

THE CONFIDENCE GAME: MANIPULATION OF THE MARKETS BY GOVERNMENTAL AUTHORITIES

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The global financial crisis that began in the summer of 2007¹ has focused the attention of governments and international financial institutions on the regulation of financial institutions to an unusual degree.² In response to the crisis, the G20 and national governments are developing new mechanisms for ensuring financial stability in order to try to prevent similar problems from arising in the future.³ Concerns about the financial viability of banks and about the value of asset-backed securities issued by financial institutions were reflected in banks' share prices. The crisis represents a massive global loss of confidence in the ability of the world's financial markets to value financial assets appropriately, which has raised a range of issues for legislators and regulators.

The global financial crisis thus renders visible and urgent a perennial (although often ignored) tension in financial regulation with respect to the extent to which governments should intervene to fix the financial markets.⁴ Governments have reacted to the crisis with short-term emergency measures and longer-term initiatives. In the short term, governments have provided financial support to troubled financial institutions, and they have implemented regulatory fixes by varying rules on short selling,⁵ deposit insurance,⁶ and accounting⁷ in order to calm the

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¹ Bank for International Settlements, 78th Annual Report: 1 April 2007–31 March 2008, at 3 (June 30, 2008), <http://www.bis.org/publ/arpdf/ar2008e.pdf> (“The simmering turmoil in financial markets came to the boil on 9 August 2007.”).

² See, e.g., U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, 2 (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (proposing reforms to “build a new foundation for financial regulation and supervision”); HM TREASURY, REFORMING FINANCIAL MARKETS, CM 7667 (July 2009), available at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf.

³ See, e.g., G20, Declaration on Strengthening the Financial System (Apr. 2, 2009), available at <http://www.g20.org> (search “Strengthening the Financial System”) (setting out the G20's commitment to reform).

⁴ See, e.g., Caroline Bradley, *Suspension and Disbelief (Or, How Managed Should a Market Be?)*, 26 SETON HALL L. REV. 597 (1996) (criticizing the use of trading halts by regulators).

⁵ See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, REGULATION SHO: RECENT ACTIONS APPEAR TO HAVE INITIALLY REDUCED FAILURES TO DELIVER, BUT MORE INDUSTRY GUIDANCE IS NEEDED,

financial markets.⁸ These short-term measures have been designed to fix the financial markets by controlling behaviors considered to be harmful in the context of the crisis, such as short selling, and by providing regulatory and financial support for stock prices.

In normal times, governmental and self-regulatory authorities justify regulation of the financial markets by reference to the need to maintain confidence in the markets.⁹ But governmental action to protect investor confidence is generally characterized as action to guarantee the integrity of the markets, meaning that regulation should ensure that pricing in the markets is accurate. Investor protection is necessary, in part, because protecting investors' interests encourages confidence and more investment. Regulations that target fraud, insider trading, and market manipulation are designed to maintain confidence in the financial markets,¹⁰ as are

GAO-09-483, 5 (May 2009), (describing SEC emergency action to curb naked short-selling).

⁶ The crisis revealed issues with respect to confidence of depositors in depository institutions, resulting in moves to enhance depositor protection. *See, e.g.*, Sebastian Schich, *Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects*, 95 OECD J: FIN. MKT. TRENDS (2008/2)

⁷ *See, e.g.*, Press Release, U.S. Sec. & Exch. Comm'n, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, No. 2008-234 (Sept. 30, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-234.htm>; *see also* Staff Position, Fed. Accounting Standards Bd., Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, No. FAS 157-3 (Oct. 10, 2008); Staff Position, Fed. Accounting Standards Bd., Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, No. FAS 157-4 (Apr. 9, 2009).

⁸ Regulators have also reacted to the crisis by intensifying their efforts with respect to enforcement. *See, e.g.*, Yin Wilczek, *SEC Enforcement: In Mid-Year Reviews, Lawyers Give Enforcement Division High Marks for Revamp*, SEC. L. DAILY (BNA), July 15, 2009; Financial Services Authority, Annual Report 2008/09, 8 (June 2009), <http://www.fsa.gov.uk> (search "2008-09 Annual Report") ("During the past year, we have demonstrated our resolve to bring credible deterrence to bear on financial crime. On tackling market misconduct, we secured two convictions and a custodial sentence in our first ever insider dealing criminal trial – a clear warning that wrongdoers who cheat the market will be held to account.").

⁹ *See, e.g.*, Financial Services Authority, *supra* note 8, at 8 ("FSMA also sets the FSA a consumer protection objective. Maintaining financial stability and confidence is in itself a crucial means by which we pursue this objective . . ."). *Cf.* Norman S. Poser, *Why the SEC Failed: Regulators Against Regulation*, 3 BROOK. J. CORP. FIN. & COM. L. 289, 319 (2009) (citing "the underlying philosophy of the Exchange Act: that prevention of fraud, maintaining of fair and orderly markets, and assurance of honest corporate disclosure are the essential underpinnings of capital formation.").

¹⁰ *See, e.g.*, Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), 46 OFFICIAL J. EUR. UNION (L 96) 16, 17 (2003) ("The objective of legislation against insider dealing is the same as that of legislation against market manipulation: to ensure the integrity of Community financial markets and to enhance investor confidence in those markets.").

rules that are designed to prevent financial market participants from putting their own interests before those of their clients.¹¹ Such rules are designed to maintain confidence by ensuring the integrity of the markets. Because the maintenance of confidence is at the heart of much financial regulation, a massive lack of confidence seems to be a significant market or regulatory failure justifying governmental intervention.¹²

Governmental action designed to stop some market participants from manipulating the markets at the expense of others, leading to a decline in confidence in the markets, is geared to preserve confidence by preserving the integrity of the markets. Emergency amendments to rules on short selling were motivated by a concern to prevent market manipulation by market participants.¹³ However, some governmental responses to the financial market crisis seem to treat the preservation of confidence in the markets (rather than the preservation of market integrity) as the fundamental concern of regulation. This is a risky strategy because adopting emergency measures to manipulate the markets in the interests of improving confidence risks undermining the ability of regulators to control the behavior of financial institutions for the future in any meaningful way. If governments react to a crisis by misapplying existing rules in the interests of maintaining confidence, they may create expectations among market participants that they will react to future crises in the same way. Market participants' incentives to comply with the rules could be reduced, and they might experience increased confidence that they can make sure the rules will work to their advantage.¹⁴

Emergency measures must often be adopted swiftly, and they may be implemented without the level of consultation that governments and supranational authorities typically argue is necessary.¹⁵ They may therefore seem less legitimate

¹¹ Scandals involving Ponzi schemes such as the Madoff scandal harm confidence. *See, e.g.*, Stephen Joyce, *Madoff Sentenced to 150 Years in Prison As Judge Calls Crimes 'Extraordinarily Evil'*, SEC. L. DAILY (BNA), June 30, 2009 ("In announcing his sentence, Judge Denny Chin said while the actual amount of money stolen by Madoff is still in dispute, the crime's magnitude was nevertheless 'off the charts.' Madoff's crimes, additionally, were not solely about money but addressed fundamental breaches of trust and fidelity, Chin said.").

¹² *See, e.g.*, U.S. DEP'T OF THE TREASURY, *supra* note 2, at 2 ("We must act now to restore confidence in the integrity of our financial system.").

¹³ *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 5, at 5.

¹⁴ *Cf.* Simon Johnson, *Who Nationalized Whom?*, RGE MONITOR, July 17, 2009, http://www.rgemonitor.com/financemarkets-monitor/257307/who_nationalized_whom ("[A]ccess to contingent (sic) state capital-on-amazing-terms is the ironic basis of modern financial power."); Paul Krugman, *The Joy of Sachs*, N.Y. TIMES, July 17, 2009, at A23.

¹⁵ The UK's Banking (Special Provisions) Act 2008, 2008 Ch. 2, which had its first reading in Parliament on February 19, 2008 and obtained Royal Assent on February 21, 2008, gave the Treasury broad powers to amend primary legislation. This power has been superseded by a power contained in

than other, more openly debated measures. It is common for rules of financial regulation to be adopted speedily in response to a crisis. However, rules adopted in such circumstances are vulnerable to subsequent criticism, particularly the critique that politics, rather than good, policy were responsible for generating the new rules.¹⁶

Where governmental initiatives are designed to manipulate confidence in the markets, rather than to create the conditions for longer-term confidence in those markets, they may, in the end, undermine confidence. In particular, support schemes for financial institutions that place over-generous valuations on bank assets when they are purchased by governmental authorities,¹⁷ or allow financial institutions to exit from the schemes at too favorable a price,¹⁸ and governmental reluctance to impose aggressive regulation on entities whose actions contributed to the crisis, such as credit rating agencies,¹⁹ raise questions about whether the responsible governments have any real fundamental commitment to sound valuation and risk

section 75 of the Banking Act 2009, 2009 Ch. 1. Cf. House of Lords Select Comm. on the Constitution, *Fast-track Legislation: Constitutional Implications and Safeguards*, HL 116-I, 1 (2009) (discussing “constitutional issues that may arise when there is resort to emergency legislation,” [sic] and, in particular, ‘situations where bills receive an expedited passage through parliament.’”).

¹⁶ Consider, for example, the criticisms of the Sarbanes-Oxley Act of 2002, enacted very quickly in response to the collapse of a number of large US corporations, including Enron. See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005) (“[T]he corporate governance provisions were not a focus of careful deliberation by Congress. SOX was emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases.”); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 46 (2002) (“[T]hose who see corporate fraud as a wedge to push a broader regulatory agenda applied significant pressure in favor of regulation.”).

¹⁷ The U.S. Treasury’s process for establishing valuations for warrants that financial institutions repurchase from the Government includes provision for independent appraisals. See, e.g., U.S. DEPT OF THE TREASURY, SECTION 105(A) TROUBLED ASSETS RELIEF PROGRAM REPORT TO CONGRESS FOR THE PERIOD JUNE 1, 2009 TO JUNE 30, 2009, 5 (July 10, 2009), available at <http://www.financialstability.gov> (search “105 Congressional Reports”; then follow 7/10/2009 Hyperlink) (describing the process). Cf. Adrian Blundell-Wignall, Paul Atkinson & Se Hoon Lee, *Dealing with the Financial Crisis and Thinking about the Exit Strategy*, 96 OECD J: FIN. MKT. TRENDS 3 (2009/1) (“Because of great uncertainty about valuation, the risk to the taxpayer of buying at too high a price in the emergency measures phase is quite high.”).

¹⁸ See, e.g., U.S. GOV’T ACCOUNTABILITY OFFICE, TROUBLED ASSET RELIEF PROGRAM: STATUS OF EFFORTS TO ADDRESS TRANSPARENCY AND ACCOUNTABILITY ISSUES, GAO-09-920T, 7 (July 22, 2009), (“We recommended that Treasury consider publicly disclosing additional details regarding the warrant repurchase process, such as the initial price offered by the issuing entity and Treasury’s independent valuations, to demonstrate Treasury’s attempts to maximize the benefit received for the warrants on behalf of the taxpayer.”).

¹⁹ See, e.g., James Kwak, *TARP for Rating Agencies*, RGE MONITOR, Jun. 19, 2009, <http://www.rgemonitor.com> (search “TARP for Rating Agencies”; then follow hyperlink under “Matching Articles from RGE Content”).

assessment practices. Debates about whether financial institutions should be required to follow mark-to-market accounting requirements during periods of market volatility raise similar questions.²⁰

Short-term emergency measures adopted in response to the crisis risk undermining the effectiveness of more considered longer-term measures. Some commentators have emphasized the need for a response that goes beyond immediate responses to the crisis and that engages in real reform of financial regulation.²¹ Others have suggested that regulators must keep their new resolutions to be tougher enforcers of the rules after the immediate crisis is over.²² Market participants that are confident that governments will consistently prioritize maintaining confidence over maintaining market integrity will adjust their lobbying strategies accordingly.

The current debates about how to structure financial regulation and accounting requirements in the context of the crisis and for the future illustrate that different groups have dramatically different views about how the financial markets should be regulated. For example, while some have argued forcefully that fair value accounting contributed to market instability, others argue with as much force that fair value accounting requirements are essential to protect the interests of investors.²³ International institutions have contributed to this debate. For example, the Basel Committee on Banking Supervision has stated that international accounting standards should “recognise [sic] that fair value is not effective when markets [become] dislocated or are illiquid.”²⁴

²⁰ See, e.g., Statement from the Comm. of Eur. Sec. Regulators, Application of and Disclosures Related to the Reclassification of Financial Instruments, 2 (July 15, 2009), available at <http://www.cesr.eu/popup2.php?id=5802> (“If no reclassifications had been made, the total amount reported in the profit and loss account and in other comprehensive income would have been 28 billion euros lower than the figures actually reported.”).

²¹ See, e.g., Blundell-Wignall et al., *supra* note 17, at 1 (“Crisis measures need to be accompanied by genuine reform of the regulations and other incentive structures that caused the crisis.”).

²² See, e.g., House of Commons Treasury Comm., Banking Crisis: Regulation and Supervision, HC 767, 3 (2009) (“The FSA must develop the confidence to take unpopular decisions when the economic boom begins again, in the face of both industry and the political class.”).

²³ See, e.g., U.S. Sec. & Exch. Comm’n, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, 1 (Dec. 30, 2008), available at <http://www.sec.gov/news/studies/2008/marktomarket123008.pdf> (“In the months preceding passage of the Act, some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under SFAS No. 157, contributed to instability in our financial markets. . . . Just as vocal were other market participants, particularly investors, who stated that fair value accounting serves to enhance the transparency of financial information provided to the public.”).

²⁴ Basel Comm. on Banking Supervision, Guiding Principles for the Replacement of IAS 39, 2 (2009), <http://www.bis.org/publ/bcbs161.pdf?noframes=1>. The G20 has endorsed these principles. See G20, Meeting of Finance Ministers and Central Bank Governors, Declaration on Further Steps to

Policymakers have suggested long-term changes to financial regulation that involve new varieties of interference with market behavior by governments. For example, regulators are beginning to regulate compensation arrangements for executives in financial firms.²⁵ Policymakers are discussing ideas of regulating by reference to substance rather than form²⁶ and of regulating previously unregulated products.²⁷ Such proposals are being justified not only by the need to ensure the stability of the financial system and the integrity of the markets, but also by the need to maintain confidence.²⁸ However, market participants counter these proposals with arguments that they will make it impossible for firms subject to the new rules to compete effectively with firms established in other jurisdictions.²⁹

At the domestic level, policymaking with respect to financial regulation tends to be a matter for technocrats in normal conditions, but it becomes more political in times of crisis or scandal. Crises may prompt new consumer-friendly regulations, but they may also encourage financial firms to dedicate increased resources to lobbying.³⁰ Lobbying has had a significant impact on financial regulation in the past,³¹ and it is not yet clear whether the crisis has really changed attitudes toward regulation in any significant or lasting way.

Strengthen the Financial System (Sept. 4-5, 2009), <http://www.g20.org> (search “Declaration of Further Steps”).

²⁵ See, e.g., Fin. Serv. Authority, Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules, Policy Statement 09/15 (Aug. 2009), available at <http://www.fsa.gov.uk> (Search “PS 09/15”).

²⁶ See, e.g., House of Commons Treasury Comm., *supra* note 22, at 27.

²⁷ See, e.g., *id.* at 25-26.

²⁸ See, e.g., Technical Comm. of the Int’l Org. of Sec. Comm’ns, Unregulated Financial Markets and Products, 5 (Sept. 2009), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD301.pdf> (“The recommendations made are aimed at supporting investor confidence in these markets and at improving the functioning, integrity and oversight of unregulated financial markets and products.”).

²⁹ See, e.g., Fin. Serv. Authority, *supra* note 25, at 4.

³⁰ For example, during 2009, CRAs have dedicated significant financial resources to lobbying for financial regulation. See, e.g., Michael Beckel, *Capital Eye Report: Credit Rating Agencies Under Fire Drop More Dollars on Political Influence*, <http://www.opensecrets.org/news/2009/05/capital-eye-report-credit-rati.html> (May 14, 2009, 16:02 EST) (“The 10 firms accredited by the SEC to issue credit ratings spent \$370,000 on lobbying during the first three months of 2009, an increase of 42 percent compared to the 1st Quarter of 2008, the nonpartisan Center for Responsive Politics has found. Seventy-eight percent of that total comes from the so-called “Big Three” credit rating firms, whose inflated ratings of risky securities reportedly helped precipitate the financial crisis, according to some.”).

³¹ See, e.g., Poser, *supra* note 9, at 324 (“[T]he SEC must again see itself as the defender of investors and a counterweight to securities-industry and corporate lobbyists, who have the money, the lawyers, and the political influence to defeat or water down regulatory proposals. On the federal level at least, the SEC is the investor’s only champion.”).

Because the financial crisis is global, governments have stated publicly that they accept that the regulatory solutions should be the products of global as well as domestic processes.³² The Basel Committee's intervention in the debate about fair value accounting illustrates that it is not a purely domestic issue. The SEC has recognized that fair value accounting involves a debate that "extends beyond national borders."³³ Governments of the G20 countries have made public commitments to strengthen international cooperation with respect to financial stability and prudential regulation, and have agreed to work together in other areas, including the supervision of hedge funds and credit rating agencies. More than merely agreeing to increased cooperation, the G20 also committed to "implement international financial standards (including the 12 key International Standards and Codes)."³⁴

It is possible that the need to cooperate at the international level may help to constrain domestic policymakers and discourage the adoption of manipulative measures aimed to boost short-term investor confidence in domestic markets. Certainly, the language of public statements about the reform of financial regulation by groups such as the G20, the International Financial Institutions, and supranational regulatory networks suggests that there is a genuine transnational commitment to effective regulation of the financial markets. On the other hand, implementation of the transnational commitment is to be carried out in multiple levels of fora, which are less transparent to citizen-voters than to domestic legislatures, and where well-resourced financial firms and their trade associations can participate actively in the negotiation of the new standards.³⁵

But whether new rules of financial regulation are generated in domestic or transnational fora, it is important to ensure that the rules promote market integrity and thereby increase confidence in the financial markets, rather than promoting confidence and ultimately contributing to undermining market integrity.

³² See, e.g., G20, *supra* note 3.

³³ U.S. Sec. & Exch. Comm'n, *supra* note 23, at 2.

³⁴ G20, *supra* note 3, at 1.

³⁵ Cf. Caroline Bradley, *Financial Trade Associations and Multilevel Regulation*, in MULTILEVEL REGULATION AND THE EU: THE INTERPLAY BETWEEN GLOBAL, EUROPEAN AND NATIONAL NORMATIVE PROCESSES (Andreas Follesdal, Ramses Wessel & Jan Wouters eds., 2008).