THE IMPULSE TOWARDS INDIVIDUAL CRIMINAL PUNISHMENT AFTER THE FINANCIAL CRISIS

Robert Quigley[*]

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There is a widespread and influential account that the 2007–08 financial crisis was caused by the criminal acts of high-level banking executives, and that the failure to punish these acts delegitimizes our legal system and paves the way for future crises. This Article is the first piece of academic legal literature to assess this account in detail. It concludes that though high-level wrongdoing connected with the crisis may have been distressingly underprosecuted, it is neither a necessary nor a sufficient cause of the crisis. Economic regulation, not prosecution, is the surest way to prevent future crises.

INTRODUCTION

WITH one or two exceptions, no high-level banking executives have been successfully prosecuted for their roles in the United States financial crisis of 2007–08.[1] What exactly that role *was* is deeply contested,[2] but for now it will suffice to say that many people, including more than half of Americans, believe it is one of responsibility and criminal culpability.[3] The theory of responsibility is that these bankers presided over a financial system that pumped up an unsustainable housing bubble, the popping of which did great harm to the economy and to the economic prospects of many people. The theory of criminal culpability is that these bankers pumped up the bubble with fraud upon fraud, bundling up fraudulent mortgages into securities and then lying to investors about the content and value of these securities.[4] By the time their lies were discovered, these bankers had salted away large bonuses for themselves based on fictitious profits.[5] Yet taxpayers footed the bill to bail out

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[1] *See, e.g.*, Jed Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. BOOKS (Jan. 9, 2014), *available at* http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions/. For the exceptions, see *infra* notes 19–21 and accompanying text.

[2] *See infra* Part III.

[3] *Main Street View of Wall Street*, REUTERS/IPSOS (Sept. 13, 2013), http://pdf.reuters.com/pdfnews/pdfnews.asp?i=43059c3bf0e37541&u=2013_09_13_07_58_5977dfed71b041889f40e2ed4795f7dd_PRIMARY.png.

[4] *See infra* Parts I–II.

[5] *See* President Barack Obama, Remarks by the President on Financial Rescue and Reform (Sept. 14, 2009), http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall ("We will not go back to the days of reckless behavior and unchecked excess that was at the heart of this crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses.").

the banks in 2008, when those profits disappeared and the economy nearly plunged into depression.[6]

There have been prosecutions of Wall Street executives, but almost all have failed or been abandoned. An important early prosecution set the tone. The defendants, two former hedge fund managers for Bear Stearns, were accused of conspiracy, securities fraud, and wire fraud in relation to the sale of subprime mortgage-backed securities; a jury acquitted them of all charges.[7] According to former New York State Attorney General Eliot Spitzer, this defeat made the Department of Justice "back[] off and . . . bec[ome] timorous when it came to making the cases that would really have gone to the heart of what did happen in the crisis of '08."[8] Prosecutors dropped investigations of top executives at firms including Lehman Brothers, Countrywide, and AIG, with no indictments.[9] Prosecutions of major financial firms have been similarly anemic, and criminal probes of banks including UBS, Morgan Stanley, Credit Suisse, Deutsche Bank, Goldman Sachs, Bank of America, and Merrill Lynch have faltered.[10]

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[6] *Id.* ("[M]any of the firms that are now returning to prosperity owe a debt to the American people. They were not the cause of this crisis, and yet American taxpayers, through their government, had to take extraordinary action to stabilize the financial industry. They shouldered the burden of the bailout and they are still bearing the burden of the fallout—in lost jobs and lost homes and lost opportunities.").

[7] *See* United States v. Cioffi, 668 F. Supp. 2d 385 (E.D.N.Y. 2009); Grant McCool & Michael Erman, *Jury Acquits Ex-Bear Stearns Hedge Fund Managers*, REUTERS (Nov. 11, 2009), http://www.reuters.com/article/2009/11/11/bear-stearns-idUSLNE5AA00120091111 (summarizing *Cioffi*); *see also* Marty Robins, Letter to the Editors, *Why Have Top Executives Escaped Prosecution?*, N.Y. REV. BOOKS (Apr. 3, 2014), http://www.nybooks.com/articles/archives/2014/apr/03/why-have-top-executives-escaped-prosecution/ (describing *Cioffi* as "the one [criminal] case that was brought" involving mortgage-backed securities).

[8] *The Untouchables* (PBS television broadcast Jan. 22, 2013), *available at* http://www.pbs.org/wgbh/pages/frontline/untouchables/.

[9] Amir Efrati, *AIG Executives Won't Face Criminal Charges*, WALL ST. J., May 22, 2010, http://online.wsj.com/articles/SB10001424052748704852004575259240428335282; Benjamin Protess & Susanne Craig, *Inside the End of the U.S. Bid to Punish Lehman Executives*, N.Y. TIMES, Sept. 9, 2013, http://dealbook.nytimes.com/2013/09/08/inside-the-end-of-the-u-s-bid-to-punish-lehman-executives/; E. Scott Reckard, *U.S. Drops Criminal Probe of Former Countrywide Chief Angelo Mozilo*, L.A. TIMES, Feb. 18, 2011, http://articles.latimes.com/2011/feb/18/business/la-fi-mozilo-20110219.

[10] Andrew Clark & Julia Kollewe, *Wall Street Banks Investigated over Links to Rating Agencies*, GUARDIAN, May 13, 2010, http://www.theguardian.com/business/2010/may/13/wall-street-banks-investigated-mortgages-ratings (discussing New York state criminal investigations of eight banks); David Ingram & Aruna Viswanatha, *Justice Department Drops Goldman Sachs Financial Crisis Probe*, REUTERS (Aug. 9, 2012), http://www.reuters.com/article/2012

Attorney General Eric Holder told the Senate Judiciary Committee that he was "concerned" about prosecuting large financial institutions because "if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps even the world economy."[11] Holder has since said his comments were "misconstrued,"[12] and the Department of Justice has made much of the fact that two of its largest civil settlements related to the financial crisis, those with Bank of America and JPMorgan, do not release the banks, their subsidiaries, or their individual employees from the possibility of criminal prosecution.[13] To date, however, only the tiny "plankton" among banks have been exposed to criminal liability for activities related to the financial crisis.[14] That said, the

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/08/10/us-usa-goldman-no-charges-idUSBRE8781LA20120810; Rick Rothacker, *Bank of America's Merrill Deal Probed by FBI, Justice Dept.*, CHARLOTTE OBSERVER, Sept. 18, 2009, *archived at* http://www.mcclatchydc.com/2009/09/18/75646_bank-of-americas-merrill-deal.html?rh=1.

[11] Press Release, U.S. Sen. Bob Corker, Corker and Warner Ask Holder to Clarify "Too Big to Jail" Comments, (Mar. 12, 2013), http://www.corker.senate.gov/public/index.cfm/2013/3/corker-and-warner-ask-holder-to-clarify-too-big-to-jail-comments.

[12] Jason M. Breslow, *Eric Holder Backtracks Remarks on "Too Big to Jail,"* PBS FRONTLINE (May 16, 2013), http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/untouchables/eric-holder-backtracks-remarks-on-too-big-to-jail/; *see also No Bank too Big to Indict, U.S. Attorney General Says*, REUTERS (Jan. 24, 2014), http://www.reuters.com/article/2014/01/24/us-usa-holder-banks-indictments-idUSBREA0N13D20140124 (quoting Holder as saying that no banks or individuals were too big to indict or prosecute).

[13] Press Release, U.S. Dep't of Justice, Bank of America to Pay $16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (Aug. 21, 2014), http://www.justice.gov/opa/pr/2014/August/14-ag-884.html (Bank of America's August 2014 settlement with the Department of Justice—which the Department describes as "the largest civil settlement with a single entity in American history"—"does not release individuals from civil charges, nor does it absolve Bank of America, its current or former subsidiaries and affiliates or any individuals from potential criminal prosecution"); Press Release, U.S. Dep't of Justice, Justice Department, Federal and State Partners Secure Record $13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages (Nov. 19, 2013), http://www.justice.gov/opa/pr/2013/November/13-ag-1237.html (JPMorgan's $13 billion settlement with the Department of Justice did not "absolve JPMorgan or its employees from facing any possible criminal charges").

[14] Drake Bennett, *Mortgage Fraud Prosecutors Pounce on a Small Bank*, BLOOMBERG BUSINESSWEEK (Jan. 31, 2013), http://www.businessweek.com/articles/2013-01-31/mortgage-fraud-prosecutors-pounce-on-a-small-bank (describing the New York state prosecution of Abacus Bank, a "small bank, catering mostly to Chinese immigrants," for mortgage fraud); *see also* Keri Geiger, *Jeffries to Pay $25 Million over Mortgage Trading Probe*, BLOOMBERG (Jan. 28, 2014), http://www.bloomberg.com/news/2014-01-28/jefferies-discloses-25-million-settlement-of-mortgage-probe.html (describing a non-prosecution agree-

statute of limitations for new prosecutions has not yet run,[15] and in July 2013, the Department of Justice's Residential Mortgage-Backed Securities Working Group allegedly began exploring new and more creative strategies to criminally prosecute high-level individuals for fraud related to the crisis.[16]

Federal prosecutors alone have successfully prosecuted over one thousand individuals for crimes in some way related to the crisis,[17] but the targets have mostly been small fry: borrowers who lied on loan applications; straw buyers and crooked appraisers and mortgage brokers; and a few loan officers at banks.[18] The "most senior executive imprisoned for conduct related to the financial crisis" has been Lee Farkas, the former chairman of Taylor, Bean & Whitaker, a now-defunct Florida-based firm that at its peak was the nation's twelfth-largest mortgage lender.[19] The sole Wall Street executive convicted for conduct related to the crisis is Kareem Serageldin, the former global head of structured credit at Credit Suisse.[20] Serageldin's case is unusual in that he was con-

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ment between a small investment bank and the U.S. Attorney's Office for the District of Connecticut concerning "suspected abuses in the trading of mortgage-backed securities after the financial crisis").

[15] *See* 18 U.S.C. § 3293 (2012) (extending the statute of limitations for mail fraud, wire fraud, and bank fraud from five to ten years "if the offense affects a financial institution").

[16] *See* Emily Flitter, *Feds Weighing New Strategy To Criminally Charge Wall St. Bankers Tied To Housing Bust*, HUFFINGTON POST (July 17, 2013), http://www.huffingtonpost.com/2013/07/17/federal-prosecutors-crisis_n_3612361.html.

[17] OFFICE OF THE INSPECTOR GEN. AUDIT DIV., U.S. DEP'T OF JUSTICE, AUDIT REPORT 14-12, AUDIT OF THE DEPARTMENT OF JUSTICE'S EFFORTS TO ADDRESS MORTGAGE FRAUD 17 (2014) (finding a total of 1,494 criminal mortgage fraud defendants with guilty disposition from Fiscal Years 2009 through 2011).

[18] *Id.* at 18 (discussing mortgage fraud rings); Joshua Holland, *Hundreds of Wall Street Execs Went to Prison During the Last Fraud-Fueled Bank Crisis*, MOYERS & CO. (Sept. 17, 2013), http://billmoyers.com/2013/09/17/hundreds-of-wall-street-execs-went-to-prison-during-the-last-fraud-fueled-bank-crisis/ ("To date, a few loan officers—small fish—have been convicted of various offenses related to the financial crash."); Joe Nocera, *In Prison for Taking a Liar Loan*, N.Y. TIMES, Mar. 25, 2011, http://www.nytimes.com/2011/03/26/business/26nocera.html (discussing prosecution of home purchasers).

[19] Jean Eaglesham, *A Prison Life: Ex-Banker Struggles*, WALL ST. J., Mar. 18, 2014, http://online.wsj.com/news/articles/SB10001424052702303287804579445813343137266; Kevin Kingsbury, *Taylor Bean Files for Bankruptcy*, WALL ST. J., Aug. 25, 2009, http://online.wsj.com/news/articles/SB125113724702954379 (describing the firm as "the nation's 12th-largest home-mortgage lender overall").

[20] Jesse Eisinger, *Why Only One Top Banker Went to Jail for the Financial Crisis*, N.Y. TIMES, Apr. 30, 2014, http://www.nytimes.com/2014/05/04/magazine/only-one-top-banker-jail-financial-crisis.html; Nate Raymond, *For-*

victed for misleading his employer, not outsiders; it was Credit Suisse that reported him to the U.S. Attorney's Office for the Southern District of New York for "paint[ing] a false picture that the trading book Serageldin oversaw was profitable."[21]

The civil and regulatory response to the crisis has been more vigorous. The six largest banks have spent over $85 billion on crisis-related settlements with the government and private plaintiffs, and repurchased or indemnified nearly $100 billion in loans previously sold.[22] Individual Wall Street defendants, such as the Goldman Sachs trader Fabrice Tourre and the aforementioned acquitted Bear Stearns hedge fund managers, have had to pay large fines following civil enforcement actions brought by the Securities and Exchange Commission (SEC).[23] The *Wall Street Journal* has described the Dodd-Frank Wall Street Reform & Consumer Protection Act ("Dodd-Frank"), the most significant piece of legislation enacted in response to the crisis, as "the biggest expansion of government power over banking and markets since the Depression."[24] Administrative agencies including the SEC, the Commodity Futures Trading Commission (CFTC), and the Consumer Financial Protection Bureau (CFPB) have published more than 13,000 pages of rules pursuant to Dodd-Frank, filling in fewer than half of the rules called for by the Act.[25] While its critics believe Dodd-Frank does not go far enough,[26] it will at

mer Credit Suisse Trader Serageldin Gets 30 Months in Jail, REUTERS (Nov. 22, 2013), http://www.reuters.com/article/2013/11/22/creditsuisse-serageldin-idUSL2N0J71BG20131122.

[21] Raymond, *supra* note 20.

[22] Sam Carr, *Settlement Tab for Big Banks Passes $85bil.*, BANKING EXCHANGE (Dec. 13, 2013), http://www.bankingexchange.com//technology-channel/item/4270-settlement-tab-for-big-banks-rises-above-85b/4270-settlement-tab-for-big-banks-rises-above-85b.

[23] *See* Nate Raymond & Jonathan Stempel, *Big Fine Imposed on Ex-Goldman Trader Tourre in SEC Case*, REUTERS (Mar. 12, 2014), http://www.reuters.com/article/2014/03/12/us-goldmansachs-sec-tourre-idUSB REA2B11220140312; Court Approves SEC Settlements with Two Former Bear Stearns Hedge Fund Portfolio Managers; SEC Bars Managers from Regulated Industries, SEC Litigation Release No. 22398, (June 25, 2012), http://www.sec.gov/litigation/litreleases/2012/lr22398.htm.

[24] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Damian Paletta & Aaron Lucchetti, *Law Remakes U.S. Financial Landscape*, WALL ST. J., July 16, 2010, http://online.wsj.com/articles/SB10001424052748704682604575369030061839958.

[25] *3 Years of Dodd-Frank*, DAVIS POLK (July 1, 2013), http://www.davispolkportal.com/infographic/july2013infographic.html.

[26] *See, e.g.*, William Alden, *Shiller: Dodd-Frank Does Not Solve Too Big to Fail*, HUFFINGTON POST (Oct. 26, 2010), http://www.huffingtonpost.com/2010/10/26/robert-shiller-dodd-frank-too-big-to-fail_n_774302.html.

the least significantly change the way banks lend and invest money in the United States.[27]

For those who believe the crisis was the product of high-level misconduct, this response is just not good enough. Regulation may stop some subset of possible crises from occurring in the future, but it cannot foresee others. Civil penalties let off past transgressions too lightly, and where detection is less than certain, individuals and institutions may determine they are worth risking.[28] Prosecutions of small fry fail to expunge the fundamental sins of the crisis, and they may be counterproductive and even offensive for casting into relief the disparity in treatment between the lowly and the powerful.[29] The only adequate response, it is said, is to prosecute high-level executives.

This is so as a matter of corrective justice: as the parties most responsible for the crisis, high-level banking executives must be punished to redress the harm they have inflicted on society. It would be perverse to *reward* them for harming society, but we have done just this by allowing them to privatize illicit pre-crisis gains and socialize post-crisis losses by way of the bailout.[30] This is so as a matter of deterrence: future wrongdoers, who may be the unrepentant wreakers of the last crisis, will think nothing of lying and cheating their way to the next crisis. And this is so as a matter of equality under the law: for a system that harshly and frequently punishes the poor to maintain its legitimacy, it cannot let the crimes of the wealthy slide.

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This account of the crisis is rhetorically and emotionally powerful, and effective for social mobilization, because it is a strong causal story with clearly identifiable villains whose villainy happens to map onto established criminal categories. But it overstates its case.[31] Like many

[27] *See, e.g.*, Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 77 Fed. Reg. 51,116 (Aug. 23, 2012) (to be codified at 12 C.F.R. pts. 1024, 1026) (presenting proposed rule overhauling mortgage lending and documentation requirements); Press Release, Bd. of Governors of the Fed. Reserve Sys., Agencies Issue Final Rules Implementing the Volcker Rule (Dec. 10, 2013) (summarizing "Volcker Rule" restrictions on short-term proprietary trading and hedge fund and private equity investment for federally insured banks and affiliated companies).

[28] *See, e.g.*, Robert Reich, TWITTER (Aug. 27, 2013, 10:43 PM), https://twitter.com/RBReich/status/372595232388304896 ("Fines effective only if risk of being caught x probability of being prosecuted x amount of fine > profits to be made.").

[29] *See, e.g.*, Nocera, *supra* note 18 (making this argument).

[30] *See* Frank Pasquale, *The Moral Authority of Occupy Wall Street*, BALKINIZATION (Oct. 8, 2011), http://balkin.blogspot.com/2011/10/moral-authority-of-occupy-wall-street.html.

[31] *See* Martin Rein & Christopher Winship, *The Dangers of "Strong" Causal Reasoning in Social Policy*, 36 SOCIETY 38, 38, 44 (1999).

overstated cases, its simple solution ("toss the rascals in jail"[32]) risks crowding out the difficult and complex policy decisions necessary for meaningful reform.[33] The financial sector made many short-sighted and destructive choices before the crisis, and its executives are hardly misunderstood Galtian heroes. Yet as this Article shall demonstrate, high-level fraud is neither a necessary nor a sufficient explanation for the crisis.[34] The criminal law plays a meaningful role in expressing core values, and there is reason to think it has been distressingly underpursued in relation to the crisis. Ultimately, though, economic regulation is the only thing that can prevent future crises.

This Article proceeds in five Parts. Part I describes the origins and progression of the 2007–08 financial crisis. Part II summarizes and synthesizes accounts of the crisis that claim it was caused by high-level criminal activity, particularly fraud. Part III produces reasons to doubt this claim. Part IV describes the still-real harm of unpunished high-level fraud of the kind claimed to have caused the crisis. Part V evaluates the civil, regulatory, and criminal policy implications of a crisis caused by noncriminal but socially destructive practices in the financial sector.

I. THE 2007–08 FINANCIAL CRISIS

The 2007–08 financial crisis cost the U.S. economy trillions of dollars.[35] Millions of people lost their jobs,[36] their homes,[37] and their retirement savings.[38] The great, lingering consequence of this crisis, like most,[39] has been lost potential. Three economists at the Federal Reserve

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[32] *E.g.*, *Should Wall Street Chiefs Go to Jail?*, THE WEEK (Sept. 19, 2008), http://theweek.com/article/index/89029/should-wall-street-chiefs-go-to-jail (describing the popular view that this is the "only thing [that] will ease the pain").

[33] *See* Rein & Winship, *supra* note 31, at 43.

[34] *See infra* Part III.

[35] *See, e.g.*, Tyler Atkison, David Luttrell & Harvey Rosenblum, *How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis*, DALLAS FED. STAFF PAPERS (July 2013), http://dallasfed.org/assets/documents/research/staff/staff1301.pdf (estimating that between six and fourteen trillion dollars were foregone due to the recession).

[36] Drew DeSilver, *At 42 Months and Counting, Current Job "Recovery" Is Slowest Since Truman Was President*, PEW RES. CTR. (Sept. 25, 2013), http://www.pewresearch.org/fact-tank/2013/09/25/at-42-months-and-counting-current-job-recovery-is-slowest-since-truman-was-president/ (stating that 8.7 million jobs were "wiped out" because of the crisis).

[37] EXEC. OFFICE OF THE PRESIDENT, THE FINANCIAL CRISIS: FIVE YEARS LATER 10 (2013).

[38] *Id.* at 35 ("Assets in retirement accounts such as 401(k)s dropped $2.8 trillion between September 2007 and December 2008.").

[39] *See, e.g.*, CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 238 (2009) (stating that severe financial crisis have in common "a deep and lasting effect on asset prices, output, and employment").

Board have concluded that the productive capacity of the U.S. economy is "on a lower and shallower trajectory than the one that seemed to have been in place prior to 2007."[40] The damage has not been limited to the United States; the slowdown following the crisis has been by one assessment "the most severe and the most global since the Great Depression of the 1930s."[41]

The causes of the crisis are still a matter of debate. In 2009, Congress appointed the Financial Crisis Inquiry Commission (FCIC) to investigate twenty-two topics designated by statute.[42] Two years, millions of pages of documents, and seven hundred witnesses later,[43] the FCIC issued a 662-page report that identified a number of factors that contributed to the crisis, but found no smoking gun.[44] The conclusions of the FCIC were adopted by only six of its ten commissioners, all Democrats; the four Republicans issued two dissents disputing different aspects of the majority's analysis.[45] One dissent bitingly dismissed the majority's analysis as "more an account of bad events than a focused explanation of what happened and why," and argued that "[w]hen everything is important, nothing is."[46] Others who have investigated the crisis have similarly failed to reach a consensus. In a meta-analysis of twenty-one books on the crisis, Professor Andrew W. Lo concludes, "we may never settle on a single narrative that explains all the facts; such a 'super-narrative' may not even exist."[47]

Narratives of the crisis branch out differently, but they share a common root: the securitization of residential mortgages, particularly risky or "subprime" mortgages, and the development and propagation of fi-

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[40] DAVE REIFSCHNEIDER, WILLIAM WASCHER & DAVID WILCOX, AGGREGATE SUPPLY IN THE UNITED STATES: RECENT DEVELOPMENTS AND IMPLICATIONS FOR THE CONDUCT OF MONETARY POLICY 1 (2013).

[41] CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES 1 (6th ed. 2011).

[42] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xi (2011) [hereinafter FCIC REPORT].

[43] *Id.*

[44] *See id.* at xv–xxviii (summarizing the conclusions of the Commission).

[45] Sewell Chan & Eric Dash, *Financial Crisis Inquiry Wrestles with Setbacks*, N.Y. TIMES, Apr. 5, 2010, http://www.nytimes.com/2010/04/06/business/06panel.html; Brady Dennis & Zachary A. Goldfarb, *Financial Crisis Probe Ends with Partisan Vote on FCIC Report*, WASH. POST, Jan. 7, 2011, http://www.washingtonpost.com/wp-dyn/content/article/2011/01/07/AR2011010705671.html (The Commission was reportedly riven with conflict from early on, leading to a "haphazard approach.").

[46] FCIC REPORT, *supra* note 42, at 414 (dissenting statement of Keith Hennessey, Douglas Holtz-Eakin & Bill Thomas).

[47] Andrew W. Lo, *Reading About the Financial Crisis: A Twenty-One-Book Review*, 50 J. ECON. LITERATURE 151, 177 (2012).

nancial instruments the value of which depended on these mortgages. The FCIC majority and dissenters agreed on this fundamental point.[48] Deep exposure to mortgage-related instruments brought down the investment banks Bear Stearns and Lehman Brothers.[49] A core component of the federal government's bailout of the financial sector at the apex of the crisis was its allotment of $700 billion to purchase "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages."[50] Section I.A discusses how these instruments were created, Section I.B discusses why they became so popular before the crisis, and Section I.C discusses how they came to do so much damage.[51]

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[48] *Compare* FCIC REPORT, *supra* note 42, at 16–17 (majority statement), *with id.* at 417–19 (dissenting statement of Keith Hennessey, Douglas Holtz-Eakin & Bill Thomas), *and id.* at 474–77 (dissenting statement of Peter J. Wallison).

[49] *See* Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 57 (2009) (stating that Bear Stearns collapsed "due to its inability to find sufficient capital to cover its mortgage-related losses"); *id.* at 61 (stating that Lehman Brothers was "hurtling towards bankruptcy" because of the "billions of dollars in bad mortgage-related investments on its books").

[50] This is the primary definition of "troubled assets" under the Troubled Asset Relief Program (TARP), which additionally required that they be originated or issued on or before March 14th, 2008 and that their purchase be determined by the Secretary of the Treasury to promote financial stability. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Div. A, § 3, 122 Stat. 3765, 3767 (2008) (codified as amended at 12 U.S.C. § 5202 (2012)). TARP also gave the Secretary, in consultation with the Chairman of the Federal Reserve, the authority to designate as troubled assets other financial instruments "the purchase of which is necessary to promote financial market stability." *Id.* TARP may have been less central to the bailout than initially thought; in 2011, the Federal Reserve released data that revealed it had made as many as $1.2 trillion in emergency loans separate from TARP. Bradley Keoun & Phil Kuntz, *Wall Street Aristocracy Got $1.2 Trillion in Secret Loans*, BLOOMBERG NEWS (Aug. 22, 2011), http://www.bloomberg.com/news/2011-08-21/wall-street-aristocracy-got-1-2-trillion-in-fed-s-secret-loans.html.

[51] The narrative of the crisis I recount in this Part adopts a widely accepted but by no means universal thesis: that an originate-to-distribute lending model led to low-quality subprime mortgage loans, and that by a process of "subprime contagion" these loans wrought outsized damage when the housing bubble deflated. I adopt this thesis in part for its popularity and relative simplicity, and in part because it is nearly an unstated assumption of the argument that criminal acts by Wall Street bankers caused the crisis. Theories that attribute the crisis to government policy or global economic trends necessarily shift the blame away from the financial sector, and financial sector-blaming theories that focus on, for example, derivatives trading bear a far weaker connection to criminal liability.

A. Residential Mortgage-Backed Securities and Related Financial Instruments

1. The Residential Mortgage

A home is the most expensive asset most people will purchase.[52] Many people who want homes cannot afford to purchase them outright, and need to borrow money. Lenders usually do not want to extend the necessary large sums without security. Since the Middle Ages, the common law way out of this impasse has been the mortgage.[53] The conventional mortgage is an up-front loan that the borrower agrees to repay with interest in regular installments, secured by the lender's right to foreclose on the property if the borrower fails to make payments.[54] The borrower is better off because she enjoys the immediate use of the property and builds up an ownership stake in it over time as she repays the loan principal. The lender is better off because she receives interest payments, and is at least partially protected from the risk of borrower default by the right to foreclose.

Even in a plain-vanilla mortgage relationship, the lender still assumes the risk that the borrower will not pay and that the value of the property foreclosed upon will be less than the value of the loan.[55] Bor-

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[52] *See, e.g.*, Matteo Iacoviello, *Housing Wealth and Consumption*, INTERNATIONAL ENCYCLOPEDIA OF HOUSING AND HOME 673, 673 (Susan J. Smith ed., 2012) (stating that housing wealth accounts for almost two-thirds of the total wealth of the median American household).

[53] *See, e.g.*, Ann M. Burkhart, *Real Estate Practice in the Twenty-First Century*, 72 MO. L. REV. 1031, 1031 (2007) ("The instrument itself was called a mort gage as early as 1189 in England, and today's substantive mortgage law is descended directly from England's Middle Ages.") (citation omitted); John H. Wigmore, *The Pledge-Idea: A Study in Comparative Legal Ideas. III*, 11 HARV. L. REV. 18, 25 (1897) (stating that the common law mortgage has an analogue in the *hypotheca* of Roman law).

[54] More "exotic" mortgages, such as interest-only mortgages, may differ from this conventional model. Mortgage terms and relationships are for the most part governed by state law, though federal law has played a larger role since the financial crisis.

[55] This is not the only risk; others include "the general market risks of interest rate fluctuations and inflation, and the cash flow risk inherent in defaults, prepayments, reinvestment, refinancing, and illiquidity." THOMAS P. LEMKE, GERALD T. LINS & MARIE E. PICARD, MORTGAGE-BACKED SECURITIES § 1:3 (2013). Note also that while most states permit lenders to bargain for the borrower's assumption of some measure of personal liability if there is a deficiency, the repayment rate on these so-called "deficiency judgments" is very low—one 2011 government audit pegged it at one-fifth of one percent. *See* Kimbriell Kelly, *Lenders Seek Court Actions Against Homeowners Years After Foreclosure*, WASH. POST, June 15, 2013, http://www.washingtonpost.com/investigations/lenders-seek-court-actions-against-homeowners-years-after-foreclosure/2013/06/15/3c6a04ce-96fc-11e2-b68f-dc5c4b47e519_story.html; *see also* 55

rowers may not pay either because they are unable or because it is no longer worth their while; that is, if the value of the property becomes significantly less than that of the loan. Financial theory has it that lenders will insist upon greater compensation—so-called risk premiums—when they run greater risks.[56] Traditional mortgages allocate these risks via interest rates. The greater the borrower's risk of default, the greater the interest payment the lender will insist upon before making a mortgage loan.[57]

2. The Residential Mortgage-Backed Security (RMBS)

Individual residential mortgages have been and continue to be one of the "bread-and-butter products" of many lending institutions.[58] It has long been legal to buy and sell them as investments.[59] However, from the investor's perspective, they have a number of disadvantages. Individual mortgage loans are generally illiquid investments, meaning they "present[] a risk to mortgage lenders who could find themselves unable to find buyers if they wanted to sell their loan portfolios both quickly and at an acceptable price."[60] So long as a bank owns a mortgage loan with principal outstanding, accounting rules require the bank to hold the mortgage on its books for the duration of the loan and realize the revenue as payment over time.[61] Because regulatory capital requirements limit the amount of bank money outstanding at any given time, the bank may prefer the flexibility of dealing in more liquid investments the value

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Am. Jur. 2d Mortgages §§ 693-695 (2014) (discussing legal right to collect deficiency judgments by jurisdiction). As a practical matter, the right to collect deficiency judgments may be worth "pennies on the dollar," if that. *Id.*

[56] *See Risk Premium*, INVESTOPEDIA, http://www.investopedia.com/terms/r/riskpremium.asp (last visited Oct. 13, 2014) (explaining that under this theory, the baseline against which "greater compensation" is measured is the rate of return for a risk-free investment, typically a government-issued security).

[57] *See* John Krainer & Stephen LeRoy, *Risky Mortgages and Mortgage Default Premiums*, FED. RESERVE BANK OF SAN FRANCISCO (Dec. 20, 2010), http://www.frbsf.org/economic-research/publications/economic-letter/2010/december/risk-mortgages-default-premiums/.

[58] Matt Hammond, *As Mortgage Banking Industry Dwindles, Bidding Wars over Quality Housing Become Common*, NJ.COM (Jan. 12, 2014), http://www.nj.com/mercer/index.ssf/2014/01/as_mortgage_banking_industry_dwindles_bidding_wars_over_quality_housing_become_common.html (quoting American Banker reporter Kate Berry).

[59] *See, e.g.*, SAUL B. KLAMAN, THE POSTWAR RESIDENTIAL MORTGAGE MARKET 239–40 (1961) (arguing that this market first reached maturity after World War II).

[60] *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Hearing Before the H. Subcomm. on Hous. & Cmty. Opportunity*, 108th Cong. 2 (2003) [hereinafter *Protecting Homeowners*] (statement of Cameron L. Cowan, Partner, Orrick, Herrington, and Sutcliffe, LLP).

[61] *Id.* at 7.

of which it may realize upon disposition, freeing money up for reinvestment.[62] Further, because mortgages are big bets on individual homeowners, individual mortgage loans are not diversified investments unless one can afford to buy them in bulk.[63]

These disadvantages could be overcome, it was thought, by securitizing the mortgages. The simplest way to securitize a set of investments is to "place them in a pool and issue securities representing fractional undivided interests in the pool."[64] Rather than sink, say, $100,000 into a single mortgage loan, an investor might prefer to buy a security in the form of a one percent share of a pool of one hundred similar $100,000 loans. Though the dollar values in play are the same, the security will often be a more attractive investment. It is more liquid, allows for cheaper diversification, and the general ease of its disposal makes favorable accounting consequences simpler to achieve.[65] In theory, because securitization makes mortgage lending less risky and more profitable for investors, the savings are passed along to borrowers in the form of lower interest rates.[66]

a. RMBSs and Securities Law

In order for a private firm to sell RMBSs to investors, the firm must register the securities with the SEC.[67] Misstatements in SEC filings may expose issuers to civil or criminal liability; the latter generally requires

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[62] *See id.*

[63] FRANK J. FABOZZI, TRENDS IN COMMERCIAL MORTGAGE-BACKED SECURITIES 138 (1998). Diversification is an investment strategy that "strives to smooth out unsystematic risk events in a portfolio so that the positive performance of some investments will neutralize the negative performance of others." *Diversification*, INVESTOPEDIA, http://www.investopedia.com/terms/d/diversification.asp (last visited Oct. 13, 2014).

[64] *See* BOND MARKET ASSOC., AN INVESTOR'S GUIDE TO PASS-THROUGH AND COLLATERALIZED MORTGAGE SECURITIES, 2 (2002), *available at* http://www.freddiemac.com/mbs/docs/about_MBS.pdf [hereinafter MBS INVESTOR'S GUIDE].

[65] *See Protecting Homeowners*, *supra* note 60, at 7; FABOZZI, *supra* note 63, at 138–39.

[66] John J. McConnell & Stephen A. Buser, *The Origins and Evolution of the Market for Mortgage-Backed Securities*, 3 ANN. REV. FIN. ECON. 173, 177–78 (2011) ("The argument customarily advanced is that tradable MBS attract a wider set of investors to the mortgage market which, in turn, reduces the cost of housing finance.").

[67] CDOs may be registered with the SEC, but they may be sold without registration under SEC Rule 144A, which permits their unregistered resale to "qualified institutional borrowers." FCIC REPORT, *supra* note 42, at 170.

scienter on the part of the issuer,[68] while the former may but does not necessarily.[69]

The typical SEC filings for a residential mortgage securitization were a prospectus explaining the general structure of the investment and a prospectus supplement describing the underlying mortgage pools in great detail.[70] In addition to loan-level data, the prospectus supplement "usually contain[ed] information about risk-relevant variables, such as loan-to-value ratios of loans in the pool, their interest rates, borrowers' credit scores, and the occupancy status and location of the properties backing the mortgages in the pool."[71]

The firm that made the mortgage loans ("the originator"), the firm that gathered them up ("the arranger"), and the firm that issued the security ("the issuer") were often three different firms. Since the distinctions between arranger and issuer are less important than those between the originator and the other two in the analysis of criminal liability that follows, I will frequently lump together arranger and issuer under the blanket term "securitizer" throughout this Article except where the distinction is important.

Because of this separation of roles, the issuer's factual assertions about the loan pool were often based on second- or third-hand information. Rather than directly warrant that the loan pool was of a particular composition or quality, it was typical for issuers to warrant only that the originator had made representations and warranties about the pool, which were themselves qualified by "typically ha[ving] a sentence stating that 'a substantial number' or perhaps 'a substantial portion of the Mortgage Loans will represent [] exceptions'" to the usual lending policy of the originator.[72] Issuers themselves made representations and war-

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[68] *See* Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L. J. 511, 555–60 (2011) (discussing scienter requirement for criminal securities fraud).

[69] *Compare id.* at 548–53 (summarizing civil securities laws that require scienter), *with* Marc I. Steinberg & Brent A. Kirby, *The Assault on Section 11 of the Securities Act: A Study in Judicial Activism,* 63 RUTGERS L. REV. 1, 10 (2010) (discussing the "virtually absolute strict liability" historically accorded claims under Section 11 of the Securities Act).

[70] *See, e.g.*, *In re* Countrywide Fin. Corp. Mortgage-Backed Sec. Litig., 932 F. Supp. 2d 1095, 1104 (C.D. Cal. 2013) (describing SEC requirements for RMBS issuance).

[71] Tomasz Piskorski, Amit Seru & James Witkin, *Asset Quality Misrepresentation by Financial Intermediaries: Evidence from RMBS Market*, J. FINANCE (Mar. 2013) (forthcoming), *available at* http://www.mccombs.utexas.edu/~/media/Files/MSB/Centers/REFIC/2013%20summer%20symposium%20papers/AQpswfinal123%20seru%204.pdf.

[72] *See* FCIC REPORT, *supra* note 42, at 169. If the originator breached its representations and warranties by providing unacceptable or falsified loans, the terms of its contract with the securitizer generally required it to "repurchase the problem loans." Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit* 6 (Fed. Reserve Bank of N.Y. Staff Re-

ranties that they did not believe the originators had provided false information, but these were couched with "knowledge qualifiers" such as "to the best of the [issuer's] knowledge" or "to the [issuer's] knowledge," such that "actual fraud would not be enough to cause a breach"—or so they argued.[73] Subsequent analysis has revealed that a significant number of the representations and warranties made by originators and passed along by securitizers in SEC filings were untrue.[74] An important question in assessing the possible liability of the securitizers under the criminal securities laws is whether these untrue representations were attributable to them and whether the securitizers' disclaimers absolved them of liability even if so.[75]

b. Tranching and Credit Ratings

As the financial engineering of residential mortgage-backed securities (RMBSs) became more sophisticated, it became possible for investors not only to buy fractions of a pool of mortgages, but to buy a slice, or tranche, of the pool, with specified risk characteristics.[76] The ability to pick tranches based on risk preference increased investors' ability to customize their investments, as the FCIC summarizes:

> Risk-averse investors would buy tranches that paid off first in the event of default, but had lower yields. Return-oriented investors bought riskier tranches with higher yields. Bankers often compared it to a waterfall; the holders of the senior tranches—at the top of the waterfall—were paid before the more junior tranches. And if payments came in below expectations, those at the bottom would be the first to be left high and dry.[77]

Because it was often difficult to determine the value of these tranches, many investors relied on the ratings of the three leading credit rating agencies: Moody's, Standard & Poor's (S&P), and Fitch.[78] These ratings purported to express the risk of the assets underlying the tranche, as determined by detailed quantitative analysis inflected with the qualitative

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port No. 318, Mar. 2008). However, securitizers underenforced these contract terms, and even when they tried to enforce them the originators were in serious financial trouble and lacked the money to repurchase. *Id.*

[73] AMERICAN SECURITIZATION FORUM, ASF MODEL RMBS REPRESENTATIONS AND WARRANTIES 7 (2009) (stating, in introduction to model representations and warranties drafted after the financial crisis, that these clauses and this understanding of them were common before the crisis).

[74] *See* Piskorski et al., *supra* note 71.

[75] *See infra* Section III.B.

[76] *See* FABOZZI, *supra* note 63, at 2–3 (discussing the origins of tranching in the 1980s).

[77] FCIC REPORT, *supra* note 42, at 43.

[78] *Id.*

judgment of the agency.[79] S&P's system, for example, "assigns ratings such as 'AAA' (the highest rating for the safest investments, referred to here as triple-A), 'AA' (less safe than AAA), 'A,' 'BBB,' and 'BB,' and further distinguishes ratings with '+' and '–.'"[80] Credit agency ratings are of great practical consequence because many financial institutions are forbidden to hold assets with less than a AAA rating.[81]

3. The Collateralized Debt Obligation (CDO)

A detailed examination of the nomenclature and operation of the more complicated financial instruments in use right before the crisis is beyond the scope of this Article.[82] One, though, merits brief discussion: the collateralized debt obligation. Collateralized debt obligations (CDOs) are divided into tranches similar to those described above.[83] But where RMBSs are backed by mortgages, CDOs may be backed by a wider array of debt instruments,[84] including RMBSs and other CDOs, which may themselves be backed by RMBSs and still other CDOs.[85] Because they often had similar underlying assets, if separated by several levels, this Article sometimes uses the term "mortgage-related security" to generally refer to both RMBSs and CDOs.

The tranches of a CDO, like those of a tranched RMBS, are entitlements to payouts along a waterfall of risk, but the risk may be far more difficult to model because of the sheer number of inputs and their recursive nature. As economist James Crotty notes, "[s]everal thousand mortgages may go into a single [R]MBS and as many as 150 [R]MBSs can be packaged into a single CDO . . . . Higher power CDOs [that is, CDOs backed by other CDOs] are particularly difficult to value because many mortgages appear in more than one of the underlying CDOs."[86]

This complexity did not stop the rating agencies from rating the CDO tranches, using models that would later be harshly criticized. Most notoriously, the agencies frequently transformed "a sow's ear into a silk purse," to use Judge Rakoff's phrase[87]: for example, a CDO tranche

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[79] *Id.* at 120–21.

[80] *Id.* at 71.

[81] James Crotty, *Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture*, 33 CAMBRIDGE J. ECON. 563, 566–67 (2009).

[82] In particular, I refrain here from a discussion of derivatives such as credit default swaps.

[83] *See* Anna Katherine Barnett-Hart, The Story of the CDO Market Meltdown: An Empirical Analysis 5 (Mar. 19, 2009) (unpublished B.A. thesis, Harvard College), *available at* http://www.hks.harvard.edu/m-rcbg/students/dunlop/2009-CDOmeltdown.pdf.

[84] *Id.* at 3 n.3.

[85] Crotty, *supra* note 81.

[86] *Id.*

[87] Rakoff, *supra* note 1.

backed by highly risky BB-rated tranches of a number of RMBSs might receive a AAA rating, denoting low risk and low yield.[88] To take the agencies at their word, this was defensible because the CDO tranches were diversified, meaning their risks canceled each other out such that "if one security went bad, the second had only a very small chance of going bad at the same time."[89]

B. *The Rise of Mortgage-Related Securities Before the Crisis*

RMBSs and CDOs have existed since the 1970s and 1980s, respectively.[90] What changed in the years leading up to the crisis was the volume with which they were issued and the uses to which they were put. Three trillion dollars in mortgage-backed securities were outstanding at the end of 2000,[91] versus $6.5 trillion worth at the end of 2006.[92] A little over $100 billion in CDO debt was outstanding in 1998, versus $1.36 trillion worth at the end of 2008.[93] As the volume of these securities increased, their contents changed as well. Over the course of the 2000s, a greater percentage came to be backed by risky mortgage loans,[94] called "subprime" loans to distinguish them from "prime," or safer and more traditional, loans.[95] Though these loans were a relatively small percentage of the U.S. mortgage market,[96] they played an outsized role in precipitating and worsening the crisis.

1. The Demand for Subprime Mortgages

Beginning in the mid-1990s, the United States experienced a housing boom that in retrospect would be called a bubble.[97] After 1995, home

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[88] FCIC REPORT, *supra* note 42, at 128–29.

[89] *Id.* at 128.

[90] MBS INVESTOR'S GUIDE, *supra* note 64, at 3 (stating that the first MBS was issued in 1970); Barnett-Hart, *supra* note 83, at 20 (stating that the first CDOs were issued in the mid-1980s).

[91] SOLOMON SMITH BARNEY GUIDE TO MORTGAGE-BACKED AND ASSET-BACKED SECURITIES 10 (Lakhbir Hayre ed., 2000) (Note that this and the preceding figure include securities backed by commercial as well as residential mortgages).

[92] ORG. FOR ECON. CO-OPERATION & DEV., OECD ECONOMIC SURVEYS: UNITED STATES 2008, at 61 (2008).

[93] SIFMA, GLOBAL CDO DEBT OUTSTANDING—USD MILLIONS tbl.6 (2014), https://www.sifma.org/uploadedfiles/research/statistics/statisticsfiles/sf-global-cdo-sifma.xls.

[94] Ashcraft & Schuermann, *supra* note 72, at 2, tbl.1.

[95] *See* FCIC REPORT, *supra* note 42, at 67.

[96] MARK JICKLING, CONG. RESEARCH SERV., R40173, CAUSES OF THE FINANCIAL CRISIS CRS-5 (2010).

[97] *See* U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 67 exh.1j (2011) [hereinafter *Levin-Coburn Report*].

sale prices far outpaced inflation, which made housing an even more attractive investment after the technology bubble burst in 2000.[98] This led individuals to refinance their homes at "record levels"[99] and drove financial institutions to invest in housing. Because the housing boom happened at roughly the same time as the boom in mortgage securitization and collateralization, these financial institutions could and did purchase RMBSs and CDOs in addition to individual mortgage loans.

These instruments and this environment made possible a new kind of bet[100] on the housing market that purported to offer bigger gains with little increase in risk: securities backed by subprime mortgages. Judge Posner explains why subprime mortgage lending had been traditionally disfavored:

> In risky mortgage lending, the lender (more precisely, whoever ends up bearing the risk of a default by the borrower) is more like a partner in a real estate business than like a secured lender. For suppose the value of the home drops, even slightly, before much of the loan has been repaid . . . . The owner will find himself owing more on the house than it is worth. He may therefore decide to abandon it to the lender. . . .
>
> Risky mortgage lending can be *extremely* risky from the lender's standpoint, because a single default can wipe out the earnings on several good mortgage loans. Suppose that after expenses of foreclosure and brokerage and the like the lender will recover only 60 percent of his loan if the owner defaults. That 40 percent loss could well exceed the annual interest earned on seven or eight mortgage loans of the same size on other houses.[101]

For the same reasons that securitizing ordinary mortgage loans was thought to increase liquidity and decrease risk,[102] many investors thought at the time that securitizing and collateralizing subprime loans could

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[98] Dean Baker, *The Run-Up in Home Prices: Is It Real or Is It Another Bubble?*, CTR. FOR ECON. & POL'Y RES. 4 (2002) http://www.cepr.net/documents/publications/housing_2002_08.pdf.

[99] *Id.* at 13.

[100] Well, not entirely new. In the mid-1990s, there was a much smaller subprime lending boom and bust that led early subprime lenders to go "bankrupt en masse." MICHAEL LEWIS, THE BIG SHORT 13–16 (2010). Lewis writes that at the time, the failure of these lenders was interpreted as "an indictment of their accounting practices" rather than "the crappiness of the loans they had made." *Id.* at 15.

[101] RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 24–25 (2009).

[102] *See supra* notes 61–63 and accompanying text.

transform them from a risky investment to "gold-plated security."[103] If one believed the mathematical models used to value and rate the risk of CDO tranches, then it was possible to eliminate subprime risk through canny diversification while retaining the higher yield of a subprime loan.[104] And because the housing market in the early- to mid-2000s was so hot—the journalist Michael Lewis quotes a trader who claims that S&P's model for home prices at the time "had no ability to accept a negative number," as they were "just assuming home prices would keep going up"[105]—even the risk of subprime borrower default was not thought to be so bad, since the lender could simply take title to a property now worth more than the loan.

Importantly, much investor demand for subprime mortgages arose not because they were subprime, but because they were mortgages.[106] Investors who did not necessarily seek out the particular balance of risks and rewards of lending to risky borrowers might nevertheless invest in subprime mortgages because they wanted to invest in mortgages in some form, and there simply weren't enough prime mortgages to go around.[107] As economist Robert Aliber summarizes it, "[t]he rapid growth in the supply of credit led to a sharp increase in the demand for mortgages, which was greater than the supply of prime loans and so the mortgage brokers ginned up a large increase in the supply of sub-prime mortgages."[108] By 2006, subprime lending made up 13.5% of the mortgage lending in the United States, five times its share of the market in 2001.[109]

2. Subprime Mortgage Origination and Securitization

Investor demand for mortgage-backed securities led to the extension of credit to people denied it in the past.[110] Indeed, a refrain of conserva-

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[103] NOURIEL ROUBINI, CRISIS ECONOMICS 65, 65–67 (2010).

[104] FCIC REPORT, *supra* note 42, at 128.

[105] LEWIS, *supra* note 100, at 170. S&P disputed this allegation. *Id.* at 170 n.1.

[106] *See, e.g.*, Joseph R. Mason & Joshua Rosner, How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions? 14 (2007), http://ssrn.com/abstract=1027472 (stating that "[t]he growth of the subprime market has been largely driven by [] increased investor appetite for mortgage-backed products," in addition to greater access to securitizations and lender desire to move subprime loans off of their balance sheets); *see also* REINHART & ROGOFF, *supra* note 39, at 243 (stating that foreign investors bet on the U.S. subprime market "perhaps owing to the fact that profit opportunities in domestic real estate were limited at best and dismal at worst").

[107] KINDLEBERGER & ALIBER, *supra* note 41, at 8.

[108] *Id.*

[109] *Levin-Coburn Report*, *supra* note 97, at 260.

[110] These new subprime borrowers had been denied credit because they were seen as likely to default, whether because of low income or credit score, recent bankruptcy, or high debt-to-income ratio. *See id.* at 19 (summarizing 2001 interagency guidance on subprime borrowing).

tive chroniclers of the financial crisis is that political pressures to expand homeownership distorted market incentives in favor of subprime lending.[111] However, the institutions that originated these subprime loans were often different from the ones that securitized them.[112] While the lender in a traditional mortgage relationship, like the lender in the Posner excerpt, must ultimately bear the risk that the loan goes bad, pure originators do not necessarily bear any such risk. Instead, when the securitization market was hot, they could make loans knowing that someone else would be willing to buy and package them. This so-called "originate and distribute"[113] business model created a potentially grave principal/agent conflict between originator and securitizer:

> In particular, the originator has an information advantage over the [securitizer] with regard to the quality of the borrower. Without adequate safeguards in place, an originator can have the incentive to collaborate with a borrower in order to make significant misrepresentations on the loan application, which, depending on the situation, could be either construed as predatory lending (the lender convinces the borrower to borrow "too much["]) or predatory borrowing (the borrower convinces the lender to lend "too much").[114]

In the early 2000s, as the economic incentives for originators to shirk on loan quality became greater, lenders generally became less demanding about the documentation and down payments borrowers needed to provide to be approved for loans. "Low-doc" lending, more ominously known as "NINJA" lending (lending requiring no proof of income, job, or assets), was motivated by "a desire to reach out to new borrowers by focusing on housing appreciation and credit scores as the primary tools for controlling credit risk."[115] These laxer requirements neatly corresponded with the self-interest of corner-cutting originators, but they probably would not have caught on if the purchasers of mortgage-related securities had not tolerated them.[116]

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[111] *See, e.g.*, FCIC REPORT, *supra* note 42, at 487 (dissenting statement of Peter J. Wallison); *see also* Moran, *supra* note 49, at 25–30 (documenting pro-homeownership government policies that were later accused of contributing to the financial crisis).

[112] *See* Ashcraft & Schuermann, *supra* note 72, at 4 tbls.2–3.

[113] *See, e.g.*, ROUBINI, *supra* note 103, at 65.

[114] Ashcraft & Schuermann, *supra* note 72, at 5–6.

[115] ARNOLD KLING, MERCATUS CTR., NOT WHAT THEY HAD IN MIND: A HISTORY OF POLICIES THAT PRODUCED THE FINANCIAL CRISIS OF 2008, at 17–18 (2009).

[116] *Id.* at 18 ("The danger to financial firms of poor mortgage credit quality went largely unnoticed.").

According to economist Arnold Kling, laxer requirements came to be tolerated because the government-sponsored enterprises (GSEs) that had opposed them in the past, Fannie Mae and Freddie Mac,[117] were politically weakened by recent accounting scandals and were under pressure from regulators to increase credit access for low-income borrowers, and so they "had little political capital to throw into a fight to maintain underwriting standards."[118] The GSEs were major players in the subprime securitization market, purchasing between thirty and forty percent of subprime securities issued from 2003–07,[119] and their imprimatur may have made an impression even beyond their own market share because of their overall size, interconnectedness with the economy, and the sentiment among some investors that the support of these semipublic entities implied the support of the federal government.[120] The role of the GSEs in propping up the subprime market is disputed, however,[121] and in any event, would not entirely explain the willingness of other investors to purchase securities backed by thinly documented subprime mortgage loans.

These investors may have been duped by inaccuracies and outright lies in the documentation they did receive. But they may also have believed that limited information about borrower credit risk and housing appreciation was all they needed to satisfy their mathematical models, and that the agencies' ratings were a sufficient guarantee of the general soundness of the pool (though perhaps unbeknownst to investors, the agencies avoided reviewing the accuracy of securitization loan data for fear of exposing themselves to liability).[122] These investors may have also hired third-party firms to conduct due diligence on a small sample of the loans underlying a securitization, as was common practice.[123] It is

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[117] As a summer law associate, I assisted in the representation of a banking defendant in a civil suit brought by the Federal Housing Finance Agency, which became the conservator of Fannie and Freddie in 2008. The suit has since settled. The views I express in this Article on the roles of Fannie and Freddie in the financial crisis, like the views I express throughout, are my own.

[118] KLING, *supra* note 115, at 18.

[119] Jason Thomas & Robert Van Order, A Closer Look at Fannie Mae and Freddie Mac: What We Know, What We Think We Know and What We Don't Know 5–6 (Mar. 2011) (unpublished draft), http://business.gwu.edu/wp-content/uploads/2014/05/A-Closer-Look-at-Fannie-Mae-and-Freddie-Mac-What-We-Know-What-We-Think-We-Know-and-What-We-Dont-Know.pdf.

[120] *See Levin-Coburn Report*, *supra* note 97, at 42.

[121] *Compare* FCIC REPORT, *supra* note 42, at 443 (dissenting statement of Peter J. Wallison) (blaming the GSEs in large measure for the subprime bubble), *with* Joe Nocera, Op-Ed., *An Inconvenient Truth*, N.Y. TIMES, Dec. 19, 2011, http://www.nytimes.com/2011/12/20/opinion/nocera-an-inconvenient-truth.html (criticizing Wallison's claims and methodology).

[122] *See Levin-Coburn Report*, *supra* note 97, at 310–11.

[123] *Due Diligence Services Increase in the Secondary Mortgage Market*, U.S. STRUCTURED FIN. NEWSL. (DBRS, New York, N.Y.), Aug. 20, 2007 (stat-

also possible that they knew the housing bubble was unstable and would eventually pop, but thought they could get out before it did.[124]

Whatever their reasons, investors seem to have underestimated the degree to which low-quality lending would flourish in a regime where originators were paid by volume and documentation requirements were lax. Even if "[f]or the vast majority of mortgage loans, reduced documentation saved on costs without any adverse effect on loan quality," such a "program of reduced documentation becomes a magnet for fraud."[125] This intuition has been backed up by quantitative analysis of reduced-documentation loans securitized from 2000–07.[126] However, even a fraudulently obtained or otherwise suspect mortgage may not be a bad investment so long as housing prices never fall: it wouldn't matter if the strawberry-picker with a $14,000 annual income could never hope to repay the no-money-down $724,000 adjustable rate mortgage,[127] because the lender, like Judge Posner's real estate joint-venturer, would simply have the right to take a more valuable property in the future. As the FCIC observes, in this world of widespread "liar's loans," investors in subprime securities had "in essence, placed all their chips on black: they were betting that home prices would never stop rising."[128] But if the ball landed on red and home prices fell, the loss would be catastrophic.

C. *The Fall of Mortgage-Related Securities and the Precipitation of the Crisis*

Home prices did fall. The decline began in 2006 and accelerated dramatically in March 2007, when the volume of home sales dropped their furthest since 1989 and subprime foreclosures exploded.[129] One account links the decline directly to the abrupt increase in adjustable interest rates on subprime loans made in the early 2000s, making them no

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ing that "[i]n the past, investors would hire third-party due diligence vendors to re-underwrite a sample of loans (usually 10% to 25%) in order to ensure that the loans were originated in accordance with the seller's underwriting guidelines (both from a credit and compliance perspective)," but noting that "the results of these audits are not always disclosed to rating agencies or investors").

[124] *See* POSNER, *supra* note 101, at 246–47 (contrasting a speculative bubble with pyramid schemes and Ponzi schemes, and noting there need be neither deception nor irrationality in a bubble).

[125] KLING, *supra* note 115, at 17.

[126] Michael LaCour-Little & Jing Yang, *Taking the Lie Out of Liar Loans: The Effect of Reduced Documentation on the Performance and Pricing of Alt-A and Subprime Mortgages*, 35 J. REAL EST. RES. 507 (2013).

[127] *See* LEWIS, *supra* note 100, at 97 (describing a loan that was actually made).

[128] FCIC REPORT, *supra* note 42, at 111.

[129] Nancy Trejos, *Existing-Home Sales Fall Steeply*, WASH. POST, Apr. 25, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/04/24/AR2007042400627.html.

longer affordable for financially insecure borrowers,[130] while another links it to a "building boom [that] led to so much over-supply that prices could no longer be supported."[131]

Whatever its causes, the bursting of the bubble had a disastrous effect, which was compounded greatly by the scaffold of financial instruments built atop residential mortgages. Many of the core assumptions behind the pricing and credit ratings of RMBSs and CDOs were proved wrong. If the transmogrification of a packet of BB-rated RMBS tranches into a AAA CDO tranche was ever a defensible enterprise, it was so because the underlying risks were carefully calculated to cancel each other out.[132] This turned out not to be true: housing prices fell in many regions.[133] Other supposedly "uncorrelated" risks were correlated after all. Mounting subprime foreclosures added new housing stock, depressing the prices of other houses, subprime or not, and creating a self-perpetuating "death spiral" as newly underwater homeowners decided it was no longer worth it to pay, particularly if they had been hit by recent adjustable-rate mortgage interest spikes.[134]

Meanwhile, as Wall Street saw the decline in housing prices and increase in default rates, it realized how poor lending standards had been for many outstanding subprime mortgages, and how overvalued many mortgage-related securities had been as a result.[135] This led to a mass downgrade of the credit ratings of many of these securities, the rapidity and severity of which shook investors' faith in the credit-rating agencies.[136] Because of the complexity of RMBSs and CDOs and the doubt into which supposed "AAA" ratings had been cast, it wasn't immediately clear which instruments were contaminated with doomed subprime loans, and it turned out these supposedly liquid securities were not so liquid when everyone wanted to get rid of them. To use economist Gary Gorton's analogy:

> [T]he riskier mortgages in mortgage-backed securities had been intermingled like salmonella-tainted frosting

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[130] *E.g.*, Kimberly Blanton, *Adjustable-Rate Loans Come Home to Roost: Some Squeezed as Interest Rises, Home Values Sag*, BOSTON GLOBE, Jan. 11, 2006, http://www.boston.com/business/articles/2006/01/11/adjustable_rate_loans_come_home_to_roost/.

[131] Dean Baker, *The Housing Bubble and the Financial Crisis*, 46 REAL-WORLD ECON. REV. 73, 74 (2008).

[132] *See supra* notes 84–85 and accompanying text.

[133] Randall Dodd & Paul Mills, *Outbreak: U.S. Subprime Contagion*, FIN. & DEV., June 2008, at 14, 16.

[134] *See* Kim Clark, *Housing: The One Bailout America Could Really Use*, CNN MONEY (Jan. 17, 2012), http://money.cnn.com/2012/01/13/pf/ows_goodman_best_money_moves.moneymag/index.htm (describing the "death spiral" phenomenon).

[135] Dodd & Mills, *supra* note 133, at 16.

[136] *Id.*

> among a very small batch of cakes that have been randomly mixed with all the other cakes in the factory and then shipped to bakeries throughout the country. . . . [T]he collapse of the structured investment vehicle market, and the consequent stall in the repurchase (repo) market, represented the market recalling the contaminated cakes.[137]

Risky subprime mortgages actually comprised a very small portion of the overall mortgage market, but in a phenomenon sometimes called "subprime contagion," their losses quickly spread throughout the financial sector.[138] Many large financial firms that would later be deemed "too big to fail" had actually borrowed heavily to invest in mortgage-related securities, and when the value of these securities fell, the leverage of these firms would amplify their losses.[139] As these firms announced their losses and the depth of their exposure became clear, investors' faith in the financial sector was eroded further.[140] This loss of confidence had an effect similar to a bank run: investors' refusal to extend short-term credit to illiquid, leveraged firms like Bear Stearns caused them to fail.[141] Investors "fl[ed] to quality" as they became afraid to invest in anything but the safest securities, and banks stopped lending for fear of becoming victims of bank runs of their own, creating a "credit crunch."[142]

The credit crunch became a full-blown crisis in September and October of 2008, when Lehman Brothers filed for bankruptcy, and the federal government took Fannie and Freddie into conservatorship, authorized emergency lending, brokered shotgun weddings between teetering financial institutions, enacted the Troubled Asset Relief Program (TARP), and generally did everything it could to prevent the financial sector from collapsing outright and causing a full-fledged depression.[143] Still, the damage was done, and it extended far beyond investors in mortgage-related securities:

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[137] Lo, *supra* note 47, at 157–58 (paraphrasing an argument made in GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND (2010)).

[138] FCIC REPORT, *supra* note 42, at 227–28.

[139] *Id.* at 228.

[140] *Id.*

[141] JICKLING, *supra* note 96, at CRS-7.

[142] *See* Francis A. Longstaff, *The Subprime Credit Crisis and Contagion in Financial Markets*, 97 J. FIN. ECON. 436, 436–37 (2010); *see also* Dodd & Mills, *supra* note 133, at 17.

[143] *See* FED. RESERVE BANK OF ST. LOUIS, THE FINANCIAL CRISIS: A TIMELINE OF EVENTS AND POLICY ACTIONS 8–14 (2009), http://timeline.stlouisfed.org/pdf/CrisisTimeline.pdf. For a firsthand account of the Treasury's work in these months by the then-Secretary of the Treasury, see generally HENRY M. PAULSON, JR., ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM (2010). On TARP, *see supra* note 50.

> The inability to find funding, financial firm deleveraging, and macroeconomic weakness translated into tighter credit for consumers and businesses. Securitization markets for other kinds of debt collapsed rapidly in 2008 and still have not recovered fully, cutting off a substantial source of financing for credit cards, car loans, student loans, and small business loans.
>
> Decreased credit availability, the collapse of the housing bubble, and additional wealth losses from a declining stock market led to a sharp contraction in consumption and output and an increase in unemployment.
>
> . . . .
>
> . . . [T]he harm to the real economy continues through today.[144]

II. Accounts of the Crisis as the Product of Criminal Activity

A systemic description of the financial crisis should not obscure the role played by individuals. The crisis was "avoidable," the FCIC majority concluded, because it was "the result of human action and inaction, not of Mother Nature or computer models gone haywire."[145]

From the early days of the crisis through the present, many in government, the academy, and the public have suspected that some of the actions and inactions of elite bankers were more than foolish and harmful: they were criminal. On this view, the fact that "not a single high-level executive has been successfully prosecuted in connection with the recent financial crisis"[146] is a serious failure of the justice system. Section II.A gathers several popular accounts of the crisis as the product of high-level criminal activity. Section II.B discusses the accounts of Professor William Black and Judge Jed Rakoff. Section II.C synthesizes the various accounts and summarizes their common themes.

A. Popular Accounts

1. Public Opinion

Just over half of Americans believed that the government had not "sufficiently prosecuted bankers for their role in the financial crisis" as of September 2013, according to one poll.[147] According to another poll conducted the same month, seventy-nine percent of Americans believe

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[144] FCIC Report, *supra* note 42, at 438 (dissenting statement of Keith Hennessey, Douglas Holtz-Eakin & Bill Thomas).

[145] *Id.* at xvii (majority statement).

[146] Rakoff, *supra* note 1.

[147] *Main Street View of Wall Street*, *supra* note 3 (summarizing poll finding that 53% of Americans hold this view).

that more "bankers and employees of financial institutions [should have been] prosecuted for their role in the financial crisis of 2008."[148] Even the lower of the two figures is stunning, but it does not reveal much about how its adherents define "sufficiently," "bankers," or "role in the crisis"—or, for that matter, if they define "prosecution" as it is legally understood or as a more general expression of condemnation.

2. Occupy Wall Street and Progressive Activists

Occupy Wall Street and progressive activist groups have been somewhat more articulate in this regard. Their accounts shed light on the views of some portion of the public, though perhaps not the median.[149]

Occupy Wall Street (OWS) began with protesters' physical occupation of Zuccotti Park in Lower Manhattan, but later developed into a broader movement, sparking protests in major cities around the world.[150] OWS is a loosely affiliated movement with many different and sometimes conflicting goals,[151] but its central message is that the "'99%' . . . the broad masses of people [have been] robbed of their due share of society's wealth and opportunities by millionaires and billionaires, i.e. by the '1%.'"[152]

This notion of 'robbery' refers in part to a sense of unfairness at the 2008 bank bailouts, a sense that bankers privatized pre-crisis gains and socialized post-crisis losses.[153] But it also refers to a sense of unpunished criminality. Many of the Zuccotti Park protesters called for Wall Street

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[148] *The New York Times/CBS News Poll: September 19–23, 2013*, N.Y. TIMES Sept. 25, 2013, http://www.nytimes.com/interactive/2013/09/26/us/politics/26poll-results.html [hereinafter *NYT/CBS Poll*].

[149] The belief that the crimes of banks and bankers led to the financial crisis is not exclusively left-wing. The libertarian/conservative Tea Party movement emerged in a wave of populist outrage over the 2008 bank bailouts. *See* Dunstan Prial, *Occupy Wall Street, Tea Party Movements Both Born of Bank Bailouts*, FOX BUSINESS (Oct. 20, 2011), http://www.foxbusiness.com/markets/2011/10/19/occupy-wall-street-tea-party-born-bank-bailouts/. In addition, some of its participants see the lack of financial crisis-related prosecutions as a sign of official corruption or incompetence. *See, e.g.*, Karl Denninger, *TEA PARTY February 1st?**, THE MARKET TICKER (Jan. 20, 2009), http://market-ticker.org/akcs-www?post=163297 (condemning, in one of the earliest Tea Party calls-to-arms, "the fraud and abuse in our banking and financial system"); Max Liberty, *I Feel Your Pain, America!*, TEA PARTY (Jan. 16, 2012), http://www.teaparty.org/i-feel-your-pain-america-4197/ (expressing outrage that "after the 2008 financial meltdowns, no banker, no credit rating agency, no CPA auditor, Fannie Mae/Freddie Mac executive has been penalized or jailed").

[150] ETHAN EARLE, ROSA LUXEMBURG STIFTUNG, A BRIEF HISTORY OF OCCUPY WALL STREET 3–4 (2012).

[151] *Id.* at 8–9.

[152] *Id.* at 1.

[153] *See* Pasquale, *supra* note 30; *see also* Prial, *supra* note 149 (claiming that OWS originated with the populist anger over the bailout).

executives to be jailed.[154] Nearly 100,000 people have signed progressive group petitions to New York Attorney General Eric Schneiderman to indict Wall Street bankers for "mortgage fraud" or "their role in wrecking our economy."[155] Nearly 150,000 have signed a MoveOn petition asking President Obama to take "immediate steps to break up the big banks and prosecute the criminals who used them to destroy our economy."[156] (The petition goes on to accuse Wall Street banks and executives of "systemic fraud."[157]) The theory of fraud in these petitions is fuzzy, and one sometimes gets the sense that their signatories believe that the wreckage of the economy would merit individual criminal punishment with or without the culpable state of mind traditionally required by the criminal law in this arena.[158] What is clear, though, is that OWS and progressive groups believe that noncriminal punishments that do not affect individuals are insufficient, and that without "prosecutions for the criminals at the top," the financial sector will not "learn [its] lesson from the last mess."[159]

3. Legislators

As early as October of 2008, a number of legislators expressed the view that the financial crisis was caused by criminal fraud within the financial sector. At a hearing on October 16, Senator Chris Dodd called the crisis "the financial crime of the century."[160] At the same hearing,

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[154] Andrew Ross Sorkin, *On Wall Street, a Protest Matures*, N.Y. TIMES DEALBOOK (Oct. 3, 2011), http://dealbook.nytimes.com/2011/10/03/on-wall-street-a-protest-matures/.

[155] *See 30,000 Tell Eric Schneiderman: We Need a Real Wall St Investigation*, THE OTHER 98% (Oct. 10, 2012), http://inewp.com/30000-tell-eric-schneiderman-we-need-a-real-wall-st-investigation/ (describing petition that gathered over 30,000 signatures); *Urge Eric Schneiderman: Jail Bankers Who Broke the Law*, PROGRESSIVE CHANGE CAMPAIGN COMM., http://act.boldprogressives.org/sign/sign_wallstreet_bankerjail (last visited Oct. 13, 2014) (describing different petition that gathered over 63,000 signatures).

[156] Brian Kettenring, *ACTION: Tell Obama to End Too Big to Jail*, MOVEON.ORG, http://petitions.moveon.org/sign/action-tell-obama-to (last visited Oct. 13, 2014).

[157] *Id.*

[158] *See, e.g.*, *Hold Wall Street Accountable! Occupy Our Homes Week of Action, May 18–25*, OCCUPY WALL ST. (Apr. 4, 2013, 9:39 AM), http://occupywallst.org/article/hold-wall-street-accountable-occupy-our-homes-week/ ("Communities have been destroyed as millions of families have already lost their homes to foreclosure, while millions more are underwater on their mortgages. The big banks are bigger and more powerful than ever. To date, no high level Wall Street executives have been prosecuted for their crimes, such as mortgage fraud and predatory lending.").

[159] *Id.*

[160] *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*,

Senator Sherrod Brown described the 40,000 emails he had received from "very angry Ohioans," most of whom "believe[d] that some of this behavior was illegal."[161] In an open letter, Representatives Mark Kirk and Christopher Carney urged the FBI to "redirect substantial resources to uncover and prosecute financial crime on Wall Street," and linked the crisis to "a failure of regulatory and government agencies to adequately uncover financial problems and prosecute fraud."[162] Representative Bill Sali asked SEC Chairman Christopher Cox, "[a]re the people that have caused this—is somebody going to go to jail?"[163]

One might suspect that these fiery statements were made in reaction to the public mood at the time—40,000 angry Ohioans can't be wrong—and indeed they tapered off as the peak of the crisis faded from memory. But they are still an important part of public discourse, at least among some of the more liberal members of Congress. Before leaving office, former Democratic Senator Ted Kaufman said "fraud and potential criminal conduct were at the heart of the financial crisis," and expressed the view that "[i]f we uncover bad behavior that was nonetheless lawful . . . then we should review our legal rules in the US and perhaps change them so that certain misleading behavior cannot go unpunished again."[164] Since leaving office, he has vented his frustration that "not one banker has gone to jail for anything that led to the great financial meltdown of 2008-2009."[165] Representative Michael Capuano grilled Federal Reserve Chairwoman Janet Yellen on whether she could effectively regulate "too big to jail" institutions, wrongdoers within which, he said, keep their "ill-gotten gains" while shunting losses onto shareholders or the public.[166] Senator Elizabeth Warren, who had said of the crisis that "when that much money disappears it's usually because somebody broke

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110th Cong. 3 (2008) (statement of Sen. Christopher J. Dodd, Chairman, S. Comm. Banking, Hous. & Urban Affairs).

[161] *Id.* (statement of Sen. Sherrod Brown).

[162] Letter from Reps. Mark Stephen Kirk & Christopher P. Carney to Robert S. Mueller III, Dir., FBI (Oct. 10, 2008), http://votesmart.org/public-statement/387187/.

[163] *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 64 (statement of Rep. Bill Sali).

[164] Simon Johnson, *Senator Kaufman: Fraud Still at the Heart of Wall Street*, HUFFINGTON POST (May 15, 2010), http://www.huffingtonpost.com/simon-johnson/senator-kaufman-fraud-sti_b_500146.html.

[165] Ted Kaufman, *Why DOJ Deemed Bank Execs Too Big to Jail*, FORBES (July 29, 2013), http://www.forbes.com/sites/tedkaufman/2013/07/29/why-doj-deemed-bank-execs-too-big-to-jail/.

[166] *Rep. Capuano Questioning Janet Yellen on Too Big to Fail, Too Big to Jail, and GSEs*, YOUTUBE (Feb. 11, 2014), https://www.youtube.com/watch?v=P9KOtZiLm3I.

some laws somewhere,"[167] also expressed her frustration at the lack of high-level prosecutions, arguing that "[w]hen banks are too big to fail, too big to jail, too big for trial . . . they are just too big," and it may be time to "cut these banks down to size."[168]

B. Legal Accounts

1. Professor Black's Account: Control Fraud

The most outspoken academic proponent[169] of the theory that the financial crisis was caused by widespread criminal fraud has been William Black, a law professor and criminologist who served as a bank regulator

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[167] Nicholas Graham, *Elizabeth Warren Speaks with Michael Moore (VIDEO): Exclusive Footage*, HUFFINGTON POST (Mar. 18, 2010), http://www.huffingtonpost.com/2009/10/22/elizabeth-warren-speaks-w_n_329425.html.

[168] Elizabeth Warren, *Just too Big*, ELIZABETH WARREN FOR SENATE: BLOG (Mar. 9, 2013), http://elizabethwarren.com/blog/just-too-big.

[169] I treat Professor Black's work as emblematic of the academic literature on criminality and the financial crisis. I do so in part to avoid a long-winded and unnecessary literature review and in part because Black has been influential in public as well as academic discourse. For other works dealing with similar issues, *see also* STEPHEN ROSOFF, HENRY PONTELL & ROBERT TILLMAN, PROFIT WITHOUT HONOR: WHITE COLLAR CRIME AND THE LOOTING OF AMERICA (2009); JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY (2010); Samuel W. Buell, *Is the White-Collar Offender Privileged?*, 63 DUKE L.J. 823, 826, 846–47 (2014); June Carbone, *Once and Future Financial Crises: How the Hellhound of Wall Street Sniffed Out Five Forgotten Factors Guaranteed to Produce Fiascos*, 80 UMKC L. REV. 1021 (2012); Andrew J. Ceresney, Gordon Eng & Sean R. Nuttall, *Regulatory Investigations and the Credit Crisis: The Search for Villains*, 46 AM. CRIM. L. REV. 225 (2009); Sandra D. Jordan, *Victimization on Main Street: Occupy Wall Street and the Mortgage Fraud Crisis*, 39 FORDHAM URB. L.J. 485 (2011); Anton R. Valukas, *White-Collar Crime and Economic Recession*, 2010 U. CHI. LEGAL F. 1 (2010); Shayna A. Hutchins, Comment, *Flip that Prosecution Strategy: An Argument for Using RICO To Prosecute Large-Scale Mortgage Fraud*, 59 BUFF. J. INT'L L. 293 (2011); Colin Maher, Note, *Crisis Not Averted: Lack of Criminal Prosecutions Leave Limited Consequences for Those Responsible for the Financial Crisis*, 39 NEW ENG. J. ON CRIM. & CIV. CONFINEMENT 459 (2013); Jeff Madrick & Frank Portnoy, *Should Some Bankers Be Prosecuted?*, N.Y. REV. BOOKS (Nov. 10, 2011), *available at* http://www.nybooks.com/articles/archives/2011/nov/10/should-some-bankers-be-prosecuted/; Joseph E. Stiglitz, *Moral Bankruptcy*, MOTHER JONES, (Jan./Feb. 2010), http://www.motherjones.com/politics/2010/01/joseph-stiglitz-wall-street-morals; James K. Galbraith, Remarks at the 20th Annual Levy Institute Hyman Minsky Conference, Without the Rule of Law, the Financial Sector Is No Use to Anyone Except Those Who Own It and the Politicians They Own (Apr. 15, 2011), *available at* http://www.netrootsmass.net/2011/07/james-k-galbraith-without-the-rule-of-law-the-financial-sector-is-no-use-to-anyone-except-those-who-own-it-and-the-politicians-they-own/.

with the Office of Thrift Supervision following the savings and loan crisis of the 1980s.[170] Professor Black's hearing testimony before the FCIC is one of the Commission's main sources for the portions of its Report discussing mortgage fraud.[171] According to Black, mortgage loans and mortgage-related securities were deliberately misvalued in the years leading up to the crisis because individuals within financial institutions stood to gain from their inflated appraisals.[172]

Black describes this phenomenon as one of "control fraud": because the "top executives" who control financial institutions are often compensated on the basis of short-term profits, they deliberately corrupt the institutions' accounting and risk management structures to "show the corporation's profitability without identifying or providing for the risks."[173] The victims of a control fraud are the controlled institution and its shareholders and creditors, which will suffer large losses when the risks come to light.[174] By this time, the controllers have "looted" the institution by appropriating compensation and bonuses on what amount to false pretenses:

> Lenders loot by making loans that are irrational from the bank's standpoint but wholly rational from the looter's standpoint. Indeed, it is the very irrationality of the action from the standpoint of an honest bank that allows juries to infer so strongly that the CEO caused the bank to operate in that suicidal manner because it optimized his looting.[175]

Black looks upon the financial crisis and sees control fraud all the way down. Mortgage brokers often collected larger fees if they could persuade borrowers to take out larger loans and if they could make the loans appear less risky.[176] Far from being duped by borrowers who misrepresented their income and assets, Black writes that these brokers "engineered" fraudulent loans "to the detriment of the borrower."[177] Loan officers employed by subprime originators were almost all paid volume

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[170] William K. Black, *Curriculum Vitae*, UMKC SCHOOL OF LAW, http://law.umkc.edu/faculty-staff/vitas/black.pdf (last visited Oct. 13, 2014).

[171] FCIC REPORT, supra note 42, at 110–11, 160–64.

[172] *E.g.*, William K. Black, *The Department of Justice "Chases Mice While Lions Roam the Campsite": Why the Department Has Failed to Prosecute the Elite Frauds That Drove the Financial Crisis*, 80 UMKC L. REV. 987, 1003–05 (2012).

[173] *Id.* at 990; *see also* WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE: HOW CORPORATE EXECUTIVES AND POLITICIANS LOOTED THE S&L INDUSTRY 3 (2005) (describing the "control fraud" theory generally).

[174] BLACK, *supra* note 172, at 271–72 (describing shareholders and creditors as "the primary intended victims" of control fraud).

[175] *Id.* at 1015.

[176] *Id.* at 1010–11.

[177] *Id.* at 1010.

bonuses, he says, which had the expected effect of making them rubber-stamp loan approvals in bulk.[178] Black alleges that executives at these firms, whose short-term compensation structure created similar "perverse incentives," countenanced this "cheaters prosper" regime for low-level employees and agents of mortgage originators.[179] Black also believes that the firms that packaged and sold mortgage-related securities were in on the racket. Quoting the FCIC Report, he notes that employees and executives of arrangers, issuers, CDO managers, and rating agencies "collected fees based on the dollar volume of securities sold. . . . [a]nd those fees were in the billions of dollars across the market."[180] As a result, Black says these firms "adopt[ed] the financial version of 'don't ask; don't tell' (and ignore or hide bad results), produc[ing] a criminogenic environment that helped drive the primary mortgage fraud epidemic."[181]

While Professor Black advocates a number of regulatory reforms in response to the crisis, he believes that "only prison sentences can deter the violations that caused the debacle."[182] Since, in his view, calculating, self-enriching individuals in high-level positions caused the crisis, only the threat of imprisonment for these individuals, as opposed to civil or regulatory penalties, is enough to deter them.[183]

2. Judge Rakoff's Account: Prosecutorial Failure

In January of 2014, the *New York Review of Books* published an essay by Judge Jed Rakoff of the Southern District of New York, provocatively titled "The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?"[184] Judge Rakoff had attained unusual public prominence for his critical tone towards Wall Street in litigation after the financial crisis,[185] most notably for his rejection of a proposed consent

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[178] Bruce E. Aronson, *The Financial Crisis One Year Later: Proceedings of a Panel Discussion on Lessons of the Financial Crisis and Implications for Regulatory Reform*, 43 CREIGHTON L. REV. 275, 318 (2010) (statement of Prof. William K. Black).

[179] *Interview with William K. Black*, Transcript, Bill Moyers Journal (PBS television broadcast Apr. 23, 2010), http://www.pbs.org/moyers/journal/04232010/transcript1.html.

[180] Black, *supra* note 172, at 1008 (quoting FCIC REPORT, *supra* note 42, at 129).

[181] *Id.* at 1007.

[182] *Wall Street and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?: Hearing Before the Subcomm. on Crime & Drugs of the S. Comm. on the Judiciary*, 111th Cong. 49 (2011) (statement of Prof. William K. Black).

[183] *See* Holland, *supra* note 18.

[184] Rakoff, *supra* note 1.

[185] *See, e.g.*, Nathaniel Popper, *Judge Jed Rakoff Taps into Nation's Outrage over Economic Crisis*, L.A. TIMES, Apr. 10, 2010, http://articles.latimes.com/2010/apr/10/business/la-fi-rakoff10-2010apr10 (quoting the executive di-

decree between the SEC and Citigroup in an action related to the bank's mortgage-backed security offerings.[186] His essay is thus of interest not only for its thoughtfulness, but also for being more likely to influence public policy than many pieces written in a more or less academic register.

Rakoff (who is, after all, a sitting judge) claims to have "no opinion about whether criminal fraud was committed in any given instance" leading up to the financial crisis.[187] However, he notes the FCIC's finding of widespread fraudulent mortgage borrowing and lending in the years leading up to the crisis, as well as "the prevailing view of many government officials (as well as others) . . . that the crisis was in material respects the product of intentional fraud."[188] If this view is correct, he asks, and if this fraud permeated every level of finance, including high-level management, then why hasn't a single high-level executive been prosecuted?[189] Judge Rakoff's project is not necessarily to call for new prosecutions, but to understand what would be "one of the more egregious failures of the criminal justice system in many years" if the widespread view of pervasive fraud is correct.[190] The main object of Judge Rakoff's criticism is the Department of Justice, which he claims was much more vigorous in prosecuting high-level officials responsible for "mammoth fraud" in the past (the rather different junk bond, savings and

rector of the Center on the Administration of Criminal Law at New York University as saying Rakoff "has tapped into some of the national and populist outrage that has followed the economic meltdown"); Michael Rothfeld, *No Mr. Nice Guy—Just Ask Wall Street*, WALL ST. J., Nov. 9, 2011, http://online.wsj.com/news/articles/SB10001424052970203733504577026422455885502 (profiling Judge Rakoff); Matt Taibbi, *Finally, a Judge Stands Up to Wall Street*, ROLLING STONE (Nov. 10, 2011), http://www.rollingstone.com/politics/news/finally-a-judge-stands-up-to-wall-street-20111110 (praising Judge Rakoff as "a sort of legal hero of our time").

[186] The SEC alleged that Citigroup had created a billion-dollar fund to dump poorly performing mortgage-backed securities it owned onto unsuspecting investors, but the SEC was willing to settle with Citigroup without the latter's admitting or denying the underlying allegations. The Second Circuit stayed Judge Rakoff's rejection of the consent decree pending review by a merits panel, which has not yet issued its decision. SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011), *stayed pending appeal*, 673 F.3d 158 (2d Cir. 2012). Interestingly, the new Chair of the SEC, Mary Jo White, has announced that the SEC will now require admissions of wrongdoing as a condition of settlement in some cases. Jean Eaglesham & Andrew Ackerman, *SEC Seeks Admissions of Fault*, WALL ST. J., June 18, 2013, online.wsj.com/article/SB10001424127887324021104578553931876196990.

[187] Rakoff, *supra* note 1.

[188] *Id.* (citing FCIC REPORT, *supra* note 42, at xxii–xxiii; 160–64).

[189] *Id.*

[190] *Id.*

loan, and accounting scandals), and which he says has offered only weak excuses for its current inaction.[191]

First, Judge Rakoff takes Department officials to task for claiming that high-level fraud would be too difficult to prove.[192] Rakoff brushes away the claim that reliance would be difficult to prove in cases involving sophisticated counterparties, because, he says, it is not necessary to prove reliance under the relevant federal criminal statutes.[193] More aggressively, Judge Rakoff questions the supposed difficulty of proving fraudulent intent, which he says can be done on a willful blindness theory:

> A top-level banker, one might argue, confronted with growing evidence from his own and other banks that mortgage fraud was increasing, might have inquired why his bank's mortgage-based securities continued to receive AAA ratings. And if, despite these and other reports of suspicious activity, the executive failed to make such inquiries, might it be because he did not want to know what such inquiries would reveal?
>
> This, of course, is what is known in the law as "willful blindness" or "conscious disregard." It is a well-established basis on which federal prosecutors have asked juries to infer intent, including in cases involving complexities, such as accounting rules, at least as esoteric as those involved in the events leading up to the financial crisis.[194]

Second, Judge Rakoff criticizes the "too big to jail" argument. Even if there is a limited set of Arthur Andersen-like circumstances in which the economic harm caused by prosecuting a financial institution is too great—a prospect Rakoff still calls "disturbing" for the principle of equality under the law—this rationale falls apart as applied to individuals.[195] He writes, "no one that I know of has ever contended that a big financial institution would collapse if one or more of its high-level executives were prosecuted, as opposed to the institution itself."[196]

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[191] *Id.*

[192] *Id.*

[193] *Id.* While this is certainly true of mail fraud, wire fraud, and bank fraud, the question is not entirely settled with regard to securities fraud. *See* Neder v. United States, 527 U.S. 1, 24–25 (1999) (stating that the common law reliance element "plainly [has] no place in the federal fraud statutes"); United States v. Schlisser, 168 F. App'x 483, 486 (2d Cir. 2006) (noting that criminal 10b-5 actions may be an exception to this rule because the criminal and civil provisions are usually interpreted similarly, and the civil provision requires reliance).

[194] Rakoff, *supra* note 1.

[195] *Id.*

[196] *Id.*

Rakoff concludes that if the crisis was the product of high-level fraud, then the failure to prosecute the high-level executives responsible was caused by interconnected systemic failures within federal investigative agencies and the Department of Justice.[197] With regard to federal investigative agencies, he mentions that after 9/11, the FBI reassigned many of its financial fraud investigators to antiterrorism work, and after the Bernie Madoff scheme came to light, the SEC shifted its "primary focus" to "Ponzi schemes and misallocation-of-asset cases."[198] As for the Department of Justice, he dismisses the theory that AUSAs and Department of Justice officials held back on prosecutions to curry favor with financial institutions—successful high-level prosecutions are career-makers, not career-killers—though he doesn't rule out the possibility that prosecutors held back because the government was enmeshed with both the bailout and the policies that gave rise to the crisis.[199]

Judge Rakoff's two most insightful points concern the institutional pressures at work on individual prosecutors and prosecutions. First, building a complex fraud case takes time and may lead nowhere, and financial crimes prosecutors with an eye towards résumé-building will often prefer the relative certainty of, say, an insider trading case.[200] If every prosecutor makes this choice—tipped further, perhaps, by limited financial and investigative resources—the big cases just won't be brought. Second, Judge Rakoff claims that federal prosecutors have shifted their focus from prosecuting individuals to prosecuting companies. Rather than "go up the ladder" within a corrupt organization and "flip" low-level participants by persuading them to turn on their leaders, Judge Rakoff argues that the modern trend is to threaten to prosecute the organization, with the goal of enticing it to enter a deferred prosecution agreement.[201] Judge Rakoff fears, though, that the compliance measures required by these agreements are "often little more than window-dressing."[202] He concludes that the "future deterrent value of successfully prosecuting individuals far outweighs" these uncertain prophylactic benefits.[203]

C. *Synthesis*

While these accounts differ somewhat in tone, audience, and prescription, they are similar in important respects.

First, and most importantly, they posit a *causal relationship* between the criminal behavior of financial executives and the crisis:

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[197] *Id.*

[198] *Id.*; *see also* FCIC REPORT, *supra* note 42, at 162–63 (discussing the FBI's reassignment of agents after 9/11).

[199] Rakoff, *supra* note 1.

[200] *Id.*

[201] *Id.*

[202] *Id.*

[203] *Id.*

- Judge Rakoff: "the crisis was in material respects the product of intentional fraud."[204]
- Former Senator Ted Kaufman: "fraud and potential criminal conduct were at the heart of the financial crisis."[205]
- Seventy-nine percent of respondents to the New York Times/CBS poll: "more bankers and employees of financial institutions [should have been] prosecuted for their role in the financial crisis of 2008."[206]

In its strong form, this is a claim that but for high-level fraud, there would have been no financial crisis. The strong-form claim leaves open the possibility that fraud was one of several but-for causes. In its weak form, this is a claim that even if the crisis was inevitable, the 2008 crisis was significantly worse because of high-level fraud.

Second, these accounts claim that individual criminal prosecution is *necessary to prevent future financial crises*:

- Professor Black: "only prison sentences can deter the violations that caused the debacle."[207]
- Occupy Wall Street: "the financial industry didn't learn their lesson from the last mess. It's more important than ever for us to take action to demand . . . prosecutions for the criminals at the top."[208]
- Judge Rakoff: "the future deterrent value of successfully prosecuting individuals far outweighs the prophylactic benefits of imposing internal compliance measures that are often little more than window-dressing."[209]

This is really an application of the Benthamite theory of utilitarian deterrence to the fraud-causation theory of the crisis.[210] If fraud causes crises, and if would-be fraudsters engage in a calculus of benefits and burdens before perpetrating their crimes, it follows that the threat of likely prosecution, made credible by vigorous prosecution of recent frauds, will deter fraud and so prevent future crises.

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[204] *Id.*

[205] Johnson, *supra* note 164 (quoting former Sen. Ted Kaufman).

[206] *NYT/CBS Poll*, *supra* note 148 (emphasis added).

[207] Black, *supra* note 182, at 49.

[208] *Hold Wall Street Accountable!*, *supra* note 158.

[209] Rakoff, *supra* note 1.

[210] *See, e.g.*, Irving Piliavin et al., *Crime, Deterrence, and Rational Choice*, 51 AM. SOC. REV. 101, 101–02 (1986) (discussing and formally expressing Bentham's theory).

Third, these accounts forcefully argue that the failure to criminally punish the individuals responsible for the financial crisis *calls into question the fairness of the legal system itself*:

- Former FCIC Chairman Phil Angelides: "there's a question here: do we have a dual justice system? One for ordinary people and then one for people with money and enormous wealth and power."[211]
- Senator Elizabeth Warren: "[w]e are a country that believes in equal justice under the law—not special deals for the big guys. . . . When banks are too big to fail, too big to jail, too big for trial . . . they are just too big."[212]
- Judge Rakoff: "if . . . the Great Recession was in material part the product of intentional fraud, the failure to prosecute those responsible must be judged one of the more egregious failures of the criminal justice system in many years."[213]

As these quotes suggest, this is a more pointed accusation than the general Kantian one that "a failure to punish those who deserve it leaves guilt upon the society."[214] Its thrust is that because the people who perpetrated the crisis occupied positions of power, they were not punished for their crimes.

I regard the first and second of these claims as fundamentally mistaken. Even the weak form of the fraud-causation theory claims too much, and the deterrence claim is premised on still more doubtful assumptions. Part III elaborates on these observations. The third claim, however, still has merit even if high-level fraud did not cause the financial crisis. Although the conclusion "high-level people got away with serious crimes in the run-up to a social and economic disaster" qualifies the broader conclusion "high-level people got away with serious crimes that *caused* the social and economic disaster," even the first is a significant indictment of the justice system. Part IV elaborates.

III. CRIME, CRISIS, AND CAUSATION

Part I's systemic account of the crisis leaves plenty of room for unpunished fraud in high and low places. Many people and firms profited from the sale and exchange of assets the value of which they arguably

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[211] Barry Ritholtz, *America Is a "Failed State" with a "Dual Justice System,"* THE BIG PICTURE (Apr. 16, 2011), http://www.ritholtz.com/blog/2011/04/america-is-a-failed-state-with-a-dual-justice-system/ (quoting former FCIC Chairman Phil Angelides).

[212] Warren, *supra* note 168.

[213] Rakoff, *supra* note 1.

[214] *See* Kent Greenawalt, *Punishment*, 74 J. CRIM. L. & CRIMINOLOGY 343, 347 (1983); *infra* Part IV.

misrepresented to their counterparties, and some may have known what they were doing. There is no compelling reason to suppose that the 1500 or so primarily low-level defendants convicted in federal prosecutions comprise an exhaustive list of the guilty.[215] High-level fraud prosecutions pose the steep evidentiary challenge of proving beyond a reasonable doubt the knowledge of individuals several levels removed from lower-level individuals within the firm who actually made false statements of material fact. But, to paraphrase Donald Rumsfeld, the absence of sufficient evidence of scienter is not evidence of its absence.[216] Furthermore, Judge Rakoff's institutional critique leaves doubt that even the pockets of sufficient evidence accessible to federal prosecutors and investigators have been adequately mined.

If it occurred, high-level fraud in the run-up to the financial crisis would be reprehensible, an abuse of the trust and power granted to people with responsibility over our financial system. But it is not a necessary or sufficient explanation for the crisis. As Section III.A discusses, even the pervasive origination fraud that we know for a fact occurred had a doubtful effect on the overall progression of the crisis. Section III.B discusses further limitations on the ability of high-level fraud to bring about a crisis, drawing on the historical lessons of past financial crises. Section III.C brings these observations to bear on the deterrence rationale for punishing high-level fraud.

A. *Origination Fraud and Causation*

Whether or not there were knowing misrepresentations in the creation and sale of mortgage-related securities, we already know from prosecutions, FCIC findings, and empirical research that there were knowing misrepresentations in the origination of subprime mortgages.[217] Some subset of borrowers, whether actively encouraged by originators or given free rein by their laxity and indifference, misstated their assets and earnings to qualify for bigger loans.[218] These liar loans were securitized, in which process their misstatements were repeated in offering documents.[219] For Judge Rakoff, the central question is whether higher-ups at

[215] *See supra* notes 17–18 and accompanying text.

[216] Press Conference at NATO Headquarters, Donald H. Rumsfeld, Sec'y of Def., (June 6, 2002), *available at* http://www.defense.gov/transcripts/transcript.aspx?transcriptid=3490 ("[T]he absence of evidence is not evidence of absence.").

[217] *See supra* notes 125–26 and accompanying text.

[218] *See* Ashcraft & Schuermann, *supra* note 72, at 5–6 (describing "predatory lending" and "predatory borrowing").

[219] *See supra* Subsection I.A.ii.a.

securitizers knew of or turned a blind eye to these lower-level misrepresentations.[220]

This is certainly the central question with respect to the liability of these higher-ups for criminal fraud, as the knowledge element of the offense is the hardest to prove. It is not surprising that it should be the question a judge and former prosecutor would zero in on. But the fraud-causation theory presents an additional empirical question: were the low-level misrepresentations the spoiled ingredients that caused mortgage-related securities to be recalled like tainted cakes,[221] or would the same result have occurred even without liar loans because of good-faith but badly mistaken valuation assumptions?

The evidence is messy and inconclusive. On one side of the ledger, loans based on demonstrably false representations defaulted at much higher rates than otherwise similar loans, and their investors were not compensated for the greater risk.[222] On the other, the difference in delinquency rates between high- and low-documentation loans was only five to eight percent, according to one study,[223] and loans that were not securitized but were kept on the originating lender's books did poorly as well.[224] Fraudulent loans were unquestionably bad news for the investors stuck with them, but these data and others point to a mortgage market more deeply unsound. As the FCIC dissent concluded:

> The Commission heard convincing testimony of serious mortgage fraud problems. Excruciating anecdotes showed that mortgage fraud increased substantially during the housing bubble. There is no question that this fraud did tremendous harm. But while that fraud is infuriating and may have been significant in certain areas (like Florida), the Commission was unable to measure the impact of fraud relative to the overall housing bubble.
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> The explosion of legal but questionable lending is an easier explanation for the creation of so many bad mortgages. Lending standards were lax enough that lenders could remain within the law but still generate huge volumes of bad mortgages. It is *likely that the*

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[220] Rakoff, *supra* note 1 ("I want to stress again that I have no opinion whether any given top executive had knowledge of the dubious nature of the underlying mortgages, let alone fraudulent intent.").

[221] *See supra* note 135 and accompanying text.

[222] Piskorski et al., *supra* note 71, at 1, 23–24.

[223] Wei Jiang, Ashlyn Aiko Nelson & Edward Vytlacil, *Liar's Loan? Effects of Origination Channel and Information Falsification on Mortgage Delinquency*, 1 REV. ECON. & STAT. 1, 2 (2014) (stating that this difference was attributable almost entirely to borrower information falsification).

[224] JICKLING, *supra* note 96, at CRS-5.

> *housing bubble and the crisis would have occurred even if there had been no mortgage fraud.* We therefore classify mortgage fraud *not as an essential cause of the crisis* but as a *contributing factor* and a deplorable effect of the bubble. Even if the number of fraudulent loans was not substantial enough to have a large impact on the bubble, the increase in fraudulent activity should have been a leading indicator of deeper structural problems in the market.[225]

The FCIC majority's inability to quantify the impact of fraud on the bubble does not mean that impact was zero. Quantification is difficult precisely because of the feedback loops, like CDO pricing and public confidence in financial institutions, which made subprime contagion so dangerous and unpredictable. Even a small "contributing factor" to a social ill as vast as the financial crisis may fairly be judged a serious ill itself. But if low-level fraud could be no more than a weak cause of the crisis, then no stronger than a weak theory of higher-level fraud-causation could be correct.

B. *High-Level Knowledge and Causation*

1. The Explanatory Power of High-Level Knowledge

The fraud-causation theory insists that a category of behavior defined by criminal law caused a mass socioeconomic event. The law may classify behavior as legal or illegal for instrumental reasons,[226] but particularly within the criminal law, its classifications serve an expressive function. They designate the act and the actor as bad, which is why scienter is such an important element of *malum in se* offenses like fraud and theft.[227] But the actors' knowledge may have only indirect relevance in explaining a mass socioeconomic event. It may be enough for the purposes of economists and historians—and regulators seeking to prevent future crises—that people overvalued misdescribed securities using inaccurate models, and that the eventual correction did a great deal of collateral damage. Ascribing knowledge to these people is descriptively useful only if what they knew explains what they did.

A premise of the fraud-causation theory is: "they must have known." The theory claims that for the events of the crisis to make sense, high-level executives must have known that they were making misrepresentations about what they were packaging and selling. In criminal-law terms,

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[225] FCIC REPORT, *supra* note 42, at 424 (dissenting statement of Keith Hennessey, Douglas Holtz-Eakin & Bill Thomas) (emphasis added).

[226] *Cf.* MORTON HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780–1860 (1977) (arguing that instrumental economic and political considerations guided the development of early American law).

[227] *See, e.g.*, Morissette v. United States, 342 U.S. 246, 260–61 (1951).

this claim is of something like motive. From 2001–06, investment banks paid "consistently large bonuses [to] the bankers and traders that worked with subprime-related securities," and the profits they generated padded the bonuses of executives all the way up to CEOs.[228] The overvaluation of mortgage-related securities looks less like an innocent mistake when the people responsible for packaging and selling them had the motivation to let lies slide. While these lies would have begun at the loan-origination level, if the securitizers knew of them, then the knowledge qualifiers in securities offerings, such as "to the best of the [issuer's] knowledge," would themselves be knowing, material misstatements sufficient to expose the securitizers to fraud liability.[229]

More fundamentally, the securitizers who purchased liar loans would look less like the victims of originators and more like their co-conspirators. Their willingness to purchase low-documentation loans is what created the market for them,[230] and if securitizers happily bought up non-conforming loans without examination, originators may have taken this as a tacit signal to produce more. (Perhaps there was even an explicit conspiratorial agreement that further investigation would reveal.) Professor Black's control-fraud theory provides that this could be wholly rational from the perspective of individuals even if it was bad for their employers in the long run.[231] Every benign explanation for the pyramid of mistakes building up to the crisis takes on a malign tint when viewed through the lens of conscious, self-enriching behavior by top banking executives.

2. Competing Explanations

a. *The Crisis Was Against Self-Interest for Many Banks and Bankers*

The fraud-causation explanation may credit top banking executives with being smarter and more powerful than they were. One weakness is that for this conspiratorial pipeline to work, there must be patsies at the end of it to buy the pumped-up securities. Many of the big losers on subprime mortgages were institutional investors such as pension funds, GSEs, insurance companies, and domestic and overseas municipalities[232]—the kinds of less plugged-in, less sophisticated investors (except-

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[228] *See* KEVIN CONNOR, NAT'L TRAINING & INFO. CTR., WALL STREET AND THE MAKING OF THE SUBPRIME DISASTER 5–7 (2007).

[229] *See supra* notes 72–74 and accompanying text.

[230] *See* text accompanying notes 114–20.

[231] *See supra* Subsection II.B.i.

[232] *See Levin-Coburn Report*, *supra* note 97, at 243 (discussing the losses of pension funds and insurance companies); Marcy Gordon, *Fannie, Freddie Post Solid Earnings for 1Q*, ASSOCIATED PRESS (May 8, 2014), http://bigstory.ap.org/article/fannie-freddie-post-solid-earnings-1q (discussing Fannie and Freddie's risk of "collapse under the weight of losses on risky mortgages," but noting they have since become profitable); Jackie Range, *Ruing CDOs Down Under*, WALL

ing the GSEs) who one worries about getting fleeced by Wall Streeters. In fact, however, the biggest losers may have been the banks themselves, whose combined losses on mortgage-related securities topped $590 billion in 2008.[233] A fraudulent scheme to pump up securities looks less plausible when the supposed pumpers heavily invest in the things. And remember, it was the crisis of confidence *in the banks* caused by their exposure to toxic mortgage-related securities that spread the subprime crisis to the real economy and made it orders of magnitude more serious—that transformed it into a global financial crisis.[234]

It may be that the banks and their officers recklessly gambled because they knew they were too big to fail, and so reaped privatized gains confident that the eventual losses would be socialized. (If so, the executives at Bear Stearns and Lehman Brothers misplaced their confidence.) There is some empirical evidence, consistent with moral-hazard theory, that banks make riskier bets after they have received government bailouts.[235] While this may be socially undesirable and wrongful behavior, it does not involve knowing misrepresentation, and is not fraud. If this form of moral hazard explains why banks and their officers behaved as they did before the financial crisis, this would speak to a need for better regulation, not prosecutions.

Harder to address is the control-fraud theory that the financial crisis was caused by frauds perpetrated by banking executives against their own firms, similar to the theory under which Kareem Serageldin was prosecuted.[236] The judge who presided over his sentencing, Alvin Hellerstein, described the culture in Credit Suisse as "an overall evil climate inside that bank and many other banks."[237] Again, the motive would be short-term gains at the expense of the best interests of the employer.

ST. J., Oct. 4, 2007, http://online.wsj.com/news/articles/SB119145916317748442 (stating that securitizers "found a willing audience [to buy mortgage-related securities] among town councils, small governments, charities, conservative state-run banks and risk-averse individual investors. Most of them were outside the U.S. and many had just a few million dollars, at most, to invest"); Dennis Schaal, *Pension Funds Fired Up About Subprime Mortgage Write-Downs*, CORP. RESP. MAG. (Jan. 30, 2008), http://thecro.com/node/603 (discussing union pension funds' subprime losses).

[233] *See* Yalman Onaran & Dave Pierson, *Banks' Subprime-Related Losses Surge to $591 Billion: Table*, BLOOMBERG (Sept. 29, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aSlW.imTKzY8.

[234] *See supra* Part I.C.

[235] *See* Ran Duchin & Denis Sosyura, *Safer Ratios, Riskier Portfolios: Banks' Response to Government Aid*, 113 J. FIN. ECON. 1 (2014).

[236] *See supra* text accompanying notes 20–21.

[237] Rachel Abrams & Peter Lattman, *Ex-Credit Suisse Executive Sentenced in Mortgage Bond Case*, N.Y. TIMES DEALBOOK (Nov. 22, 2013), http://dealbook.nytimes.com/2013/11/22/ex-credit-suisse-executive-sentenced-in-mortgage-case/.

There have been major job cuts in the financial sector since the crisis,[238] but these have mostly fallen on "junior people," not executives.[239] Fraud perpetrated by individual bankers against their employers may well have occurred at high levels; however, there is a limit on the pervasiveness of such fraud. Even if one is skeptical of Wall Street's capacity to self-regulate, it stretches credibility to say that every bank is a shell for self-enriching looters. For the housing bubble to have inflated, a significant number of people must have actually believed in it.[240] This is part of the reason district courts have dismissed many civil subprime security-related fraud suits brought since the crisis for failure to adequately plead scienter.[241] The historical evidence of the following Subsection further supports this conclusion with regard to the causation of the crisis.

b. Historically, Bubbles Have Not Needed Masterminds

Like all unhappy financial events, the 2007–08 financial crisis was unhappy in its own way,[242] but it was still the result of a speculative bubble popping, and it bears many similarities to earlier crises caused by speculative busts. Analogy to these suggests that no fraud was necessary for the 2007–08 crisis to progress as it did.

According to economists Carmen Reinhart and Kenneth Rogoff, a recurring feature of bubbles is "this-time-is-different syndrome": governments, banks, or corporations take on larger short-term debts, confident that there will not be a sharp correction like corrections past, every-

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[238] *See* Max Abelson & Ambereen Choudhury, *Wall Street Unoccupied with 200,000 Job Cuts*, BLOOMBERG (Nov. 21, 2011), http://www.bloomberg.com/news/2011-11-22/wall-street-unoccupied-with-200-000-job-cuts.html; Paul Davidson, *Financial Firms Cutting Thousands of Jobs*, USA TODAY, Nov. 4, 2013, http://www.usatoday.com/story/money/business/2013/11/02/financial-services-firms-job-cuts/3283105/ (stating that financial firms have "recover[ed] more slowly than other sectors from the 2008 financial crisis").

[239] *See* William Alden, *Laid Off on Wall Street: Lowest-Paid Workers Losing Jobs*, HUFFINGTON POST (Sept. 21, 2011), http://www.huffingtonpost.com/2011/07/22/wall-street-layoffs_n_906364.html ("[A]s banks again resort to pink slips, they appear inclined to spare the most generously compensated executives—the people who enjoyed the biggest gains from the bubble in mortgage-related investments that savaged the economy—while instead dismissing less-expensive employees.").

[240] *See, e.g.*, REINHART & ROGOFF, *supra* note 39, at xxxix–xlv (arguing that financial bubbles do not inflate without a baseline of institutional, governmental, and public confidence, and that bubbles burst when this confidence collapses).

[241] *See* Christopher J. Miller, Note, *"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 (2011).

[242] *Cf.* LEO TOLSTOY, ANNA KARENINA 1 (Constance Garnett trans., Doubleday & Co., Inc. 1948) (1877) ("Happy families are all alike; every unhappy family is unhappy in its own way.").

thing is "merrily rolling along for an extended period, when *bang!*—confidence collapses, lenders disappear, and a crisis hits."[243] They argue that this syndrome developed in full force with the 2007–08 crisis; overconfidence in financial modeling, U.S. regulation and monetary policy, and international diversification caused private banks to take on dangerous amounts of leverage and regulators to "take steps that push[ed the] economy toward greater risk in an effort to keep the boom going."[244] Robert Shiller explains that this paralleled a wave of irrational exuberance in the housing market, when homeowners took on bigger mortgages on bigger properties because they believed prices would keep going up.[245]

As Judge Posner points out, private investors encourage institutions to adopt risky strategies in the run-ups to eventual financial crises, even if the investors do not do so consciously. Because they move their money to investment funds that have done well recently, and the funds that have doubled down on speculation such as risky lending are the likeliest to have done well recently, capital flows from safe-but-middling to risky-but-well-performing funds.[246] This is because of risks that are "invisible to most investors," but this invisibility "need [involve] no deception."[247] Bubble investing may be rational "if investors have a reasonable expectation of a continued increase in value" because "it is only after the bubble bursts that a run up in prices can be said for sure to have been a bubble," and even if it is clear that a bubble is building, it may still be possible to come out ahead if one gets out at the right time. [248] The patterns and developments discussed by Reinhart, Rogoff, Shiller, and Posner speak to defects of human foresight for which regulation may be the best antidote, but they also explain how booms and busts happen time and again without anyone needing to criminally deceive anyone on a large scale.

It is true that in the years leading up to the crisis, there was a spike in mortgage fraud, but this may be effect rather than cause.[249] Economist

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[243] REINHART & ROGOFF, *supra* note 39, at xxxix.

[244] *Id.* at 213–14.

[245] ROBERT J. SHILLER, IRRATIONAL EXUBERANCE, xiv, 26, 78–80 (2d ed. 2009).

[246] POSNER, *supra* note 101, at 26–27.

[247] *Id.* at 27, 246–47.

[248] *Id.* at 247.

[249] *But see Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?: Hearing Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong. 127 (2010) (statement of James K. Galbraith, Lloyd M. Bentsen, Jr. Chair in Gov't/Bus. Relations, Lyndon B. Johnson Sch. of Pub. Affairs, Univ. of Tex. at Austin) (Galbraith, a proponent of William Black's control fraud theory and one of the few academic economists to take seriously the claim that fraud caused the 2007-08 crisis, chastises other economists for "soft-pedal[ing] the role of fraud in every crisis they examined").

Nouriel Roubini writes that "the revelation of a staggering fraud" like Bernard Madoff's may be the spark that ignites a crisis, but also that "widespread fraud" is one of the "hallmarks of a classic crisis."[250] Fraud is easier to conceal as a bubble inflates because "investors are content and often are happy to borrow against the increase in their wealth if they need the money for their living expenses," though when the bubble bursts there is a call on paper wealth and so swindles come to light.[251] Even if one views the mass downgrade in mortgage-related securities as the "revelation of a staggering fraud" of sorts that precipitated the crisis, its precipitation was a matter of when, not if. Some high-level executives may have known of and profited from the shoddiness of what they were selling, but their efforts are not necessary and not sufficient to explain the crisis. The dynamics of forming and popping a multitrillion-dollar bubble of global scope seem too big, too complex, and subject to too many exogenous variables to be engineered by a central group of manipulators.

C. The Doubtful Reach of Deterrence

If high-level fraud alone does not cause financial crises, it is plain enough that even if high-level fraud convictions deter future frauds, they still will not prevent future financial crises. But even if there is a weak causal link between fraud and crises, the deterrent effect of convictions may still be limited.

The deterrence theory of punishment assumes that would-be criminals are rational actors who derive positive utility from their crimes. The threat of punishment will only deter them where the likelihood of punishment multiplied by the magnitude of the penalty produces an expected negative utility greater than the expected positive utility gained by committing the crime.[252] If this rationalistic model of criminality accurately reflects any real person's thought processes, it is probably those of the white-collar criminal who makes similar calculations in her daily life. It is fair to concede that punishing elite bankers for committing fraud will to some extent deter other elite bankers tempted to commit fraud.

But the extent of that deterrence, empirical research suggests, will largely depend upon the certainty of punishment rather than its severity.[253] For the fraud-causation theory of the crisis to make sense, there must have been many high-level perpetrators of fraud, not just a few bad apples. It follows that quite a few high-level convictions would be need-

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[250] ROUBINI, *supra* note 103, at 21, 52.

[251] KINDLEBERGER & ALIBER, *supra* note 41, at 118.

[252] Piliavin et al., *supra* note 210, at 101–02.

[253] *E.g.*, Jeffrey Grogger, *Certainty vs. Severity of Punishment*, 29 ECON. INQUIRY 297, 308 (1991) (summarizing meta-analysis of several studies as "point[ing] to large deterrent effects emanating from increased certainty of punishment, and much smaller, and generally insignificant effects, stemming from increased severity of sanction").

ed to effectively deter similar frauds. But high-level convictions take lots of time and money, and more than a few may be too much to ask of a thinly spread investigative and prosecutorial corps. As criminal law professor and former Assistant U.S. Attorney Daniel Richman warns:

> Unless we are careful—or are ready for a more sustained commitment of resources—the message of a relative handful of prosecutions will be "a few heads will roll when the market takes a deep dive and the public seeks retribution." And the target deterrence audience will weigh the slim chance that lightning will strike them against the enormous financial gains from continued play.[254]

The obvious retort is, "so make a more sustained commitment of resources." This is not a frivolous request, but given the at-best weak causal link between fraud and crisis, it is a tough sell to a society with limited resources, at least if the point of prosecution is Benthamite consequentialist deterrence.

IV. THE HARM OF UNPUNISHED HIGH-LEVEL FRAUD

Prosecution, however, has objectives and meanings other than deterrence. The popular narrative that high-level fraud caused the financial crisis is inaccurate, but even if the facts surrounding the crisis were more widely known, the impulse towards individual punishment for crimes committed during the run-up to the crisis probably would not disappear entirely, for reasons this Part explains.

A. Unpunished Elite Crime, Crisis, and Expressive Failure

Criminal punishment expresses society's judgment that an act is wrongful, and authorities' failure to punish acts so designated harms society by failing to vindicate its judgment.[255] A failure to punish elite crimes is particularly harmful because it calls into question the fairness and impartiality of the justice system itself. As journalist Matt Taibbi puts it, "the shocking pattern of nonenforcement with regard to Wall Street . . . raises a profound and difficult question about the very nature of our society: whether we have created a class of people whose misdeeds are no longer perceived as crimes . . . . [a] nonjailable class."[256] Even a hardcore utilitarian skeptical of expressivist appeals must

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[254] Daniel Richman, *Corporate Headhunting*, 8 HARV. L. & POL'Y REV 265, 276 (2014).

[255] *See* Amy J. Sepinwall, *Failures to Punish: Command Responsibility in Domestic and International Law*, 30 MICH. J. INT'L L. 251, 295 (2009).

[256] Matt Taibbi, *Why Isn't Wall Street in Jail?*, ROLLING STONE (Feb. 16, 2011), http://www.rollingstone.com/politics/news/why-isnt-wall-street-in-jail-20110216.

acknowledge that as a matter of pure utility, a society in which most people believe the authorities do not punish elites who deserve it is an unwell society. Depending on who's polling, that's either a majority or a supermajority of the United States.[257]

After serious social, political, and economic turmoil, there is often a public desire to punish elites.[258] This makes sense so far as society gives elites privileges and advantages on the expectation that they will use their greater power to benefit the community and prevent bad things from happening.[259] Of course, our criminal justice system only permits individual punishment after individual determinations of guilt based on evidence. Failures to prevent bad things from happening may not be the result of crimes, and even where they are, it does not follow that they are Banker *A*'s crimes. When authorities cynically divert this public impulse in the direction of revanchism, the result may be "show trials" that hinder meaningful reform.[260]

But the impulse itself is a legitimate one, and deserves at least the dignity of committed investigation and pursuit when the facts indicate that members of the elite have committed crimes. The perceived failure of the authorities to make this commitment after the financial crisis has disturbed many people and caused social unrest.[261] These impulses would probably still be present—and have reason to be—even if the weakness of the causal link between high-level crime and the crisis was more widely understood.

B. Which Elites?

The years after the crisis have seen a number of high-profile prosecutions of prominent individuals in the financial sector. Those convicted have included former NASDAQ chairman Bernard Madoff, billionaire financier Allen Stanford, billionaire hedge fund manager Raj Rajaratnam, Goldman Sachs director and former McKinsey leader Rajat Gupta, and executives at SAC Capital, formerly one of the largest and highest-paying hedge funds on Wall Street.[262] Maybe this list should be

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[257] *See supra* Subsection II.A.i.

[258] *See* W. Michael Reisman, *Myth System and Operational Code*, 3 YALE STUD. WORLD PUB. ORD. 229, 238–39 (1977).

[259] *Id.* at 233–34.

[260] *See* Richman, *supra* note 254, at 280 ("[T]hose who worry about the heavy hand of government may not be as keen to see heads roll. But if forced to choose, I suspect they would prefer a few show trials to sustained regulatory intervention.").

[261] *See supra* Section II.A.

[262] *See Ex-Tycoon Stanford Sentenced to 110 Years in Prison*, ABC 13 EYEWITNESS NEWS (June 14, 2012), http://abc13.com/archive/8700708/; Stephen Gandel, *SAC Guilty Verdict: What It Means for Steven Cohen* (Feb. 6, 2014), http://finance.fortune.cnn.com/2014/02/06/sac-guilty-martoma-steve-cohen/ (discussing eight SAC convictions); Diana B. Henriques, *Madoff Is*

longer, but it illustrates a meaningful commitment to punish even very powerful people for their transgressions.

Nonetheless, there are patterns to the list that suggest troubling limits to this commitment. First, the convicted were all punished for crimes that are relatively easy to prove: Ponzi schemes for the first two, and insider trading for the latter three.[263] This supports Judge Rakoff's charge that white-collar investigative and prosecutorial resources are spread too thin to go after the hardest cases. Second, there are no convictions for crimes related to the financial crisis, although the "low tide" of the crisis helped expose the Ponzi schemes.[264] Third, the convicted individuals were affiliated with hedge funds rather than banks. Individual hedge fund managers may have better chances of striking it rich than individual bankers,[265] and in the aggregate hedge funds play an important role in our financial system,[266] but banks are orders of magnitude larger. SAC had 1000 employees and $14 billion under management before its unraveling in 2013;[267] Lehman Brothers, the fourth-largest investment bank before its collapse, had 26,200 employees and $639 billion in assets.[268]

Sentenced to 150 Years for Ponzi Scheme, N.Y. TIMES, June 29, 2009, http://www.nytimes.com/2009/06/30/business/30madoff.html; David S. Hilzenrath, *Hedge Fund Billionaire Raj Rajaratnam Is Convicted of Fraud*, WASH. POST, May 11, 2011, http://www.washingtonpost.com/business/economy/hedge-fund-billionaire-raj-rajaratnam-is-convicted-of-fraud/2011/05/11/AFN6fRuG_story.html; Walter Pavlo, *Ex-McKinsey Boss, Rajat Gupta, Sentenced to 2 Years in Federal Prison*, FORBES (Oct. 24, 2012), http://www.forbes.com/sites/walterpavlo/2012/10/24/ex-mckinsey-boss-rajat-gupta-sentenced-to-2-years-in-federal-prison/.

[263] *See* Rakoff, *supra* note 1 (describing these as easy crimes to prove).

[264] *See supra* note 251 and accompanying text.

[265] *See* Alexandra Stevenson, *Hedge Fund Moguls' Pay Has the 1% Looking Up*, N.Y. TIMES DEALBOOK (May 6, 2014), http://dealbook.nytimes.com/2014/05/06/hedge-fund-moguls-pay-has-the-1-looking-up/ ("The 25 highest-earning hedge fund managers in the United States took home a total of $21.15 billion in compensation in 2013.").

[266] *See* Timothy F. Geithner, Keynote Address at the National Conference on the Securities Industry (Nov. 17, 2004) ("The term hedge fund is used to describe a diverse group of financial institutions, which together play an increasingly important role in our financial system.").

[267] *See* Agustino Fontevecchia, *Steve Cohen Personally Made $2.3B in 2013 Despite Having to Shut Down SAC Capital*, FORBES (Mar. 13, 2014), http://www.forbes.com/sites/afontevecchia/2014/03/13/steve-cohen-personally-made-2-3b-in-2013-despite-having-to-shut-down-sac-capital/.

[268] *See* PRICEWATERHOUSECOOPERS, LEHMAN BROTHERS' BANKRUPTCY: LESSONS LEARNED FOR THE SURVIVORS 2 (2009) (stating Lehman's assets); Dan Wilchins, *M&A Fees Lift Lehman Profits*, REUTERS (June 12, 2007), http://blogs.reuters.com/reuters-dealzone/2007/06/12/lehman-brothers-profit-lifted-by-record-merger-advisory-fees/ (stating Lehman's size relative to other banks); Alistair Osborne, Philip Aldrick & James Quinn, *Lehman Collapse: The*

Judge Rakoff is surely correct that the too-big-to-jail logic that militates against prosecution of banks makes no sense for their employees.[269] Though conspiracy theories abound about favoritism and political corruption preventing prosecutions of bankers, the better explanation may just be that it is too hard for resource-poor outsiders to know beyond a reasonable doubt what individuals within enormous institutions know. It is significant that Kareem Serageldin, the convicted Credit Suisse trader, was turned in to the S.D.N.Y. U.S. Attorney's Office by his bosses.[270] How else would the prosecutors have known, or known enough, to bring the case? The demanding evidentiary standard for conviction of the specific intent crime of fraud combines with the inherent difficulty of discerning what is going on within a complex organizational form to make high-level banking prosecutions uniquely daunting, even compared with prosecutions of officers of smaller, simpler organizations.[271]

Though I do not purport to quantify it here, the disparity in the treatment of members of large and small firms qualitatively *feels* great, and this may explain why even if high-level fraud by bankers did not cause the financial crisis, the near-complete lack of banking prosecutions is disturbing. Occupy Wall Street and its supporters claim it is a sign of a "two-tiered justice system in which the powerful are immunized while the powerless are punished with increasing mercilessness."[272] This message resonates in an age of ramping income inequality,[273] a shrinking middle class,[274] and greater political power for the wealthy.[275] And the

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Drama of a Mad 48 Hours that Will Never Fade, TELEGRAPH (Sept. 13, 2009) http://www.telegraph.co.uk/finance/financialcrisis/6179138/Lehman-collapse-the-drama-of-a-mad-48-hours-that-will-never-fade.html (stating Lehman's number of employees).

[269] Rakoff, *supra* note 1.

[270] *See supra* notes 20–21 and accompanying text.

[271] *See* F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 522–26 (1945) (discussing the problem of diffuse knowledge within the organization); *see also* Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2214 (2010) (applying Hayekian framework to the problem of identifying fraud within firms). *But see* Richman, *supra* note 254, at 269 (questioning whether "beyond a reasonable doubt" standard is a meaningful barrier to banking prosecutions where prosecutors "regularly meet [it] in any number of mundane white-collar cases").

[272] Glenn Greenwald, *How the Rich Subverted the Legal System and Occupy Wall Street Swept the Land*, THE NATION (Oct. 25, 2011), http://www.thenation.com/article/164162/how-rich-subverted-legal-system-and-occupy-wall-street-swept-land.

[273] *See generally* THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (Arthur Goldhammer trans., 2014).

[274] *See* Karin Kamp, *By the Numbers: The Incredibly Shrinking American Middle Class*, MOYERS & CO. (Sept. 20, 2013), http://billmoyers.com/2013/09/20/by-the-numbers-the-incredibly-shrinking-american-middle-class/.

sense of two-trackedness is no doubt heightened by the prudentially necessary but correctively unjust bailout of the industry that caused the mess, some of the money from which was diverted to executive bonuses,[276] while other people and industries suffered.

As I have tentatively suggested, insiders within large, complex institutions like banks may receive more lenient criminal treatment than others not because they are wealthy or because a governing cabal has decided to spare them, but because information about the insiders' activities is especially difficult to gather from the outside. If this is so, it is less worrisome for the ideal of equal justice under the law than a consciously crafted policy of leniency based on favor or elitism. But it is worrisome nevertheless to have a "nonjailable class," to use Taibbi's phrase, whatever the reason may be.[277] Judge Rakoff is probably right that the Department of Justice's disorganization and lack of prioritization is partly to blame for the lack of prosecutions to date, though the recent revitalization of criminal RMBS investigations in a committed working group is a welcome sign.[278] At root, the problem may simply be the lack of resources dedicated to investigation and prosecution.[279] Sustained commitments of people, money, and time are all necessary to figure out and act upon what people in very large organizations know and have done. If we as a society continue to be committed to a one-track justice system, these are commitments we must be willing to make.

V. POLICY IMPLICATIONS

A. *Civil and Regulatory Reform*

It has been a recurring theme of this Article that regulation is a more reliable means of preventing future crises than criminal punishment. In

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[275] *E.g.*, McCutcheon v. FEC, 134 S. Ct. 1434 (2014) (striking down federal limit on aggregate campaign contributions as a violation of the First Amendment).

[276] Stephanie Gaskell, *On Heels of Bailout, Wall Street Bonuses Jump 17% to $20B+ in 2009: NY Comptroller Thomas DiNapoli*, N.Y. DAILY NEWS (Feb. 23, 2010), http://www.nydailynews.com/news/money/heels-bailout-wall-street-bonuses-jump-17-20b-2009-ny-comptroller-thomas-dinapoli-article-1.165837. Henry Paulson, the former Secretary of the Treasury, told Andrew Ross Sorkin that it would have been impossible to persuade the majority of the banks to participate in the program with significant restrictions on pay. Andrew Ross Sorkin, *Five Years After TARP, Misgivings on Bonuses*, N.Y. TIMES DEALBOOK (Aug. 26, 2013), http://dealbook.nytimes.com/2013/08/26/five-years-after-tarp-misgivings-on-bonuses/.

[277] *See* Taibbi, *supra* note 256.

[278] *See* Rakoff, *supra* note 1; *supra* notes 15–14 and accompanying text.

[279] *See* Richman, *supra* note 254, at 273 ("[T]he recent record of resource commitment is poor indeed. . . . [P]rosecutors and the FBI—agencies whose punitive focus generally makes them more attractive funding targets—were . . . underfunded.").

an unregulated market, the legal and individually rational actions of participants may collectively produce the socially disastrous outcomes of boom and bust.[280] Fraud may piggyback on the booms and perhaps make the busts worse as a result, but its potency comes from its interactions with lawful but undesirable dynamics. Only the government, which is in the business of maximizing outcomes across the board rather than capturing profits heedless of the negative externalities of its methods, is in the position to prevent these dynamics from getting out of control. This is Judge Posner's conclusion:

> [T]he private sector cannot be expected to adopt measures, such as forbearing to engage in highly risky lending, that might prevent a depression, and [this is] why preventing depressions has to be a government responsibility. Even though the financial industry has more information bearing on the likelihood of a depression than the government does, it has little incentive to analyze that information. A depression is too remote an event to influence business behavior.[281]

It remains to be seen whether Dodd-Frank does the job. Its critics have argued that it focuses on minutiae but doesn't fix the defects in the American financial sector that made the crisis possible.[282] In particular, it does not address the dangerous concentration in the banking system that creates the systemic risk and moral hazard of too-big-to-fail institutions.[283] On the other hand, Dodd-Frank has effected innovations that make major and far-reaching changes in the way banks can invest and lend money, like the Volcker Rule, which restricts proprietary trading by banks, and the CFPB's Regulation Z, which creates a detailed framework to protect borrowers from abusive mortgage-lending practices.[284]

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[280] *See supra* Subsection III.B.ii.b.

[281] POSNER, *supra* note 101, at 27–28.

[282] *E.g.*, Reza Dibadj, *Reactionary Reform and Fundamental Error*, 39 W. ST. U. L. REV. 281, 285–87 (2012).

[283] *See* Alden, *supra* note 26 (summarizing the panel remarks of economist Robert Shiller).

[284] Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z), 77 Fed. Reg. 51, 116 (Aug. 23, 2012) (to be codified at 12 C.F.R. pts. 1024, 1026); Joint Press Release, Federal Reserve Board, Agencies Issue Final Rules Implementing the Volcker Rule (Dec. 10, 2013); *see also* Tyler Cowen, *Is the Volcker Rule a Good Idea?*, MARGINAL REVOLUTION (Dec. 9, 2013), http://marginal revolution.com/marginalrevolution/2013/12/the-pressure-to-finish-the-volcker-rule.html (summarizing the pros and cons of the Rule). On Dodd-Frank's role in empowering administrative agencies to promulgate sweeping reform regulations like the Volcker Rule and Regulation Z, see *supra* notes 26–29 and accompanying text.

(Their critics say the changes either go too far or do not go far enough.[285])

Reform legislation passed in the wake of scandals and crises is often criticized for looking backwards at the last problem without addressing future problems. Sarbanes-Oxley, passed after the accounting scandals of the early 2000s, was meant to prevent reckless corporate risk-taking; instead, it did a lot to prevent future accounting scandals, but failed to prevent the different kind of reckless risk-taking that caused the 2007–08 financial crisis.[286] The problem with reform legislation, its skeptics might say, isn't just that it doesn't anticipate the next crisis; it is that private-sector actors do their utmost to stay just within the letter of the law while flouting its intentions. This presents a serious challenge for legislators and regulators who want to effect lasting change without stifling legitimate economic activity.

If one shares the skeptics' concerns, then legal controls that directly target individuals may be a necessary complement to a program of technocratic reform. "Control fraud" is at once too crude and too specific a label to describe the behavior of high-level people in firms who do legally and ethically ambiguous things that benefit themselves, but Professor Black's insight that individuals who act in the name of the firm do not always act in its best interests is an important one. Meaningful financial reform must change the way these individuals make decisions as well as the way firms do. Though here too regulators may lag one step behind the legal but unnecessary risky behavior they mean to deter,[287] they stand a better chance of catching up where their adversaries do not have legal teams continually inspecting the law for loopholes, and where the individual activity they target is necessarily smaller, simpler, and easier to define than the activity of firms comprised of hundreds or thousands of individuals.

While the criminal law may seem like the most intuitive lever to this end, civil regulation may well be the best tool here as well. So long as investigative and prosecutorial resources are limited, the fear of prosecution may be an ineffective deterrent where the odds of actual enforce-

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[285] *See, e.g.*, Cowen, *supra* note 284; Jack Milligan, *What Is Good, and Bad, About the CFPB*, BANK DIR. (Apr. 20, 2012), http://www.bankdirector.com/magazine/archives/2nd-quarter-2012/what-is-good-and-bad-about-the-cfpb/ (summarizing the pros and cons of CFPB regulation).

[286] *See, e.g.*, Alex J. Pollock, *Sarbanes-Oxley in the Light of the Financial Crisis*, AEI ONLINE (Nov. 18, 2009), http://www.aei.org/article/economics/financial-services/banking/sarbanes-oxley-in-the-light-of-the-financial-crisis/ ("All Sarbanes-Oxley's efforts to control risk did not avoid the tremendous financial bubble and bust of the last several years."); *see also* Jesse Eisinger, *To Envision Dodd-Frank's Future, Look to Its Predecessor*, N.Y. TIMES, Feb. 8, 2012, http://dealbook.nytimes.com/2012/02/08/to-envision-dodd-franks-future-look-to-its-predecessor (noting that Sarbanes-Oxley largely succeeded in preventing major accounting frauds in connection with the 2007-08 crisis).

[287] I am grateful to Daniel Wallmuth for this insight.

ment are miniscule.[288] And anyway, the harmful behavior of these individuals still may not be criminal, though it may breach fiduciary duties in violation of civil law. If the basic dynamic to be disrupted is short-termist decision making that leads to immediate personal reward but harms the firm and the public in the long term,[289] mechanical rules that make these decisions less appealing may be preferable to criminal laws that require prosecutorial effort and do not implement themselves.

For example, Dodd-Frank includes mandatory clawback provisions that require executives to return some of their compensation to their firms when the firms correct erroneous financial statements, whether or not the executives were aware of any wrongdoing.[290] These provisions have disturbed some observers because of their rigidity and potential for punishing some innocent executives while preserving loopholes for bad actors.[291] The Dodd-Frank clawback provisions' mechanical rules could be better crafted, but the general idea is sound.

B. The Role of Criminal Law in Financial Reform

A targeted program of civil and regulatory reform is the best way to prevent future financial crises, but it has its limitations. First, regulated parties may have the political wherewithal to neuter regulations that harm their interests but are socially beneficial overall.[292] Second, a civil fine or regulatory rebuke lacks the expressive power of a criminal sanction to mark an action or actor as wrongful.

I have spent much of this Article questioning and criticizing the account of the crisis that claims it was caused by high-level fraud. I believe this sustained criticism is worthwhile for pointing the way towards the only reliable corrective for financial crises, economic regulation, but my intent is not to deliver an apologia for banks and bankers. I tend to agree with President Obama's assessment that "one of the biggest problems about the . . . financial crisis and the whole subprime lending fiasco is that a lot of that stuff wasn't necessarily illegal, it was just immoral or

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[288] *See supra* Section III.C.

[289] *See, e.g.*, ROGER BARKER, IOD, GETTING TO GRIPS WITH SHORT-TERMISM 3 (2012) (defining "short-termism" as "a situation in which companies display a preference for business strategies that generate an early pay-off relative to strategies that would have added much more value, but at a significantly later point in time.").

[290] *See* Jesse M. Fried & Nitzan Shilon, *The Dodd-Frank Clawback and the Problem of Excess Pay*, CORP. BOARD 15, 16 (Jan.–Feb. 2012) http://www.law.harvard.edu/faculty/jfried/1201FriedShilon.pdf.

[291] *E.g.*, Sam Sharp, Note, *Whose Money Is It Anyway? Why Dodd-Frank Mandatory Compensation Clawbacks Are Bad Public Policy*, 10 GEO. J. L. & PUB. POL'Y 321, 327, 332–35 (2012).

[292] *See* Richman, *supra* note 254, at 273, 275–80.

inappropriate or reckless."[293] For the "immoral" subset of this stuff, the stuff that is more intimately related to the pathology of the crisis than whatever epiphenomenal fraud occurred, the stuff that gives rise to the desire for condemnation and punishment, the shortcoming may be one of substantive criminal law.

This may sound odd to those who believe criminal liability is boundless, as particularly at the federal level, it is limited only by prosecutorial discretion. As Professor Tim Wu recounts, S.D.N.Y. prosecutors used to play the "darkly humorous" game of naming random celebrities, such as Mother Teresa or John Lennon, and coming up with plausible crimes for which to indict them, usually the "incredibly broad yet obscure crimes that populate the U.S. Code like a kind of jurisprudential minefield. . . . The result . . . was inevitable: 'prison time.'"[294] But this may exaggerate the breadth of the law as it is actually applied.

Dan Richman points out that many of the more expansive doctrines of criminal liability "owe [their] survival as much to careful prosecutorial use as to judicial recognition. . . . [P]rosecutors are well aware that if they can't present a clear narrative of moral wrongdoing, a felony case against an individual defendant isn't likely to go anywhere."[295] Courts may be reluctant to boundlessly expand criminal liability for vague offenses in the white-collar world, where the line between legitimate and illegitimate conduct is blurry and in flux.[296] And white-collar defendants, who are better-lawyered and have more to lose than most defendants, are less likely to plead out when threatened with a creative theory.[297] As a jurisprudential matter, new substantive law would allow judges and juries to convict or acquit those accused of an offense in the heartland of a new statute rather than bless aggressive expansions of mainstay offenses like wire fraud that could have unpredictable consequences down the road. As an expressive matter, this would have the effect of avoiding the indirection of the broadest statutes and condemning the guilty for offenses more closely related to the harm they actually did.

New enactments would still need to be careful not to criminalize legitimate economic activity. As Professor Henry Hart observes, "the criminal law always loses face if things are declared to be crimes which peo-

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[293] Press Release, President Barack Obama, News Conference on the American Jobs Act (Oct. 6, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/10/06/news-conference-president.

[294] Tim Wu, *American Lawbreaking*, SLATE (Oct. 14, 2007), http://www.slate.com/articles/news_and_politics/jurisprudence/features/2007/american_lawbreaking/introduction.html.

[295] Richman, *supra* note 254, at 270.

[296] *See* Sanford H. Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423, 429 (1962).

[297] *See, e.g.*, Rakoff, *supra* note 1.

ple believe they ought to be free to do, even wilfully."[298] I do not presume to propose a detailed solution to striking this difficult balance here. Some element of individual culpability, if not full-blown willfulness, seems necessary: a fair law would need to be something short of the 1863 proposal by the first Comptroller of the Currency that "the failure of a national bank be declared prima facie fraudulent, and that the officers and directors, under whose administration such insolvency shall occur . . . be punished criminally, unless it shall appear, upon investigation, that its affairs were honestly administered."[299] (Though as Alan Greenspan wryly observes, "Under such a regime, moral hazard surely would not exist."[300]) The United Kingdom provides a possible blueprint in its Financial Services (Banking Reform) Act 2013, which criminalizes reckless decision making by senior managers of financial institutions that causes those institutions to fail and provides for a penalty of up to seven years' imprisonment.[301] It remains to be seen how effective and fair this law is in practice.

If new substantive law with a reduced *mens rea* standard is too uneasy a prospect, politically or for its potential for abuse, then we are left with the criminal law already on the books. It might not be able to condemn the full range of behaviors people find condemnable, but it is versatile and has withstood the test of time. Now it just has to be used.

CONCLUSION

The 2007–08 financial crisis casts a long shadow. The United States economy is on a worse trajectory than it was seven years ago,[302] and millions of people are worse off. The crisis was a man-made and preventable event, and it is the more damaging because it would not have hap-

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[298] Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 L. & CONTEMP. PROBS. 401, 418 n.42 (1958).

[299] *See* Alan Greenspan, *The Crisis*, 41 BROOKINGS PAPERS ECON. ACTIVITY 201, 232 n.41 (Spring 2010).

[300] *Id.*

[301] Financial Services (Banking Reform) Act, 2013, c. 33, § 36(1) (U.K.), *available at* http://www.legislation.gov.uk/ukpga/2013/33/section/36/enacted. The Act defines the elements of the offense as (i) being a senior manager in relation to a financial institution; (ii) taking, agreeing to take, or failing to take steps that would prevent a decision as to the way in which the business of the institution is to be carried on; (iii) being "aware of a risk that the implementation of the decision may cause the failure of the group institution"; (iv) having "conduct in relation to the taking of the decision falls far below what could reasonably be expected of a person in [the decisionmaker's] position"; and (v) the financial institution's failing as a result of the decision. *See also* Julia Black & David Kershaw, *Criminalising Bank Managers*, LAW & FIN. MARKETS PROJ. BRIEFING 3 (2013) (arguing that under the Act's standard, even where conduct is clearly unlawful, "the chances that managers will be found to fall foul of a recklessness standard are very low").

[302] REIFSCHNEIDER ET AL., *supra* note 40.

pened but for concerted human action and inaction.[303] Preventing future crises, and learning everything we can from the 2007–08 crisis, must be a major focus of public policy in the coming years.

The role of the criminal law in this undertaking will be limited. As this Article has demonstrated, high-level fraud is neither a necessary nor a sufficient explanation for the 2007–08 crisis. The civil regulation of financial institutions and the individual actors within them is a surer approach to meaningful reform than is criminal prosecution, with its uncertain deterrent effect and its inability to target socially destructive behavior that falls outside traditional categories of wrongfulness. Although the criminal law cannot determine how financial resources should be allocated or how risk should be distributed, it has a powerful expressive function that may have been neglected in the aftermath of the 2007–08 crisis. This too is an important lesson—or reminder—of the crisis, and future policymakers will forget it at their peril.

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[303] *See* FCIC REPORT, *supra* note 42, at xvii (majority statement).