of the banker ethos I describe here is not amenable to rigorous proof. Indeed, specifying the universe of people who share the ethos is not straightforward. The word "banker" as used in this article is shorthand for a category whose membership cannot be specified with necessary and sufficient conditions. But given the evidence that exists, and the severity of the crisis, the status quo seems difficult to justify: the lack of proof and precise specification should not preclude proceeding along the lines I am suggesting here.

2. The Ethos: Some Examples

The ethos is well-captured by a few examples.[4] The first set involves bankers (arguably) benefitting themselves at the expense of their clients or third parties. The second set involves bankers helping their clients benefit themselves at (arguably) third parties' expense. Obviously, the second set of examples also concern banker benefits, in the form of fees received for helping the clients.

a. *Bankers Benefitting Themselves at Others' Expense*

One example is Goldman Sachs's well-known "Abacus" deal. The Securities and Exchange Commission ("SEC") brought charges against Goldman. Goldman settled with the SEC, paying $550 million.[5] The SEC alleged that:

> GS&Co marketing materials for ABACUS 2007-ACI-…-all represented that the reference portfolio of RMBS underlying the CDO was selected by ACA Management LLC ("ACA"), a third-party with experience analyzing credit risk in RMBS. Undisclosed in the marketing materials and unbeknownst to investors, a large hedge fund, Paulson & Co. Inc. ("Paulson"), with economic interests directly adverse to investors in the ABACUS 2007-ACI CDO, played a significant role in the portfolio selection process. After participating in the selection of the reference portfolio, Paulson effectively shorted the RMBS portfolio it helped select by entering into credit default swaps ("CDS") with GS&Co to buy protection on specific layers of the ABACUS 2007-ACI capital structure. Given its financial short interest, Paulson had an economic incentive to choose RMBS that it expected to experience credit events in the near future~ GS&Co did not disclose Paulson's adverse economic interests or its role in the portfolio selection process in the term sheet, flip book, offering memorandum or other marketing materials provided to investors.[6]

In the settlement,

[4] The ethos has been written about and commented on extensively, including in many popular books and articles. *See, e.g.*, William R. Gruver, *OPM Addiction*, THE NEW REPUBLIC (Feb. 25, 2009, 12:00 AM), http://www.tnr.com/article/politics/opm-addiction. Searches on Google and Bing for the phrase investment banker greed yield millions of hits. At this writing, every day brings new articles making the point.

[5] *See* Press Release, Sec. & Exch. Comm'n, *supra* note 1 ("The Securities and Exchange Commission today announced that Goldman, Sachs & Co. will pay $550 million . . . to settle SEC charges that Goldman misled investors in a subprime mortgage product just as the U.S. housing market was starting to collapse.").

[6] Complaint at 1-2, Sec. & Exch. Comm'n v. Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y. Apr. 16, 2010).

> Goldman acknowledge[d] that the marketing materials for the ABACUS 2007-AC1 transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was "selected by" ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors. Goldman regrets that the marketing materials did not contain that disclosure.[7]

The relatively low-level (apparently, though, quite well-compensated—one source estimated his pay at $2 million[8]) Goldman Sachs banker "principally responsible" for the deal according to the SEC, Fabrice ("Fabulous Fab") Tourre, said in an email that "I've managed to sell a few Abacus bonds to widows and orphans that I ran into at the airport, apparently these Belgians adore synthetic ABS CDO2 [a complex security popular pre-crisis]."[9]

Another example is Citigroup's alleged structuring of a debt instrument that it sold to investors as being of high quality, earning structuring and sales fees, while also earning money betting correctly that the instrument was actually of low quality.[10] One news account described the allegations as follows:

> The SEC alleges that in 2007, the bank marketed and sold a mortgage-related collateralized debt obligation, or CDO, called Class V Funding III. According to the SEC complaint, one CDO trader characterized the asset group as 'a collection of dogshit' and 'possibly the best short EVER!' After marketing the CDO, Citi then took a short position -- or bet against -- the security as the housing market deteriorated, bringing in a net profit of $160 million for the bank. Investors, meanwhile, were cleaned out.[11]

Citigroup and the SEC settled the charges for $285 million.[12] The judge, Jed Rakoff, rejected the settlement.[13] Citi and the SEC have appealed the reversal[14], and they seem likely to prevail.[15]

A third example involves Repo 105. Lehman Brothers, whose bankruptcy precipitated the financial crisis, developed and used a transaction structure, "Repo 105" to hide its debt. In Repo 105, Lehman recorded repurchase transactions as asset sales, thus appearing to have a far more favorable debt

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[7] Press Release, Sec. & Exch. Comm'n, *supra* note 1. Goldman did not admit or deny the allegations. *Id.* Parties settling with the SEC commonly do not admit or deny the allegations, a practice that has been critiqued by Judge Rakoff in his rejection of Citigroup's settlement. *See infra* note **Erreur ! Signet non défini.** and accompanying text.

[8] Jessica Pressier & Jeff VanDam, *The Fabulous Life of Fabrice Tourre*, NEW YORK (Apr. 23, 2010), *available at* http://nymag.com/news/intelligencer/topic/65634/.

[9] Harper, *supra* note 1.

[10] *See* Press Release, Sec. & Exch. Comm'n, Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market (Oct. 19, 2011), *available at* http://www.sec.gov/news/press/2011/2011-214.htm . Banks sometimes defend taking positions on the 'other side' of bets they help their own clients make by arguing that they are simply being prudent risk managers. Broadly speaking, the defense is sensible but the particular allegations here are of banks crafting or being party to the crafting of 'bad bets' that they promote to their clients as good bets, while themselves taking what they believe to be the good bets.

[11] Charles Riley, *Citigroup settles with SEC for $285 million*, CNNMONEY (Oct. 19, 2011, 12:22 PM), http://money.cnn.com/2011/10/19/news/companies/citigroup_sec_settlement/index.htm.

[12] *See id.* ("Citigroup has agreed to pay $285 million to settle Securities and Exchange Commission charges that the bank misled investors about the strength of a security tied to the struggling U.S. housing market.").

[13] David S. Hilzenrath, *Judge rejects SEC-Citigroup settlement*, WASHINGTON POST (Nov. 28, 2011), http://www.washingtonpost.com/business/economy/judge-rejects-sec-citigroup settlement/2011/11/28/gIQA8KsH5N_story_1.html.

[14] Bill Singer, *SEC Files Historic Appeal of Judge Rakoff's Citigroup Settlement Rejection*, FORBES (Dec. 16, 2011, 11:30 AM), http://www.forbes.com/sites/billsinger/2011/12/16/sec-files-historic-appeal-of-judge-rakoffs-citigroup-settlement-rejection/.

[15] Mark Hamblett, *Circuit Poised to Reverse Rakoff Rejection of SEC/Citi Deal*, N.Y.L.J., May 16, 2012, at 1; *see also* Sec. & Exch. Comm'n v. Citigroup Global Mkts. Inc., No. 11-5227-cv, 2012 WL 851807 (2d Cir. Mar. 15, 2012) (granting a stay on the district court decision to reject the parties' settlement).

ratio than it actually did.[16] The Bankruptcy Examiner's Report's Introduction describes Repo 105 as follows:

> [Repo 105 helped Lehman temporarily remove] approximately $50 billion of assets from the balance sheet at the end of the first and second quarters of 2008. In an ordinary repo . . . such transactions were accounted for as financings, and the assets remained on Lehman's balance sheet. In a Repo 105 transaction, Lehman did exactly the same thing, but . . . accounting rules permitted the transactions to be treated as sales rather than financings, so that the assets could be removed from the balance sheet. *With Repo 105 transactions, Lehman's reported net leverage was 12.1 at the end of the second quarter of 2008; but if Lehman had used ordinary repos, net leverage would have to have been reported at 13.9.*
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> . . . *Lehman used Repo 105 for no articulated business purpose except "to reduce balance sheet at the quarter-end."* Rather than sell assets at a loss, "[a] Repo 105 increase would help avoid this without negatively impacting our leverage ratios." Lehman's Global Financial Controller confirmed that "the only purpose or motive for [Repo 105] transactions was reduction in the balance sheet" and that "there was *no substance* to the transactions."
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> Lehman did not disclose its use – or the significant magnitude of its use – of Repo 105 to the Government, to the rating agencies, to its investors, or to its own Board of Directors. Lehman's auditors, Ernst & Young, were aware of but did not question Lehman's use and nondisclosure of the Repo 105 accounting transactions."[17]

A fourth example involves Jefferson County, Alabama. The county is now bankrupt;[18] one important contributor to its bankruptcy is a swap transaction arranged for it by J.P. Morgan Securities, which bribed local officials to get the business. J.P. Morgan's fees were reportedly enormous relative to fees for comparable transactions; one source said that the fees may have been up to six times the norm.[19] Thanks to interest rate movements during the crisis, the payments due on the swap soared, leading Jefferson County to default. There have been several lawsuits, including one by the SEC. As described in the SEC press release announcing the settlement:

> [While not admitting or denying any allegations,] J.P. Morgan Securities settled the SEC's charges and will pay a penalty of $25 million, make a payment of $50 million to Jefferson County, and forfeit more than $647 million in claimed termination fees.
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> The SEC alleges that J.P. Morgan Securities and former managing directors Charles LeCroy and Douglas MacFaddin made more than $8 million in undisclosed payments to close friends of certain Jefferson County commissioners. The friends owned or worked at local broker-dealer firms that performed no known services on the transactions. In connection with the payments, the county commissioners voted to select J.P. Morgan Securities as managing underwriter of the bond offerings and its affiliated bank as swap provider for the transactions.

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[16] *See* 3 Report of Anton R. Valukas, Examiner, at 732, In re Lehman Brothers Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. Mar. 11, 2010).

[17] 1 Report of Anton R. Valukas, Examiner, at 6-8, In re Lehman Brothers Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. Mar. 11, 2010) (first set of italics added).

[18] Mary Williams Walsh, *When a County Runs Off the Cliff*, N.Y. TIMES, Feb. 19, 2012, at BU1.

[19] William Selway & Martin Z. Braun, *JPMorgan Proves Bond Deal Death in Jefferson County No Bar to New Business*, BLOOMBERG (Aug. 12, 2011, 12:01 AM), http://www.bloomberg.com/news/2011-08-12/jpmorgan-proves-bond-deal-death-in-jefferson-county-no-bar-to-new-business.html.

> J.P. Morgan Securities did not disclose any of the payments or conflicts of interest in the swap confirmation agreements or bond offering documents, yet passed on the cost of the unlawful payments by charging the county higher interest rates on the swap transactions.[20]

Other investment banks were also allegedly involved, by some accounts getting inflated fees for doing very little or nothing.[21]

What did J.P. Morgan do that was so bad? Certainly, bribing people to get business is bad, as well as illegal. But another aspect of the deal is a bit trickier for purposes of my analysis. The transaction was a complex one, and it appears that the Jefferson County officials may have been motivated to engage in it because they were bribed to do so, rather than because they thought it was a good idea for the citizens of Jefferson County. It seems reasonable to suppose that bankers involved in the transaction knew that the transaction was not motivated by its benefits for Jefferson County's citizens and indeed, may very well have been bad for the county. Consider in this regard an email from a JP Morgan banker to a colleague: "When asked to prepare materials explaining why the county should buy more derivatives, the banker wrote: 'Do these guys know the risks they are taking (in large doses)?' 'Shouldn't we be pitching diversification arguments?'"[22] But to what extent does a bank have a duty to look out for its (true) client when the client's agent is not doing so? I will return to this question in the next Section.

b. *Bankers Assisting "Bad" Client Behavior*

The next set of examples involves bankers helping their clients behave in problematic ways.[23] One example involves Goldman Sachs. Goldman Sachs helped Greece "hide"[24] its debt by arranging a cross-currency swap. One account of the transaction is as follows:

> In a series of deals, Goldman Sachs bought Greek debt held in dollars or yen using euros, but for an off-market, made-up exchange rate. The inflated value given to the Greek debt resulted in an extra €1billion credit for Greece. This was to help Greece meet strict debt-to-GDP criteria to join the single currency laid out in the Maastricht treaty. This extra billion did not show up as Greek debt, though it would have to be paid back, in addition to the pay-out on maturity of the bonds, at a later date. The deal was originally reported by Risk Magazine back in 2003. Greece was allowed to continue borrowing as it hadn't disclosed the debt from its currency swap deals. It borrowed as much as €5.3billion more because of the off-market deals, according to a Eurostat report.[25]

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[20] Press Release, Sec. & Exch. Comm'n, J.P. Morgan Settles SEC Charges in Jefferson County, Ala. Illegal Payments Scheme (Nov. 4, 2009), *available at* http://www.sec.gov/news/press/2009/2009-232.htm.

[21] Matt Taibbi, *Looting Main Street*, ROLLING STONE (Apr. 15, 2010, 9:15 AM), http://www.rollingstone.com/politics/news/looting-main-street-20100331. Some of the payments at issue even came from the bank trying to preserve its business. *See id.* ("JP Morgan at one point even paid Goldman Sachs $3 million just to back . . . off.").

[22] *See* Selway & Braun, *supra* note 19 (describing a May 12, 2003, e-mail by Charles Giffin, a banker at J.P. Morgan, to a colleague).

[23] The example of Jefferson County is about bad behavior by the banks and Jefferson County officials, not by the county itself, hence its placement in my category of bankers helping themselves.

[24] "Hide" is in quotation marks because it is not clear who was actually fooled. I will return to this issue in the next section, but for purposes of this discussion, suffice it to say that even if many people were not fooled, the behavior involved – both of Greece and the bankers – is problematic. The technique's only function was to depict as not being debt something that was actually debt. The defense quoted in the beginning of this article defends Goldman in a way that 'indicts' the whole industry: doing these types of deals is something the banking industry does. Salmon, *supra* note 2.

[25] Shane Croucher, *Eurozone Crisis: Greece-Goldman Deal That Sparked Debt Mayhem Not Repeated*, INT'L BUS. TIMES (Nov. 15, 2011, 2:59 PM), http://www.ibtimes.co.uk/articles/249767/20111115/eurozone-crisis-greece-goldman-deal-sparked-debt.htm#ixzz1mDYc7ZEO; for an in-depth discussion of this deal, see also Nick Dunbar, *Revealed: Goldman Sachs' Mega-Deal for Greece*, RISK MAGAZINE, http://www.risk.net/risk-magazine/feature/1498135/revealed-goldman-sachs-mega-deal-greece (last visited Mar. 26, 2012).

My last example involves Enron. Enron went bankrupt after it became clear that its attractive financial appearance had been achieved through misrepresentation and deception. Enron's bankers were instrumental in this misrepresentation and deception: their techniques helped Enron fool the rating agencies, the investing public and the markets more broadly into thinking Enron had far less debt, and far more income and cash flow, than it actually did. One important technique was "prepays," which was a way to disguise debt. As described in materials from a Senate subcommittee hearing on Enron:

> The participants in Enron's "prepays" were not only aware that the transactions were driven by Enron's desire to manipulate its financial statements, the financial institutions actively aided Enron in designing and implementing financial structures that created and maintained the fiction that the transactions were trades rather than loans.
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> . . . .
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> In addition to helping Enron design and execute multiple "prepay" transactions, the financial institutions complied with Enron requests to restrict disclosure of the nature and extent of its prepay activities. By design and intent, the "prepays" structured by Enron and the financial institutions made it impossible for investors, analysts, and other financial institutions to uncover the true level of Enron's indebtedness.
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> . . . .
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> There are many possible explanations for why major financial institutions were willing to go along with and even expand upon Enron's "prepay" activities. One obvious incentive was the fees paid by Enron which provided lucrative business deals to a number of financial institutions on Wall Street and elsewhere. Citigroup earned approximately $167 million from 1997 through 2011.[26]

Some "bad" banker behavior is documented; some of it is merely alleged. I take no position here as to whether all the allegations are true. Still, there are enough allegations, and enough has been documented, that a sufficient factual basis exists for my overall characterization. Moreover, there are surely other examples that have thus far escaped regulatory and media notice; in this regard, the SEC is reportedly considering bringing suits against several major banks for perhaps having known that the mortgages being packaged into "toxic" subprime securities were of far lower quality than was being represented to investors.[27]

3. The Ethos: An Explanation

The examples above are of an ethos in which people are arguably trying to benefit themselves without regard for the effect on others, including the greater society and the vulnerable people within it, sometimes even taking pride in negative effects on 'widows and orphans' or in the cleverness of their loopholes. They are lying to and betting against their own clients,[28] crafting and using loopholes to disguise their and their clients' financial appearances and sometimes boasting about it to one another. And they are causing their banks to plunge headfirst into complex financial instruments that the banks' 'rocket

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[26] *The Role of Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcomm. of Investigations of the S. Comm. on Governmental Affairs*, 107th Cong. 232 (2002). One banker, from Chase, wrote in an e-mail: "Enron loves these deals as they are able to hide funded debt from their equity analysts because they (at the very least) book it as deferred rev[enue] or (better yet) bury it in their trading liabilities." *Id.* at 232-240.

[27] *See, e.g.*, Jean Eaglesham et al., *Banks to Face Lawsuit By U.S.*, WALL ST. J., Feb. 9, 2012, at C1; Alexander Eichler, *SEC May Target Big Banks in Lawsuit Over Mortgage-Backed-Securities*, HUFFINGTON POST (Feb. 9, 2012, 5:31 PM), http://www.huffingtonpost.com/2012/02/09/sec-mortgage-backed-securities-lawsuit_n_1266218.html.

[28] The behavior I am criticizing here is not *any* bet a firm makes that wins if the security the firm sold its client loses. That sort of behavior may appropriately be criticized, but as part of a more expansive account of desirable behavior, not as 'exhibit A' for the case that much undesirable behavior is occurring.

scientists' develop, structuring, buying and selling significant volumes of those instruments, perhaps only recklessly, but also, arguably more culpably, perhaps because of compensation structures that reward "performance" at year end and do not claw back previously awarded compensation in the event of bad performance in subsequent years.[29] In the period leading up to the crisis, bankers kept the assembly line of transactions moving briskly, not asking for, or perhaps ignoring, information that would suggest the potential for broader effects, including, again, negative effects on the greater society. Some, and perhaps many, bankers did risk their own funds in such transactions, but of course did so voluntarily; more importantly, the amounts they risked were amounts they could afford to lose. The same is not true of the greater society. The society did not 'voluntarily take these risks—and the crisis reveals that society could ill afford the amounts lost as a result of the risks taken.

Why are bankers behaving this way? One simple answer is that they are rewarded for doing so[30] in the form of large bonuses and esteem from their peers.[31] Indeed, banking now attracts people who strongly value big financial rewards, and are willing and inclined to take large risks to get them. As Richard Painter and I have written in our article *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have Some Personal Liability*,[32] investment banks used to be general partnerships; bankers, the general partners, were liable if their banks failed. Compensation and risk-taking were much lower; banking thus attracted different sorts of people. This characterization seems more helpful than saying that bankers or bank behavior are 'bad,' a characterization in which I have no stake except insofar as it permits a felicitously alliterative title.

Why should we care so much about how bankers are behaving? The answer is that how they are behaving – what they are rewarded for doing and have been doing – can yield, and has yielded, disastrous results for society. In a world where (1) financial institutions and, indeed, many other entities are very interconnected, suggesting that damage from one may spread widely, and also that there will be considerable political pressure for bail-outs, (2) financial instruments can be extremely complex, with significant and largely intractable uncertainty, (3) multiple bets can be made on the performance of one asset by many different parties, so that the exposure should the asset lose value is many multiples of the value lost, and (4) many investments directly or indirectly are being made with the money of people who did not consent to risky bets, the potential for damage is enormous.

A naïve view of professional rewards suggests that rewards should reward something that – well, from someone's point of view, hopefully society's – *should* be rewarded. (And there should not be rewards for something that from society's point of view is harmful and should be discouraged.) A performer or athlete is rewarded for giving pleasure; the more pleasure, the greater the reward (again, this is the naïve view). An entrepreneur is rewarded for "building a better mousetrap." Somebody who predicts that subprime mortgages are wildly overvalued makes billions betting against those holding a contrary view (or at least investing as though they did). Matters quickly become more complicated: a

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[29] How, and how much, the structure of banker compensation influenced banks' participation and investments in subprime mortgages is controversial. *Compare* Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis*, 99 J. FIN. ECON. 11, 24 (2011) ("Based on our evidence, lack of alignment of bank CEO incentives with shareholder interests cannot be blamed for the credit crisis or for the performance of banks during that crisis."), *with* Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257, 257 (2010) (suggesting that some CEO compensation systems provide perverse incentives to make decisions focusing on the short-term). The non-agency cost story tends to include "faith" in the ever-increasing powers of "rocket scientists" to model risk. *See* Steve Lohr, *In Modeling Risk, the Human Factor Was Left Out*, N.Y. TIMES, Nov. 5, 2008, at B1.

[30] This answer is too simple, but a fuller answer is beyond the scope of this article, and the answer suffices for present purposes. In a book to be co-authored with Richard Painter, I am exploring the answer to this question in more depth.

[31] Of course, the question of why banks reward what they reward is an important one for the broader inquiry, again beyond the scope of this article but within the scope of my book with Richard Painter. Part of the story relates to change in bank organizational form, from general partnership before the 1980s to corporations starting thereabouts. *Infra* text accompanying note 32.

[32] Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1177 (2010).

CEO is rewarded for increasing profits, but maybe this is because he replaced many employees with robots – good for the shareholders, perhaps (?) less so for society as a whole. The easy case, at least in theory, is that the CEO should not be rewarded for "performance" which consists of gaming the performance measures.[33]

It is obvious why people would want to game performance measures. If true good performance was easy, it wouldn't be so well rewarded. People want the benefits – rewards – of great performance even though they may not perform sufficiently well.[34] The same can also be said about measures of financial health generally: gaming is not just of performance (measures), but also of financial condition. Why don't employers figure out how to reward only 'true' good performance? The main reason is because performance is exceedingly hard to measure. Enormous amounts of cleverness are thrown at gaming performance measures.[35] Moreover, even independent of "gaming," people will clearly be motivated to maximize their performance-as-it-will-be-measured more than their performance as they assess what might be best for their employer.

Given that people will want to game performance measures, it is also obvious why they would be willing to pay others to help them, and why those others would accept. The foregoing paragraph applies to all business; this paragraph is about something largely done by banks. "Gaming" on someone else's behalf – for instance, coming up with techniques to improve a client's financial appearance – is predictably lucrative, more so than many other ways of spending time and effort. Arranging a traditional financing might be more predictable, but far less lucrative. Trying to build a better mousetrap is potentially more lucrative, but a great deal less predictable. Why the employers reward this kind of gaming is a more complicated question than the question of why they have gameable performance measures, but the difficulties in line-drawing between legitimate and illegitimate techniques are also part of the story.

The foregoing is an account of behavior that is rewarded and that has caused enormous difficulties. One other type of behavior also needs to be discussed: banks trading for their own accounts, something that they have increasingly done. Bank proprietary trading has been identified as quite risky; the Volcker rule is seeking to curtail it.[36] For now, a simple explanation will suffice. Risk and reward are of course highly correlated: a lottery ticket is very unlikely to pay off, but if it does, the payoff may be enormous. Individuals whose bonuses can capture quite a bit of the upside, but whose exposure to the

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[33] Many notorious examples can be given, one involving Sunbeam's sale, under CEO "Chainsaw" Al Dunlap, of heavily discounted barbecue grills:

> Of all the ploys, few were as controversial and daring as the "bill-and-hold" sales of barbecue grills the company began making in early November. Anxious to extend the selling season for the product and boost sales in Dunlap's "turnaround year," the company offered retailers major discounts to buy grills nearly six months before they were needed. The retailers did not have to pay for the grills or accept delivery of them for six months. The downside was evident: The company was booking what would have been future sales in the present. Indeed, after Dunlap's departure from the company, outside auditors would force a restatement of Sunbeam's financials, pushing most of these sales -- $62 million worth -- into future quarters. (Outside auditor Arthur Andersen & Co. declined to comment, citing pending litigation. Dunlap said bill-and-hold sales were proper under accepted accounting principles. "There is absolutely nothing improper about this practice," he said.)

John A. Byrne, *Chainsaw*, BUSINESS WEEK, Oct. 18, 1999, at 128, 141 (*excerpting* JOHN A. BYRNE, CHAINSAW: THE NOTORIOUS CAREER OF AL DUNLAP IN THE ERA OF PROFIT-AT-ANY-PRICE (2003)).

[34] A banking analogue to selling discounted barbecue grills, see *supra* note 33, may be suggesting transactions to clients because of the fee income the transactions would bring for the bank; a more benign analogue may be where the banker and the others involved persuade themselves that "hockey stick" earnings projections justify the transaction (and the fee).

[35] There also may be an agency cost story in which those setting performance measures are also people who would like to have gaming opportunities available for themselves.

[36] *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620 (2010) (to be codified at 12 U.S.C. § 1851).

downside is limited, will be motivated to take higher risks. Bankers' employers reward this behavior for the same reason: the banks' downside risk is ultimately limited.

Let us return briefly to the naïve characterization of professional rewards. Imagine someone trying to explain what she does to someone whose esteem she wants. Even if what the person does is quite technical, it may lend itself to a simple explanation. Some examples: "I try to find a cure for cancer" or "I try to help people who have good business ideas get funding for those ideas." Imagine trying to 'simply' explain the currency swaps arranged for Greece, or any of the Enron devices. Probably the most defensible thing one could say is that "everyone is doing it" and that not doing it makes one look worse than one really is. Indeed, 'everyone' may actually be 'doing it': Consider in this regard a memorandum by one of Enron's bankers at Citigroup: "The prepaid forward structure will allow Enron to raise funds without classifying the proceeds from this transaction as debt (it is accounted for as 'deferred revenue'). This is a common method of raising non-debt financing among energy companies."[37]

That explanation – "everyone is doing it" – wouldn't necessarily pass muster in the greater society. In any event, in some cases everyone is *not* doing it. Some techniques may be particularly novel and clever. They may enable a company to look better than its otherwise comparable peers, as well as far better than it is. Sometimes, the banker is taking advantage of the bank's clients being dopes or dupes. Consider in this regard some of the quotes above, from the CDO trader about the CDO that was "a collection of "dogshit" being marketed by Citigroup and from Goldman Sachs banker Fabrice Tourre about selling CDO^2 s to widows and orphans. Tourre did not sell CDOs to widows and orphans, but the fact that he joked about it is telling. One can envision a pernicious dynamic in which bankers egg one another on, according status to the cleverest at gaming[38] and to the most heartless. The Enron traders – not bankers, technically, but doing something quite akin to what is done in banks – notoriously gloated about sticking "Grandma Millie" with higher utility prices: as one account describes it, "[t]hose mischievous imps at the Enron energy-trading desk were famously caught on tape laughing [uproariously] at how they were manipulating the West Coast markets through all sorts of skullduggery, and how "Grandma Millie" – the prototypical pensioner struggling to pay an electric bill – was not happy."[39]

The picture that emerges is the following. People working long hours on quite-technical matters, as bankers do, would be inclined to create or become part of a subcommunity of others who understand what they do. The subcommunity has its own values and norms. It becomes more insular and more exclusive insofar as the people in it do something that outsiders not only wouldn't understand, but might not approve of if they did. There is both a logistical and a moral "crowding out" of values and norms that might be antithetical to the subcommunity's values, norms and, indeed, livelihood.

4. Law's Limits

Where is law in all this? It of course has an important role, but a limited one. Its limitations reflect, among other things, the inability of regulators to keep up with the intricacies and potential perils of new financial instruments, the difficulty of setting performance-based pay that rewards true performance rather than some gameable measure, and the preference for certainty in business that helps cause regulatory schemes too often rely on (gameable) accounting rules rather than potentially more expansive standards. Add to that the problems of defining the behavior we want to prohibit, and the incentive and ability of the many actors who can profit enormously by finding ways around those definitions, and law's limits can readily be perceived. Trying to change what behavior is rewarded

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[37] *The Role of Financial Institutions in Enron's Collapse: Hearings Before the Permanent Subcomm. of Investigations of the S. Comm. on Governmental Affairs*, 107th Cong. 519 (2002).

[38] *See generally* Jeffrey N. Gordon, *What Enron Means for the Management And Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Claire A. Hill, *Tax Lawyers are People Too*, 26 VA. TAX REV. 1065 (2007).

[39] Richard Connelly, *Enron's "Grandma Millie" in High School Classrooms, F-Bombs and All*, HOUSTONPRESS (Mar. 2, 2009, 11:48 AM), http://blogs.houstonpress.com/hairballs/2009/03/enron_grandma_millie.php.

encounters the same sorts of problems, and an extra problem: that law is generally hard pressed to directly control private companies' compensation systems.[40]

5. What Might Help?

Let us take a step back and consider another way of viewing law's limits. A simple story about law is that it works instrumentally: it makes disfavored behavior more costly because there is a non-zero probability that certain sanctions will result. There is also a simple expressive story: law also works by expressing the law's view that certain conduct is disfavored. The law provides information that this is so, and makes it so by saying so. But law here is providing mixed messages. On the one hand, it makes some disfavored behavior more costly. But, given our considerable use of rules, it often increases the return to behavior that is just "on the other side of the line." The return isn't just financial; it's also one of esteem within the reputational subcommunity.

In other work, my colleague Richard Painter and I have argued that whatever else is done in response to the recent financial crisis, considerable energy ought to be directed at changing the banker ethos so that bankers have more personal and professional responsibility. Our specific legal proposals include increasing personal liability for bankers if their firms become insolvent. We would also like to see changes in compensation for banking, and are considering how the law might be involved in bringing this about. But one of our big aims is to encourage a focus and national dialogue on the problem of banker behavior and attitudes. We have seen the extent to which bankers can do serious damage to the economy. The ethos that permits and sometimes rewards the damage-causing behavior needs to be addressed. Law changes can and should be part of a broader societal message: a shift in norms away from glorification of "greed," and towards a greater recognition that with banking's privileges come a need to be personally and professionally responsible to the society as a whole.

[40] There are exceptions, though, including tax law's attempts to restrict certain types of payments and compensation and the recent rule contemplated in Dodd-Frank to prohibit compensation structures that reward excessive risk-taking. *See generally* Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (proposed Apr. 14, 2011) (to be codified at 12 C.F.R. pt. 42).