

FAIR AND ORDERLY MARKETS: MANIPULATION OF THE MARKETS BY GOVERNMENTAL AUTHORITIES

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The global financial crisis which began in the summer of 2007¹ has focused the attention of governments and the international financial institutions on the regulation of banks and shadow banks.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 involves 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

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¹ Bank for International Settlements, 78th Annual Report 1 April 2007 – 31 March 2008, 3 (Jun. 30, 2008) available at <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., US Treasury, Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation (Jun. 17, 2009) available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf ; HM Treasury, Reforming Financial Markets, CM 7667 (Jul. 2009) available at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf.

³ See, e.g., Declaration on Strengthening the Financial System (Apr. 2, 2009) available at http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.

⁴ See, e.g., Caroline Bradley, *Suspension and Disbelief (or, How Managed Should a Market Be?)* 26 SETON HALL L. REV. 597 (1996).

varying rules on short selling,⁵ deposit insurance,⁶ and accounting⁷ in order to calm the financial markets.⁸ These short term measures have been designed to manipulate the financial markets by controlling behaviors considered to be harmful (short selling) and by providing regulatory and financial support to support 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 Investor protection is necessary in part because protecting investors' interests encourages confidence, and more investment. Regulations which target insider trading and market manipulation are designed to maintain confidence in the financial markets,¹⁰ as are rules which are designed to prevent

⁵ See, e.g., GAO, Regulation SHO: Recent Actions Appear to Have Initially Reduced Failures to Deliver, but More Industry Guidance Is Needed, 5, GAO-09-483 (May 2009) *available at* <http://www.gao.gov/new.items/d09483.pdf> (describing SEC emergency action to curb naked short selling).

⁶ The crisis revealed issues with respect to confidence of depositors in depositary institutions, resulting in moves to enhance depositor protection. *See, e.g.,* Sebastian Schich, Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects, 95 Financial Market Trends (OECD 2008/2) *available at* <http://www.oecd.org/dataoecd/36/48/41894959.pdf>.

⁷ *See, e.g.,* SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting," SEC Press Release No. 2008-234 (Sept. 30, 2008) *available at* <http://www.sec.gov/news/press/2008/2008-234.htm>; FASB Staff Position 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (Oct. 10, 2008); FASB Staff Position 157-4, 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 (Apr. 9, 2009).

⁸ Regulators have also reacted to the crisis by intensifying their efforts with respect to enforcement. *See, e.g.,* FSA Annual Report for 2008-9, 8 (Jun. 2009) *available at* http://www.fsa.gov.uk/pubs/annual/ar08_09/ar08_09.pdf (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."); Yin Wilczek, SEC Enforcement: In Mid-Year Reviews, Lawyers Give Enforcement Division High Marks for Revamp, BNA Securities Law Daily (Jul. 15, 2009).

⁹ *See, e.g.,* FSA Annual Report 2008-9, *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".)

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, Recital 12, OJ No. L 96/16 (Apr. 12, 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.")

financial market participants from putting their own interests before those of their clients.¹¹

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

However, treating the preservation of confidence in the markets as the fundamental concern of regulation, rather than the preservation of market integrity in the service of maintaining confidence, is misguided. 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 disapplying the rules in the interests of maintaining confidence, they may be expected to react to future crises in the same way. And these expectations are likely to reduce incentives to comply with the rules or at least to encourage financial institutions to feel confident that they can ensure that the rules will work to their advantage.¹³ Moreover, because emergency measures have been adopted without the level of consultation Governments and supranational authorities typically argue to be necessary,¹⁴ they seem less legitimate than other, more openly debated,

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'*, BNA Securities Law Daily (Jun. 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., US Treasury, Financial Regulatory Reform, *supra* note 2, at 2 ("We must act now to restore confidence in the integrity of our financial system.")

¹³ Cf. Simon Johnson, Who Nationalized Whom?, RGE Monitor (Jul. 17, 2009) *available at* http://www.rgemonitor.com/financemarkets-monitor/257307/who_nationalized_whom ("access to contingent (sic) state capital-on-amazing-terms is the ironic basis of modern financial power"); Paul Krugman, The Joy of Sach, N.Y. Times (Jun.16, 2009) *available at* http://www.nytimes.com/2009/07/17/opinion/17krugman.html?_r=1.

¹⁴ 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 gives the Treasury broad powers to amend primary legislation ("(1) The Treasury may by order make— (a) such supplementary, incidental or consequential provision, or (b) such transitory, transitional or saving provision, as they consider appropriate for the general purposes, or any particular purposes, of this Act or in consequence of any provision made by or under this Act, or for giving full effect to this Act or any such provision. (2) An order under this section may in particular— (a) disapply (to such extent as is specified) any specified statutory provision or rule of law..."") Cf. House of Lords Select Committee on the Constitution, Fast-track Legislation: Constitutional Implications and Safeguards, 15th Report of Session 2008–09, HL 116-1 (Jul. 7, 2009) *available at*

measures.

I suggest that some recent governmental initiatives, in attempting to manipulate confidence in the markets, may in the longer term undermine confidence. In particular, support schemes for financial institutions which place over-generous valuations on bank assets,¹⁵ the acceptance by public authorities of arguments by financial institutions that mark-to-market accounting requirements should be adjusted,¹⁶ and a reluctance to regulate credit rating agencies aggressively,¹⁷ raise questions about whether the governments that implement such policies have any real fundamental commitment to sound valuation practices. At the same time, and in contrast to changes with respect to mark-to-market accounting, emergency amendments to rules on short selling were designed to combat market manipulation by market participants.¹⁸ But there is a risk that the short-term emergency measures adopted in response to the crisis will undermine the effectiveness of the more considered longer term measures governments are considering.

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

<http://www.publications.parliament.uk/pa/ld200809/ldselect/ldconst/116/116.pdf>.

¹⁵ The US Treasury's process for establishing valuations for warrants which financial institutions repurchase from the Government includes provision for independent appraisals. *See, e.g.*, United States Department of the Treasury, Section 105(a) Troubled Assets Relief Program Report to Congress For the Period June 1, 2009 to June 30, 2009, 5 *available at* http://www.financialstability.gov/docs/105CongressionalReports/105aReport_07102009.pdf (describing the process). However, commentators have suggested that banks have in fact repurchased warrants at less than fair value. *See, e.g.*,

¹⁶ *See, e.g.*, CESR Statement, Application of and Disclosures Related to the Reclassification of Financial Instruments, 2 (Jul. 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.")

¹⁷ *See, e.g.*, James Kwak, TARP for Rating Agencies (Jun. 19, 2009) *available at* http://www.rgemonitor.com/financemarkets-monitor/257121/tarp_for_rating_agencies.

¹⁸ *See, e.g.*, GAO Report, *supra* note 5, at 5.

the interests of investors.¹⁹ At the domestic level, policy-making with respect to financial regulation tends to be a matter for technocrats in normal conditions but becomes more political in times of crisis or scandals. Crises may prompt new consumer-friendly regulations, but they may also encourage financial firms to dedicate increased resources to lobbying.²⁰

Because the financial crisis is global, there is a new acceptance that the regulatory solutions should be the products of global as well as domestic processes.²¹ In reviewing fair value accounting in late 2008, the SEC noted that “the debate over fair value measurements extends beyond national borders”.²² Governments of the G20 countries have made public commitments to strengthen international co-operation 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 co-operation, the G20 also committed to “implement international financial standards (including the 12 key International Standards and Codes)”.²³ It is possible that the need to co-operate at the international level may help to constrain domestic policy-makers and discourage the adoption of manipulative measures aimed to boost short term investor confidence in domestic markets.

¹⁹ See, e.g., SEC, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, (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.”)

²⁰ For example, during 2009, CRAs have dedicated significant financial resources to lobbying on financial regulation. See, e.g., Center for Responsive Politics, Capital Eye Report: Credit Rating Agencies Under Fire Drop More Dollars on Political Influence, Capital Eye Blog (May 14, 2009) *available at* <http://www.opensecrets.org/news/2009/05/capital-eye-report-credit-rati.html> (“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.”)

²¹ See, e.g., the G20 Declaration, *supra* note [3](#).

²² SEC Report, *supra* note [19](#) at 2.

²³ G20 Declaration, *supra* note [3](#).