THE CONFIDENCE GAME: MANIPULATION OF THE MARKETS BY GOVERNMENTAL AUTHORITIES

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The global financial crisis which began in the summer of 2007 has focused the attention of governments and the international financial institutions on the regulation of financial institutions to an unusual degree. In response to the crisis the G20 and national governments are developing new mechanisms for ensuring financial stability, in order to try to prevent similar problems from arising in the future. Concerns about the financial viability of banks, and about the value of asset-backed securities issued by financial institutions were reflected in banks’ share prices. The crisis represented a massive global loss of confidence in the ability of the world's financial markets to value financial assets appropriately which has raised a range of issues for legislators and regulators.

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

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4 See, e.g., Caroline Bradley, Suspension and Disbelief (or, How Managed Should a Market Be?) 26 SETON HALL L. REV. 597 (1996).
These short-term measures have been designed to fix the financial markets by controlling behaviors considered to be harmful in the context of the crisis, such as short selling, and by providing regulatory and financial support for stock prices.

In normal times, governmental and self-regulatory authorities justify regulation of the financial markets by reference to the need to maintain confidence in the markets. But governmental action to protect investor confidence is generally


8 Regulators have also reacted to the crisis by intensifying their efforts with respect to enforcement. See, e.g., FSA Annual Report for 2008-9, 8 (Jun. 2009) available at http://www.fsa.gov.uk/pubs/annual/ar08_09/ar08_09.pdf (During the past year, we have demonstrated our resolve to bring credible deterrence to bear on financial crime. On tackling market misconduct, we secured two convictions and a custodial sentence in our first ever insider dealing criminal trial – a clear warning that wrongdoers who cheat the market will be held to account.”); Yin Wilczek, SEC Enforcement: In Mid-Year Reviews, Lawyers Give Enforcement Division High Marks for Revamp, BNA Securities Law Daily (Jul. 15, 2009).

9 See, e.g., FSA Annual Report 2008-9, supra note 8, at 8 (“FSMA also sets the FSA a consumer protection objective. Maintaining financial stability and confidence is in itself a crucial means by which we pursue this objective”.)

Cf.
characterized as action to guarantee the integrity of the markets, meaning that regulation should ensure that pricing in the markets is accurate. Investor protection is necessary in part because protecting investors’ interests encourages confidence, and more investment. Regulations which target fraud, insider trading, and market manipulation are designed to maintain confidence in the financial markets, as are rules which are designed to prevent financial market participants from putting their own interests before those of their clients. Such rules are designed to maintain confidence by ensuring the integrity of the markets. Because the maintenance of confidence is at the heart of much financial regulation, a massive lack of confidence seems to be a significant market or regulatory failure justifying governmental intervention.

Governmental action designed to stop some market participants from manipulating the markets at the expense of others, leading to a decline in confidence in the markets is geared to preserve confidence by preserving the integrity of the markets. Emergency amendments to rules on short selling were motivated by a


10 See, e.g., Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation, Recital 12, OJ No. L 96/16 (Apr. 12, 2003)(“The objective of legislation against insider dealing is the same as that of legislation against market manipulation: to ensure the integrity of Community financial markets and to enhance investor confidence in those markets.”)

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

12 See, e.g., US Treasury, Financial Regulatory Reform, *supra* note 2, at 2 (“We must act now to restore confidence in the integrity of our financial system.”)
concern to prevent market manipulation by market participants. However, some governmental responses to the financial market crisis seem to treat the preservation of confidence in the markets (rather than the preservation of market integrity) as the fundamental concern of regulation. This is a risky strategy, because adopting emergency measures to manipulate the markets in the interests of improving confidence risks undermining the ability of regulators to control the behavior of financial institutions for the future in any meaningful way. If governments react to a crisis by disapplying existing rules in the interests of maintaining confidence, they may create expectations among market participants that they will react to future crises in the same way. Market participants’ incentives to comply with the rules could be reduced, and they might experience increased confidence that they can make sure that the rules will work to their advantage.

Emergency measures must often be adopted swiftly, and they may be implemented without the level of consultation governments and supranational authorities typically argue to be necessary. They may therefore seem less legitimate than other, more openly debated measures. It is common for rules of financial regulation to be adopted speedily in response to crisis, but rules adopted in such circumstances are vulnerable to subsequent criticism, and in particular to the critique that politics rather than good policy were responsible for generating the new rules.

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


Consider, for example, the criticisms of the Sarbanes-Oxley Act of 2002, enacted very quickly in response to the collapse of a number of large US corporates,
Where governmental initiatives are designed to manipulate confidence in the markets, rather than to create the conditions for longer term confidence in those markets, they may in the end undermine confidence. In particular, support schemes for financial institutions which place over-generous valuations on bank assets when they are purchased by governmental authorities, and/or allow financial institutions to exit from the schemes at too favorable a price, and a reluctance to impose aggressive regulation on entities whose actions contributed to the crisis, such as credit rating agencies, raise questions about whether the responsible governments have any real fundamental commitment to sound valuation and risk assessment practices. Debates about whether financial institutions should be required to follow mark-to-market accounting requirements during periods of market volatility raise including Enron.


18 See, e.g., GAO, Troubled Asset Relief Program: Status of Efforts to Address Transparency and Accountability Issues, 7 GAO-09-920T (Jul. 22, 2009) (“We recommended that Treasury consider publicly disclosing additional details regarding the warrant repurchase process, such as the initial price offered by the issuing entity and Treasury’s independent valuations, to demonstrate Treasury’s attempts to maximize the benefit received for the warrants on behalf of the taxpayer.”)

similar questions.\footnote{20}

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

The current debates about how to structure financial regulation and accounting requirements in the context of the crisis and for the future illustrate that different groups have dramatically different views about how the financial markets should be regulated. For example, while some have argued forcefully that fair value accounting contributed to market instability, others argue with as much force that fair value accounting requirements are essential to protect the interests of investors.\footnote{23}

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

\footnote{21 See, e.g., Blundell-Wignall et al, supra note \textbf{17}, at 2 (“Crisis measures need to be accompanied by genuine reform of the regulations and other incentive structures that caused the crisis.”)}

\footnote{22 See, e.g., House of Commons Treasury Committee, Banking Crisis: Regulation and Supervision, 3 HC 767 (Jul. 31, 2009) (“The FSA must develop the confidence to take unpopular decisions when the economic boom begins again, in the face of both industry and the political class.”)}

\footnote{23 See, e.g., SEC, Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, (Dec. 30, 2008) available at http://www.sec.gov/news/studies/2008/marktomarket123008.pdf (“In the months preceding passage of the Act, some asserted that fair value accounting, along with the accompanying guidance on measuring fair value under SFAS No. 157, contributed to instability in our financial markets... Just as vocal were other market participants, particularly investors, who stated that fair value accounting serves to enhance the transparency of financial information provided to the public.”)}
International institutions have contributed to this debate. For example, the Basel Committee on Banking Supervision has stated that international accounting standards should “recognise that fair value is not effective when markets became dislocated or are illiquid”.  

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

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

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

27 See, e.g., id. at 25-6.


lobbying. Lobbying has had a significant impact on financial regulation in the past, and it is not yet clear whether the crisis has really changed attitudes to regulation in any significant or lasting way.

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

It is possible that the need to co-operate at the international level may help to constrain domestic policy-makers and discourage the adoption of manipulative

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

31 See, e.g., Poser, supra note 9, at 324 (“the SEC must again see itself as the defender of investors and a counterweight to securities-industry and corporate lobbyists, who have the money, the lawyers, and the political influence to defeat or water down regulatory proposals. On the federal level at least, the SEC is the investor's only champion.”

32 See, e.g., the G20 Declaration, supra note 3.

33 SEC Report, supra note 23 at 2.

34 G20 Declaration, supra note 3.
measures aimed to boost short term investor confidence in domestic markets. Certainly, the language of public statements about the reform of financial regulation by groups such as the G20, and by the International Financial Institutions and supranational regulatory networks would tend to suggest that there is a genuine transnational commitment to effective regulation of the financial markets. On the other hand, implementation of the transnational commitment is to be carried out in multiple levels of fora, which are less transparent to citizen-voters than domestic legislatures, and where well-resourced financial firms and their trade associations can participate actively in the negotiation of the new standards.35

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