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Unfinished Business

A Look at Wall Street, America's Financial Markets and The Obama Administration's Second Term

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President Obama faces many pressing issues in the wake of his reelection this past November, not least of which is ensuring the effectiveness of his financial reforms and continuing America's role as a leading financial market. The administration has achieved some notable successes in improving the transparency and integrity of the U.S. securities markets, including the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In addition, the SEC and other agencies have obtained numerous monetary recoveries and other settlements in enforcement actions. However, many investor advocates believe the Obama administration did not do enough to protect investors in its first term.

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The First Term: Some Notable Enforcement Successes, But a Mixed Record Overall

When President Obama took office in January 2009, the country was embroiled in a financial meltdown of historic proportions caused by years of high-risk lending practices and inflated asset valuations on Wall Street. Such an environment cried out for an aggressive enforcement policy and presented an opportunity to demonstrate that the grave consequences of financial fraud would not go unpunished. Against this backdrop, the Obama Administration scored some victories for investors in the years following the onset of the financial crisis.

For example, in April 2010, the SEC brought fraud charges against Goldman Sachs for failing to disclose to investors in a mortgage-related security known as a "CDO," or collateralized debt obligation, that the underlying assets of the security had been selected by an outside entity that was simultaneously shorting the security. Goldman paid $550 million to settle the charges in July 2010—the largest penalty ever assessed against a financial services firm in the SEC's history—and, in a rare move, admitted that its disclosures were misleading. In July 2010, the SEC obtained another large settlement against a Wall Street bank, as Citigroup paid $150 million to settle charges that it misled investors about its exposure to toxic subprime mortgage-related securities. In parallel proceedings, two former Citigroup executives paid $180,000 of their personal funds to settle similar charges. Finally, in October 2010, Angelo Mozilo, the former CEO of Countrywide Financial, agreed to pay $67.5 million to settle the SEC's fraud charges that he misled investors about Countrywide's lending practices and financial condition — the largest SEC settlement ever paid by a corporate executive.

Other aspects of the Obama Administration's enforcement record are more mixed. The Administration has not achieved success in criminally prosecuting senior executives of financial institutions who played a culpable role in the subprime crisis. The Department of Justice ("DOJ") brought criminal charges against two Bear Stearns hedge fund managers, Ralph Cioffi and Matthew Tannin, for misleading investors about the fund's financial condition, but they were acquitted in 2009. In the wake of that acquittal, the DOJ has not brought criminal charges against any of the senior executives of the firms at the epicenter of the financial collapse, such as Lehman Brothers, AIG, and Bear Stearns, for misleading statements and omissions about those companies' financial condition. In addition, the criminal investigation against Countrywide CEO Mozilo — who is considered by some to have been personally responsible, in some measure, for the subprime mortgage crisis — was quietly dropped without much explanation following his civil settlement with the SEC. Instead, the DOJ has elected to focus on insider trading cases, typically against employees of hedge funds. Although the Administration has achieved some significant success in this area — including obtaining the conviction of Raj Rajaratnam, founder of the Galleon Group, in May 2011 — the very different stance taken against individuals such as Mozilo and Dick Fuld, the former CEO of Lehman Brothers, has raised questions for some investors.

Overall, the SEC has been criticized by many for not acting as aggressively as it could have during the past four years. In 2009, the agency sued Bank of America for misleading shareholders in connection with the shareholder vote on its merger with Merrill Lynch, contending that the Bank failed to disclose a secret agreement allowing Merrill to pay up to $5.8 billion in bonuses regardless of its financial condition. Despite evidence indicating that the Bank's senior executives were aware of the agreement, the SEC pursued only negligence claims against the Bank rather than suing any individuals for fraud. Further, the SEC initially proposed to settle the action for just $33 million — a proposal that the presiding federal judge, Judge Jed Rakoff of the Southern District of New York, rejected as inadequate in a withering opinion, calling it "a contrivance designed to provide the S.E.C. with the façade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry — all at the expense of the sole alleged victims, the shareholders." In 2010, the SEC expanded the case to include the Bank's failure to disclose massive losses that Merrill was suffering prior to the shareholder vote, and increased the proposed settlement amount to $150 million. Although there was evidence that the Bank's most senior executives were aware of the losses, the SEC again decided to bring only negligence claims against the Bank. Judge Rakoff approved the settlement but remained highly critical of it, calling it "better than nothing" and "half-baked justice at best."

Judge Rakoff similarly rejected the SEC's October 2011 settlement with Citigroup, where the bank agreed to pay $285 million to settle charges alleging (like the case against Goldman Sachs) that Citigroup sold complex mortgage-related securities to investors while misleading them about the fact that Citigroup had taken a large short position on the security's underlying assets. Judge Rakoff explained that the proposed settlement "leaves the defrauded investors substantially short-changed." The SEC has appealed Judge Rakoff's decision; however, even if the SEC's appeal is successful, Judge Rakoff's criticism of the Citigroup settlement was yet another significant blemish in the SEC's recent track record.

The SEC has also had some mixed results at trial during President Obama's first term. In August 2012, the SEC brought charges against a Citigroup trader, Brian Stoker, for his role in misleading investors about the fact that Citigroup had taken a short position against a CDO that it had structured and marketed to investors. After a trial in the Southern District of New York, a jury cleared Stoker of all civil fraud charges. In November 2012, the SEC achieved a partial verdict against the senior executives of the Reserve Fund — Bruce R. Bent, and his son, Bruce R. Bent II — who the SEC alleged committed fraud in issuing false statements to investors when the

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President Obama nominates former federal prosecutor Mary Jo White as SEC Chief. (Getty Images)

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Reserve Fund "broke the buck," or fell below $1 per share, in September 2008. After a trial, the jury found for the SEC on a count alleging that Bruce R. Bent II acted negligently and on another count alleging that the parent company had violated the securities laws with scienter.

An Uncertain Enforcement Agenda Over The Next Four Years

Because the leadership of the SEC and the DOJ — the Administration's two principal securities enforcement agencies — is in flux, the enforcement agenda for President Obama's second term is not entirely clear, but is taking shape. In mid-December, SEC Chairman Mary Schapiro announced that she was stepping down, and on January 24 President Obama nominated former federal prosecutor Mary Jo White — the first-ever female U.S. attorney for the Southern District of New York — as his next Chairman. Ms. White's background in enforcement and record of success may send a signal that she plans to hold Wall Street accountable for wrongdoing. That said, she would be coming to the post from her position as counsel to major Wall Street banks such as Bank of America and Morgan Stanley.

SEC enforcement chief Robert Khuzami also stepped down. Khuzami was named head of enforcement in 2009 following widespread public criticism of the agency's failure to detect the Madoff scheme. Khuzami was the architect of the SEC's enforcement strategy following the financial collapse, and dramatically reshaped the enforcement division by eliminating bureaucracy, expanding investigators' powers and creating specialized units to police Wall Street. However, his ties to Wall Street, including through his prior employment as general counsel of Deutsche Bank, have been noted by some who have criticized the SEC's failure to bring more enforcement actions against the senior executives and large financial institutions that were responsible for the financial crisis.

George Canellos, a longtime SEC prosecutor, has stepped in as acting interim enforcement chief, but it is uncertain whether he will remain the SEC's top enforcement officer under White. The reshuffling of top positions at the agency has raised larger questions about the SEC's enforcement agenda during President Obama's second term and renewed calls for the administration to ensure the agency's independence from Wall Street. When former Citigroup and Bank of America lawyer Sallie Krawcheck was recently floated as a potential successor to Schapiro, critics immediately claimed her past employment would hamper the SEC's ability to effectively police Wall Street. Similarly, the candidates that the next SEC chairman considers to lead the enforcement division will give investors insight into the agency's forthcoming approach to enforcement, and whether the agency will be more aggressive than it has been in the past.

One sign that the administration appears to remain committed to pursuing financial crisis-related cases is the Department of Justice's recent filing of civil fraud charges against Standard & Poor's for allegedly awarding knowingly inaccurate credit ratings to numerous RMBS and CDO securities from 2004 through 2007. While it is uncertain whether the new lawsuit against S&P marks a shift in enforcement focus, many have heralded the lawsuit as a constructive, if belated, step in seeking accountability from those responsible for the financial crisis.

Preventing the Next Financial Crisis Through the Dodd-Frank Wall Street Reform and Consumer Protection Act

Beyond enforcement, the Obama administration's most enduring impact on investor protections and the integrity of the securities markets will ultimately depend on the success of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. By far the most significant and far-reaching financial reform legislation passed since the Great Depression, Dodd-Frank spans 848 pages and targets numerous regulatory failings that contributed to the financial crisis. The Act created several federal agencies, including the Financial Stability Oversight Counsel, which is charged with monitoring and addressing systemic risks to the financial system, and the Consumer Financial Protection Bureau, an agency designed to promote fairness and transparency in mortgages, credit cards and other consumer financial products. The Act also created new sets of rules for major financial industry participants and made significant improvements to the regulation of the securities markets. These reforms have already begun to remedy some of the most glaring regulatory loopholes that were exploited by financial institutions, rating agencies, and other market participants in the lead up to the financial crisis.

For example, the Act attempts to strengthen investors' ability to hold rating agencies accountable for inaccurate and/or fraudulent ratings. For example, Dodd-Frank established that rating agencies can be held civilly liable as "experts" for providing materially inaccurate ratings in public securities offerings, and made it easier for investors to allege claims for fraud. However, as discussed below, putting these measures into practice has proved difficult at best, and some of the Act's new rules are still not being enforced.

The Act also provided investors with additional protections designed to limit risk-taking by financial institutions. Chief among them is a measure that provides shareholders with a "say-on-pay" vote indicating whether they support their companies' executive-compensation packages. Many believe the say-on-pay measure played a key role in the abrupt resignation of former Citigroup CEO Vikram Pandit,

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The signing of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010 marked a historic occasion, but much of the law remains unwritten. (Getty Images)

At a news conference on the one-year anniversary of the passage of the Dodd-Frank Act, House Republicans prepared to "score" the bill. (Getty Images)

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which followed Citigroup shareholders' rejection of his proposed compensation plan.

Dodd-Frank also includes numerous provisions that strengthen regulatory oversight and encourage greater transparency. These measures include:

- Increased protections and incentives for whistleblowers to report illegal or fraudulent conduct. The SEC issued its first award under the whistleblower protection this past year, and awarded the whistleblower 30 percent of the SEC recovery (the maximum award recoverable).

- Several measures to help shine a light on the so-called "shadow banking system"—the web of non-bank financial institutions (like hedge funds and private equity advisors) that were virtually unregulated in the lead up to the financial crisis. Dodd-Frank requires that these entities register with the SEC and provide information about their trading.

- Requirements that certain transactions that had previously been largely unregulated in the derivative markets be conducted on central clearing systems or through exchanges, and that participants in these transactions have sufficient financial resources to cover their obligations.

- Provisions that provide the Commodity Futures Trading Commission ("CFTC") and SEC with authority to regulate the over-the-counter derivatives market, which was an area that was previously considered a regulatory black hole. Indeed, the lack of such systems and controls are blamed by many for enabling AIG to secretly accumulate disastrous derivative wagers on mortgage-related securities that ultimately led to its multi-billion dollar government bailout.

Falling Short: Regulatory Reform Stunted by Wall Street

Despite its lofty aims, the Obama administration's hallmark financial reform legislation has also been criticized for failing to achieve its drafters' primary goals. For example, the Dodd-Frank Act failed to provide for "aiding and abetting" liability to enable private investors to hold underwriting banks, auditors and law firms accountable when they actively participate in fraud—a remedy that the U.S. Supreme Court had previously limited in prior court decisions. Dodd-Frank also failed to explicitly restore investors' rights to bring federal securities law claims in cases involving foreign-based securities transactions, an area that was significantly altered by the U.S. Supreme Court's decision in *Morrison v. Australia National Bank*.

Critics also point to Dodd-Frank's failure to effectively address the "Too-Big-To-Fail" problem — i.e., the perception that large financial institutions are too important to the global financial system to be effectively punished when they violate the law. For example, the government recently decided not to criminally indict HSBC, even though the bank admitted to its role in enabling drug traffickers to launder hundreds of billions of dollars, as well as to knowingly allowing hundreds of millions of dollars to move through the U.S. financial system on behalf of banks in countries subject to U.S. sanctions, including Iran, Cuba, and Sudan. The head of the DOJ's criminal division acknowledged that the decision not to criminally indict HSBC was based at least in part on a concern that the government did not "want to make a decision that is going to have all kinds of horrible collateral consequences"— in other words, HSBC was too important to the economy to prosecute.

But while many rightly criticize Dodd-Frank for not going far enough in promoting investor protections, arguably the biggest challenge to the bill's supporters is the simple fact that much of the law literally remains unwritten. Congress left some of the most difficult issues to be solved by regulators, who are charged with writing the vast majority of its implementing rules. Indeed, Dodd-Frank imposed nearly 400 rulemaking requirements on federal enforcement agencies and required the SEC and other regulatory bodies to complete dozens of studies. As of December 2012, regulators had finalized only 133 of the 398 regulations they were tasked with crafting in 2010. The process of writing the rules that Congress left to these regulators has invited intense lobbying by the financial services industry, which has spent millions of dollars in ensuring Dodd-Frank's implementing regulations are interpreted as favorably to their interests as possible.

One particularly illustrative example of Wall Street's lobbying efforts has been the financial industry's campaign against the so-called "Volcker Rule," a measure aimed at restricting federally-insured depository banks from engaging in "proprietary trading" (i.e., a bank trading its own money for profit). Proprietary trading by federally-insured banks has long been a concern because of the perception that such banks are essentially making bets with taxpayers' money. As with many other Dodd-Frank provisions, the law left the drafting of some of the key components of that legislation to regulators — including the task of defining exactly what would be considered prohibited "proprietary trading" under the statute. Regulators, pushed by industry lobbyists led by JPMorgan and its CEO Jamie Dimon, were poised to consider an exemption for certain kinds of trading that Wall Street banks argued were "risk mitigating" activities that should be allowed under the Volcker Rule, and not proprietary trading. The danger of Wall Street banks attempting to influence this legislative process became apparent in May of last year when JPMorgan announced a multi-billion trading loss arising from the very type of proprietary trading that JPMorgan tried to convince Congress to exempt from the Volcker Rule as a "risk mitigating" activity.

In other instances, industry participants have thwarted reform through sheer resist-

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ance. For example, the credit rating agencies essentially nullified some of the Act's new rules by simply refusing to provide their ratings on new securities offerings. The rating agencies' boycott essentially froze the asset-backed securities market in July 2010, prompting the SEC to issue a "no action" letter indicating that it would not enforce the rule.

Financial services companies and their lobbyists have also had considerable success in challenging Dodd-Frank's implementing rules in court. In one case, the Washington, D.C. Circuit Court of Appeals threw out an SEC final rule implementing a Dodd Frank provision that allowed institutional investors to nominate board members. The Court held that the SEC's rule could not stand because the agency's cost-benefit analysis had not taken into account how much it would cost companies to protest investor nominations. Critics of the D.C. Circuit's decision claim that the Court simply ignored the SEC's extensive review of the empirical evidence of the law's benefits. Nevertheless, the SEC did not appeal the decision, and instead issued new guidelines based on the D.C. Circuit Court's ruling that many critics argue embrace that court's business-friendly approach. The result of the Court's ruling is to compound the already formidable influence the financial industry has had in shaping the final outcome of Dodd-Frank.

Looking Ahead: Finalizing Dodd-Frank in Obama's Second Term

While many of Dodd-Frank's final rules have yet to be written, the strongest chances for the law's success will depend on the administration's effectiveness in navigating a combative rule-making process, and the political will of investors and their advocates in Congress. One clear opportunity for the administration will be to fill the three current vacancies on the eleven-member D.C. Circuit, which hears all appeals arising from direct challenges to SEC regulations. While the administration's efforts to fill those vacancies were scuttled in Obama's first term, there will be an opportunity to try again over the next four years.

Also looking ahead, many believe that the election of investor advocates to Congress this past November — including of Massachusetts Senator Elizabeth Warren, who conceived the Consumer Financial Protection Bureau — will have a positive influence on the ultimate outcome of Dodd-Frank.

But investor advocates in Congress face a daunting task. With industry lobbying in full force, public pension funds and other institutional investors are the last line of defense in maintaining the integrity of our capital markets. The institutional investor community will have to continue pressing President Obama and those in Congress to stand up to Wall Street, and to push for meaningful reforms that will have a real impact on the safety and integrity of the securities markets.

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