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# The New Financial Assets: Separating Ownership from Control

*Tamar Frankel*<sup>†</sup>

## INTRODUCTION

In *The Modern Corporation and Private Property*, Adolf A. Berle and Gardiner Means wrote about the separation of ownership from control in corporations. They noted that the interests of the controlling directors and managers can diverge from those of the shareholder owners of the firm.<sup>1</sup>

They wrote:

It has been assumed that, if the individual is protected in the right both to use his own property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as an effective incentive to his efficient use of any industrial property he may possess.

In the quasi-public corporation, such an assumption no longer holds. As we have seen, it is no longer the individual himself who uses his wealth. Those in control of that wealth, and therefore in a position to secure industrial efficiency and produce profits, are no longer, as owners, entitled to the bulk of such profits. Those who control the destinies of the typical modern corporation own so insignificant a fraction of the company's stock that the returns from running the corporation profitably accrue to them in only a very minor degree. The stockholders, on the other hand, to whom the profits of the corporation go, cannot be motivated by those profits to a more efficient use of the property, since they have surrendered all disposition of it to those in control of the enterprise. The explosion of the atom of property destroys the basis of the old assumption that the quest for

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1. Murray Weidenbaum & Mark Jensen, *Modern Corporations and Private Property*, 30 Soc'y 101, 101 (1993).

profits will spur the owner of industrial property to its effective use.<sup>2</sup>

Berle and Means concluded that the separation of ownership from control would lead to the inefficient use of property because the motivation for the most efficient use of the property would no longer lie with those who profit from the enterprise.<sup>3</sup> Harold Laski expressed a similar concern, focusing on those who control the corporations. He suggested that the modern corporation may have to face control by dishonest managers in addition to inefficiency.

Under the modern company laws, any body of men may secure capital from its owners, with no sufficient guarantee either of a genuine service to be rendered or of a possible return on the investment. The company may be dishonest in its operation, or inefficient, without the public being able at any point to have knowledge. Its proceedings are wrapped in secrecy . . . .<sup>4</sup>

Today's scholars have similarly identified this separation of components of ownership, naming the separation "decoupling." These scholars note the decoupling of the "bundle of rights" represented by a traditional financial asset, such as a share of stock. Professors Hu and Black noted, for example, that "[l]ongstanding legal and economic theories of the public corporation assume that the elements of this package of rights and obligations are generally bundled together—and in particular that voting rights are linked to an economic interest in the corporation, and usually held in proportion to that economic interest."<sup>5</sup> They then note that decoupling changes this package of rights.

There are those who consider such a decoupling beneficial. Others express the same concern that Berle and Means have expressed. And depending on what one focuses on in viewing the pluses and minuses of these separations, one could reach different conclusions. I reach a number of conclusions. First, the separation of ownership from control creates the problems that Berle, Means, and Laski noted, regardless of how sophisticated, complex, or enticing the separation is. That is, those

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2. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 9 (Harcourt, Brace & World, Inc. 1968) (1932).

3. *Id.*

4. HAROLD J. LASKI, *A GRAMMAR OF POLITICS* 477–78 (New Haven: Yale Univ. Press 1929) (1925).

5. Henry T.C. Hu & Bernard Black, *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663, 664 (2008). Hu and Black explain that "[s]ome of these rights are economic, including dividend, liquidation, and appraisal rights under corporate law. Some rights are not purely monetary, including voting rights, director fiduciary duties, rights to bring suits and inspect corporate records, access to corporate proxy machinery, and so on." *Id.* at 666.

who control but do not own may control corporations inefficiently and sometimes dishonestly. Second, there is a need to maximize the benefits from decoupling while minimizing the potential losses by those who do not have their “skin” in the losses. Above all, the aspects of decoupling that pose a threat to the financial system must be controlled by private and public regulation.<sup>6</sup> The time has come to raise the scholarly and public awareness about these issues.

This Article is organized in three parts. Part One examines the nature of financial assets and their transition by market transactions from contracts to property. The discussion highlights the gray areas which financial assets occupy in decoupling, falling within both contract and property law.

Part Two describes four types of decoupled financial assets. The first type separates into two financial assets: ownership benefits and ownership risks. The presumed reduction of owners’ risks prompted some academics to justify reducing the owners’ protection. I suggest that attempts to protect owners from ownership risk have failed. Therefore, the suggestion was ill-conceived. The second type of decoupling separates into two financial assets: voting control and the ownership of financial assets. It creates “empty votes.” This innovation can be abused in many different ways, as has been shown. The third type of decoupling is, in fact, coupling. It is called “reverse exchange securities.” The fourth form of decoupling is process-based securitization. In fact, it may have been the first to appear publicly in the 1970s. It offers advantages, but excesses have created great disadvantages. Part Two concludes by noting that during the past thirty years, fundamental financial concepts and designs have been warped or eliminated. Therefore, we must reanalyze the new financial assets to discover whether the decoupling of these assets produces the results Berle and Means were concerned with.

Part Three poses a number of questions. First, does decoupling undermine the traditional property-type protections? Second, does decoupling warrant more regulation? Third, where is decoupling headed?<sup>7</sup> Fourth, what regulation can we expect for current decouplings? And finally in this part, I argue that a radical regulatory view may be worth examining based on the principle that those who create benefits and risks for sale may not collect just part of the benefits. They should have “skin

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6. It seems that those who control without ownership are lobbying hard to avoid regulation in order to protect their profits. Randall Smith & Sarah N. Lynch, *How Overhauling Derivatives Died*, WALL ST. J., Dec. 26, 2009, at B1 (regulators press for exchanges but introducing exchanges would reduce profits).

7. Robert Ahdieh and Professor Jill E. Fisch asked these questions at the conference held at Seattle University Law School on November 7, 2009.

in the game” and bear a significant part of the risk as well; then, many of the problems that we reviewed might be ameliorated.

# I. THE NATURE OF FINANCIAL ASSETS AND THE APPLICATION OF CONTRACT AND PROPERTY LAWS

## A. What Are Financial Assets?

I define financial assets to mean promises by one person or institution to another person or institution to pay money or deliver another financial asset upon certain conditions, in exchange for money or another financial asset to be provided immediately or at a later date. Financial assets differ from real assets and from money because they consist of *promises*; in other words, *they are contractual promises*.<sup>8</sup>

Like real assets, some financial assets are tradable—for example, shares of stock—and some are not tradable—for example, loans. This distinction is crucial because non-tradable financial assets are treated in law as contracts. Tradable financial assets are treated in law as contracts as well, but the *trading of these contracts* is treated as the trading of property and is subject to conditions different from contract law.

Contract law is designed to encourage interaction among fewer and more specific parties.<sup>9</sup> Therefore, the parties may agree on any legal terms, impose limitations on the transfer of the contract rights to others and, with some exceptions, keep the terms of their relationships secret; contract law allows the parties to “personalize” their relationship. In contrast, property law is designed to encourage the creation and development of markets.<sup>10</sup> Therefore, to reduce information costs, property law limits the deviations of terms classifying ownership property to approximately thirteen types.<sup>11</sup> In addition, property law declines to enforce a total prohibition on the transfer of property; such a prohibition is

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8. Since the dollar got off the gold standard, a dollar can be viewed as a promise backed by the full faith and credit of the United States.

9. Cf. Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389, 398 n.38 (1993).

10. Cf. *id.*

11. See WILLIAM B. STOEBOCK & DALE A. WHITMAN, *THE LAW OF PROPERTY* § 2.1 (3d ed. 2000) (classifying present estates as “freehold” or “nonfreehold” and “inheritable” or “noninheritable”); *id.* § 3.1 (discussing future interests); Lawrence C. Becker, *The Moral Basis of Property Rights*, in *NOMOS XXII* 190–92 (J. Roland Pennock & John W. Chapman eds., 1980).

deemed contrary to public policy.<sup>12</sup> Further, property law imposes different degrees of publicity regarding transfers of property.<sup>13</sup>

*B. Financial Assets Offer Promises and Combine Contract and Property Law*

One feature of financial assets is that they combine contract and property. To be sure, property rights include the right to contract with others on various terms. Financial assets, however, consist of the parties' agreements. The law rarely imposes conditions on the structure and terms of these agreements; they are, after all, contracts. However, agreements subject to market trading must be suitable for trading, and market rules apply to tradable financial assets, including publicity of relevant information. If, however, the number of parties is small, and the parties are wealthy and sophisticated, then more of the contract view will be taken, and the availability of legal intervention will be weakened.

As noted, like property rights in real assets, trading in financial assets is limited to a fairly small number of forms of alienation (e.g., sale, lease). However, the *content* of financial assets, being contracts, remains unlimited.<sup>14</sup> It is assumed that, regardless of their complexity, disclosure of the terms of these assets will suffice to protect the buyers and the traders from misunderstanding the benefits and risks that they are taking. One could argue that some real assets are highly complex as well. After all, most buyers of electronic and other complex instruments do not understand what these instruments are made of. However, most complex real assets are easier to evaluate: they work or do not work. Because financial assets consist of promises to do something in the future, it is far more difficult to predict whether and how the promises will be kept. And while there are often government and commercial standards for real assets, there are fewer government standards for financial assets; they have remained promises by contracts.

In addition, historically, financial assets represented real assets. Financial assets later moved to representing financial assets that may or may not represent real assets. This process resulted in rendering promises very similar to, and as important as, real assets. The process of parties betting on the outcome of a certain event concerning real assets or enter-

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12. See RESTATEMENT (FIRST) OF PROP. §§ 404–427 (1936); STOEBCUK & WHITMAN, *supra* note 11, § 2.3, at 36–37 (discussing Restatement); Frankel, *supra* note 9, at 402 (citing authorities).

13. See, e.g., MASS. GEN. LAWS ch. 183, § 4 (2008) (requiring recordation of conveyance of estates in fee simple, fee tail, for life, and certain other interests in land); U.C.C. § 6-105 (2009) (requiring notice of bulk sale to seller's claimants); Frankel, *supra* note 9, at 401 (citing authorities).

14. See Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2006) (defining “security” to include any of a long list of interests).

prises, shifted to bets on the performance of financial assets in the market for financial assets. The legal prohibition on betting has all but disappeared.<sup>15</sup>

Today's markets in financial assets have grown significantly.<sup>16</sup> Accompanying or leading this growth was a rise in decoupling. It is harder and costlier to decouple a real asset as compared to a financial asset. Decoupling is a step towards changing the terms of promises. This step leads to the next step of creating a market in the decoupled pieces. The separation is complete but, as we have experienced in the case of securitization, it can breed the problem of sub-prime mortgages. Thus, trading in financial assets is, in essence, trading in promises to do something in the future, often based on promises of yet another party's future promise—a world of promise-based promises.

## II. FOUR TYPES OF DECOUPLINGS

### A. Ownership Without Risk

A number of excellent and illuminating articles describe the changes that have occurred in the structure of financial assets in recent decades. Professors Charles Whitehead and Ronald Gilson examined the decoupling of benefits and risks related to shares and the assimilation of shares to debt.<sup>17</sup> Traditionally, share ownership was viewed as more risky than debt ownership. The authors suggest that this higher risk justified the right to the following: residual profits; the right to vote for the directors of the corporation; the right to vote on some important decisions concerning the future of the corporation; the right to sue derivatively under certain circumstances; and the imposition of fiduciary duties on the directors, including fiduciary duties towards bondholders when the corporation became bankrupt and the bondholders became, in fact, shareholders.<sup>18</sup>

15. See, e.g., *Bd. of Trade of Chicago v. Christie Grain & Stock Co.*, 198 U.S. 236 (1905); *Albers v. Lamson*, 42 N.E.2d 627, 630 (Ill. 1942); Roy Kreitner, Essay, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk*, 100 COLUM. L. REV. 1096, 1102–13 (2000) (discussing development of distinction between futures trading and gambling).

16. See Aaron Unterman, *Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 56–57 (2009) (“In 2005, global financial assets . . . were calculated at US \$165-trillion, . . . nearly four times the global GDP.”).

17. Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231 (2008).

18. I would add another rationale for strengthening shareholder-owners' control: it is fundamental. America is a capitalistic country. Those who own have the right to the residual profits and to control. The issue is not merely risk but entitlement to ownership. Those who serve, no matter how able, creative, and innovative they are, do not, and should not, have ultimate control. Lenders may bear high risk but are not entitled to residual profits or to control. In addition, if risk is the

Professors Whitehead and Gilson noted that recently, the components of shareholder risk, benefit, and control have been separated. In *Deconstructing Equity*, they explain that, traditionally, “a firm’s scale and scope turned on the tradeoff between the gains from expansion and the agency costs of debt and equity. . . .”<sup>19</sup> However, the past three decades gave rise to an “explosive growth in new instruments to facilitate a private owner’s purchase of risk bearing and liquidity in discrete slices,” by which executives may use “risk management”<sup>20</sup> to hedge specific risks to which the corporations they manage are exposed. Companies can transfer risk “by the slice, like New York pizza, rather than in the aggregate through common stock.”<sup>21</sup> Therefore, private enterprise can fund working capital debt. The authors conclude that reduction of risk for shareholders can align “management and shareholder incentives.”<sup>22</sup> How does risk slicing work?

Weather derivatives, such as those underlying [Agricore United’s] insurance contract, can be more finely sliced into risks associated with temperatures in an identified region or group of cities, levels of snowfall and frost, and even the occurrence of hurricanes. Through ‘catastrophe bonds,’ investors can now take on risks as diverse as earthquakes in Southeast Asia, flooding in Great Britain, and windstorms in Japan. At the cutting edge, economic derivatives permit financial intermediaries to precisely hedge their exposures to a growing array of macroeconomic risks, as evidenced by macroeconomic data releases—ranging from changes in U.S. employment rates to U.S. retail sales, industrial production, consumer prices, and economic growth—on which the value of those instruments is based.<sup>23</sup>

These are impressive risk-reducing tools. Yet, the theory that corporations can reduce the shareholders’ risks and equate shares to debt has proven weak for two reasons. First, management’s interests were not aligned with the interests of the shareholders. Management had incentives to increase the enterprises’ short-term risks and gain, and it did. In fact, management and shareholder interests grew apart as shareholders

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measure of control we will end up with managers—those who provide service—as owners, a contrary conclusion to capitalism.

19. Gilson & Whitehead, *supra* note 17, at 242 (summarizing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 319–23 (1976)).

20. *Id.* at 243 (defining “risk management” as “a firm-level management discipline that identifies and measures risks that may affect firm value, assists in choosing which risks to retain and which to transfer, and then implements and monitors strategies to execute those decisions”).

21. *Id.* at 251.

22. *Id.* at 251–52.

23. *Id.* at 246–47 (citations omitted).



suffered greater longer-term losses while management reaped increased short-term gains.<sup>24</sup> Consequently, shareholders bore higher, not lower, risks and losses. Second, shareholder risks were not reduced because the risk coverage was not effective; the coverage relied on transfers of risk to unregulated entities and on faulty risk predictions.

**The risk coverage was not effective.** Risk-transfer tools work if, and only if, the promisors who offer to cover the risks are able to do so when the losses occur. If the promisors have not appropriately calculated the probability of the losses which they offer to cover, or do not have the money to cover the losses of materialized risks that they correctly calculated, then the losses from the risks taken by corporate managers will be higher. They will pay for risk coverage, which they do not receive, and expose their enterprise to higher risk and losses. In sum, it is just as important to make sure that the risk will be actually covered as it is to splice it. It seems that innovators are focusing more attention on splicing and less on assuring coverage.

The new risk transfers rely not only on regulated institutions such as insurance companies, but also on promises of various unregulated entities. It transpired that while the buyers of risk coverage increased their risks in reliance on the coverage, many promisors who were supposed to cover these financial risks could not make the risk-buyers whole.<sup>25</sup>

Additionally, the risk-predictability was faulty. The innovative new risk-transfers are similar to, but not quite the same as, traditional insurance. Traditional insurance is based on the law of large numbers. Even though an insurance company does not know when an insured will die, the company knows the percentage of persons of the insured's age and circumstances who are very likely to die. The same system covers "longevity insurance"—annuities (the risk that the insured will outlive his or her savings). In addition, insurance schemes are regulated to prevent insurance companies from collecting premiums, speculating or wasting their assets, and failing to have sufficient resources to meet their future obligations.

Many of the new risk-transfers cannot rely on the law of large numbers. Financial models have failed to predict the financial risks. That is in part because the factors embedded in these models are not in-

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24. See TAMAR FRANKEL, *FIDUCIARY LAW* (forthcoming) (on file with author) ("[T]he executives' risks are those of workers and not of capitalists. The risk and the benefits of the owners are more directly linked to the fortunes of the enterprise. Managers participate in the owners' benefit but have rejected participation in the owners' risks.").

25. See, e.g., *Sen. Collins Introduces Legislation to Strengthen Financial Regulation and Oversight*, STATES NEWS SERV., Nov. 18, 2008 (noting that the failure of an investment bank holding company and the federal takeover of an insurance company were caused in part by risk exposures from credit-default swaps).

dependent of one another. Combining the same risk-experience by many people allows an insurance company to cover the cost of those who experience the serious losses from the small payments made by those who did not suffer the losses.

In practice, insurance is available only when the Law of Large Numbers is observed. The law requires that the risk insured must be both large in number and independent of one another, like successive deals in a game of poker.

‘Independent’ means several things: it means that the cause of a fire, for example, must be independent of the actions of the policyholder. It also means that the risks insured must not be interrelated, like the probable movement of any one stock at a time when the whole stock market is taking a nose dive, or the destruction caused by a war.<sup>26</sup>

The failure of the new risk-prediction was due to the absence of independent risk factors:

Wall Street and regulators relied on complex mathematical models that told financial institutions how much risk they were taking at any given time. Since the 1990s, risk management on Wall Street has been dominated by a model called ‘value at risk’ (VaR). . . . The model predicts with 99 percent probability that institutions cannot lose more than a certain amount of money. Institutions compare this ‘worst case’ with their actual capital and, if the amount of capital is greater, sleep soundly at night. Regulators, knowing that the institutions used these models also slept soundly . . . .

Lurking behind the models, however, was a colossal conceptual error: the belief that risk is randomly distributed and that each event has no bearing on the next event in a sequence. This is typically explained with a coin-toss analogy. If you flip a coin and get ‘heads’ and then do it again, the first heads has no bearing on whether the second toss will be heads or tails. It’s a common fallacy that if you get three heads in a row, there’s a better-than-even chance that the next toss will be tails. That’s simply not true . . . .

But what if markets are not like coin tosses? What if risk is not shaped like a bell curve? What if new events are profoundly affected by what went before?<sup>27</sup>

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26. PETER L. BERNSTEIN, *AGAINST THE GODS: THE REMARKABLE STORY OF RISK* 204 (1998).

27. James G. Rickards, *A Mountain, Overlooked: How Risk Models Failed Wall St. and Washington*, WASH. POST, Oct. 2, 2008, at A23, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/01/AR2008100101149.html>.

There was insufficient data and understanding to evaluate the purported risk-protection instruments and the incentives of management. In sum, the shareholders of corporations whose management bought risk coverage bore higher, not lower, risks. They were entitled to higher, not lower, controls over their management.

*B. "Empty Voting"—Control by Voting Without Ownership*

Professors Henry Hu and Bernard Black noted the separation of shareholder ownership from voting.<sup>28</sup> Corporate law generally makes voting power proportional to the number of shares a shareholder holds. While there are exceptions, the power to vote was linked to the economic commitment of the shareholders: share ownership. Professors Henry Hu and Bernard Black noted that these days, voting can be decoupled by hedging, which "affects economic ownership"<sup>29</sup> of the shares. Voting can also be decoupled from ownership by borrowing voting shares and reserving the right to vote them.<sup>30</sup> In a hedging case, the lender has "undisclosed economic ownership accompanied by informal voting rights."<sup>31</sup> And in the share-borrowing case, the vote buyer has "more votes than economic ownership."<sup>32</sup>

Professors Hu and Black outline various ways in which this decoupling can be effected.<sup>33</sup> One way is by enabling one person to borrow shares owned by another. "Under standard lending arrangements, the borrower has voting rights but no economic ownership, while the lender has economic ownership without voting rights."<sup>34</sup> Thus, the borrower of the shares has voting rights for payment that is far lower than the price of buying the shares. Such lending can be done pro forma by buying voting shares and selling them immediately thereafter. The risk of ownership for a day does not match the impact of the voting on those who hold the shares far longer.

An equity swap is another approach of decoupling votes from ownership. In this arrangement, one party, such as a pension fund, holds shares while another person swaps to buy the shares but does not own them yet. The buyer hopes that the price of the shares will fall and that he would be able to buy the shares for a lower price than the higher price that he agreed to sell the shares. The person who is holding sold shares

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28. Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 907 (2006).

29. *Id.* at 818–19.

30. *Id.* at 816.

31. *Id.* at 907.

32. *Id.* at 812.

33. *Id.* at 907.

34. *Id.* at 816.

(for a fixed price) has no interest in the shares. The person who bought the shares (but did not pay for them yet) has an interest in the vote but not in the economic attributes of the shares. In this situation:

a person with the long equity side (the 'equity leg') of the swap acquires economic ownership of shares (but not voting rights) from the short side (the 'interest leg'). The short side often hedges its economic risk by holding shares, thus ending up with votes but no net economic ownership.<sup>35</sup>

Other decoupling strategies exist as well. One is relying on put and call options or single-stock futures.<sup>36</sup> And yet another is "soft parking." This technique works as follows:

One party (the 'parkee') holds shares and thus apparent voting rights, but limited or no economic ownership. The parkee is informally expected to either (1) vote as another party (the 'parker') would want, or informally requests, or (2) arrange, if the parker requests, to unwind the parking transaction and return the voting rights to the parker. The parkee will often be a derivatives dealer or bank.<sup>37</sup>

For example, a Hungarian firm, MOL, defended itself from a takeover bid by launching a stock buyback program:

MOL had bought back nearly half (48.8%) of its own previously outstanding shares, with 7.8% held directly and another 41% lent to two Hungarian banks. MOL spent more than \$2 billion buying itself.

Decoupling played a critical part in MOL's defense. Under Hungarian law, a firm cannot vote its own shares. MOL avoided this limitation by lending most of the repurchased shares to the two banks. The banks were nominally free to vote as they wished but could not sell the shares and were widely expected to vote them as MOL management wished.<sup>38</sup>

A voting trust is another mechanism by which the voters (the trustees) are not the true owners. However, the owners who use this mechanism have a measure of control over the voting trustee, even though they are bound by the voting trust agreement.<sup>39</sup> In addition, most corpo-

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35. *Id.*

36. *Id.*

37. Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 638 (2008).

38. *Id.* at 647 (footnote omitted).

39. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 400 (1983). ("The voting trust [is] a form of irrevocable proxy in which several share-

rate laws require the apparent shareholder to disclose that the shareholder is a trustee. In contrast, the MOL technique leaves the voter seen as the true owner. Tender offers have been affected by “interposing a third actor between the bidder and individual target shareholders.”<sup>40</sup> The result “is to require the shareholder to exercise his vote in order to remove the impediment to his ability to sell his stock.”<sup>41</sup> In a recent case that was settled, vote decoupling was used by Perry Corp. to vote for a merger without disclosing its ownership in the merging companies, Mylan Laboratories (Mylan) and King Pharmaceuticals (King). In this case, Perry Corp. adopted a risk arbitrage spread trade involving the two companies. In 2004, Mylan announced an agreement to acquire King, subject to the approval of both Mylan and King shareholders. Following this announcement, Perry began acquiring Mylan voting rights and at the same time used a short-sale hedging strategy to eliminate its financial exposure in these shares. Perry purchased 9.89% of Mylan’s shares in foreign markets, or after hours on the over-the-counter market, in order to vote for the merger without publicly disclosing this purchase—disclosure of the purchase would have lowered the spread between the price of King and Mylan shares and would have reduced Perry’s profit.<sup>42</sup>

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holders convey their shares and the attached votes to a trustee who must vote them as a bloc in accordance with instructions.”). See also *id.* at 410 (“Voting trusts are designed to inhibit transfers of control. The separation of control from the residual interest introduces a substantial, and in public firms unnecessary, agency cost.”); 8 DEL. CODE ANN. tit. 8, § 218(a) (2001) (authorizing voting trusts); *Abercrombie v. Davies*, 130 A.2d 338, 383–84 (Del. 1957) (voting trust not prevented by fact that trustees are under control of shareholders).

40. Thomas J. Andre, Jr., *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CAL. L. REV. 533, 636 (1990).

41. *Id.* For an example of abuse of voting power see *Sommers v. Apalachicola Northern RR Co.*, 78 So. 25 (Fla. 1918). See also Eric J. Pan, *Single Stock Futures and Cross-Border Access for U.S. Investors*, 14 STAN. J.L. BUS. & FIN. 221, 253 (2008) (“In the face of growing demand by U.S. investors for access to foreign markets and pressure to restore U.S. capital markets competitiveness, the Securities and Exchange Commission (SEC) is gradually negotiating mutual recognition arrangements with select foreign markets—arrangements that will allow foreign exchanges and brokers to operate in the United States without direct SEC oversight. . . . At 20 percent, the margins for [these instruments] are lower than the 50 percent margin normally imposed on securities trading, [though] higher than the margins imposed on other types of futures contracts. . . . Nonetheless, the SEC and CFTC have refrained from using their authority to allow for [these instruments] on unregistered securities because of Section 6(h)(3)(C) which provides that the requirements for listing of security futures products shall be no less restrictive than comparable listing standards for options traded on a national securities exchange or national securities association registered pursuant to Section 15A of [the Exchange Act].”) (third alteration in the original).

42. For the full settlement, see Press Release, Sec. & Exch. Comm’n, SEC Charges Perry Corp. with Disclosure Violations in Vote Buying Scheme (July 21, 2009), <http://www.sec.gov/news/press/2009/2009-165.htm>. On July 21, 2009, Perry Corp. settled with the SEC, agreeing to pay a \$150,000 civil penalty for its failure to disclose that it acquired more than 5% of voting equity securities, allegedly in violation of Section 13(d) of the Exchange Act. *Id.*

In a recent court case on vote decoupling, the trial judge for the Southern District of New York found that two hedge funds violated Rule 13(d) by failing to disclose their beneficial ownership.<sup>43</sup> In this case, the two hedge funds identified CSX Transportation (CSX) as a target for a leveraged buyout or a proxy fight to gain control of CSX. The hedge funds began acquiring CSX shares (roughly 14.4%) without acquiring voting power. To avoid disclosing that they hold more than 5% of CSX shares (which would have required disclosure of ownership), the funds distributed their shares among eight counterparties that were likely to vote with the funds. CSX sued the funds and partners, alleging, among other things, that the funds failed to disclose their beneficial ownership of CSX. The judge held that the two hedge funds had violated the disclosure rules, mainly under the “anti-evasion” rule.<sup>44</sup>

There are other rules that can be circumvented by decoupling techniques, such as: mandatory bid rules;<sup>45</sup> “[s]tatutory, contractual [such as relying on put and call options or, where they exist, single-stock futures] and other limits on voting power;”<sup>46</sup> income tax rules;<sup>47</sup> “[r]ecapture of ‘short-swing’ trading profits;”<sup>48</sup> “[l]imits on short sales, or ‘margin borrowing’ against the value of shares;”<sup>49</sup> and antitrust rules.<sup>50</sup> Vote decoupling may be used by corporations to vote for their own stock, which corporate law forbids.<sup>51</sup> To the extent that the rules limit or direct voting, vote decoupling hides the true voter and its incentives, thereby circumventing the purpose of the rules.

While the recent CSX decision might exert pressure on the Securities and Exchange Commission to enact new disclosure rules,<sup>52</sup> a number of corporations have already amended their bylaws to protect their shareholders from empty voters. For example, on March 27, 2008, Sara Lee (SLE) amended its bylaws, requiring that “a shareholder who nominates a new board member or submits a proposal that could alter the path of

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43. *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

44. *Id.*

45. Hu & Black, *supra* note 5, at 669.

46. *Id.* at 670.

47. *Id.*

48. *Id.*

49. *Id.* at 670.

50. *Id.* at 671.

51. Hu & Black, *supra* note 37, at 642–43 (“[C]orporations can use decoupling techniques to allow insiders or other friendly third parties to vote shares with partial or no economic exposure” and “ward off changes in control.”).

52. See Hu & Black, *supra* note 5, at 669 (“Whatever the outcome of the appeal, the CSX case will likely put pressure on the SEC to adopt disclosure rules that explicitly address economic-only ownership.”).

the foodmaker's business must also disclose if it has 'hedged its ownership' or has 'any short position' in the stock."<sup>53</sup> Similarly, on February 14, 2008, Coach (COH) amended its bylaws, "requiring that 'any hedging activities engaged' in by a stockholder must be divulged when a proposal is submitted."<sup>54</sup> These changes are believed to protect shareholders from the dilution of their voting power by "empty voters" who have negative economic interests in the company.<sup>55</sup>

Professors Hu and Black list several motivations that drive to decoupling shares from voting. On one hand, "empty voting by insiders is likely to facilitate entrenchment and undermine external oversight. Empty voting with negative economic interest is also troubling . . . ." <sup>56</sup> On the other hand:

[H]edge funds can use empty voting to influence governance at underperforming corporations. Oversight of company managers by large shareholders is often considered to be beneficial, but is often ineffective. Empty voting could let votes move from less to better informed hands and, thus, could enhance the effectiveness of shareholder oversight.<sup>57</sup>

Because voting decouplings are so varied, it is difficult to evaluate them. They can range from voting without any economic interest, to voting with an economic interest that contradicts the owners' interest, to voting with an economic interest that conflicts with the interests of the chosen board of directors. The board itself might have interests that conflict with the interests of the owners. Much depends on the intentions and performance of the parties and the effect not only on the success and failure of the enterprise but on the financial markets. Nonetheless, and perhaps because, voting decouplings can be both beneficial and destructive to shareholders' ownership, the various methods of these mechanisms (and others that may be invented) should be disclosed. And if their value is in their hidden effect, they should be disclosed to destroy this value. Their benefits should be in their effect and the judgment of this effect should not be left to the holders of empty votes.

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53. Matt Andrejczak, *Sara Lee, Coach Set Rules to Spot Shareholder Actions*, MARKETWATCH, Apr. 2, 2008, available at <http://www.marketwatch.com/story/sara-lee-coach-set-rules-to-deter-devious-shareholders>.

54. *Id.*

55. "[Sara Lee spokesperson Mike] Cummins said that the 'interests of a stockholder who has hedged its Sara Lee stock ownership may not align with the interests of other stockholders, so we believe the additional information now required by the bylaws will enable all stockholders to make better-informed decisions.'" *Id.*

56. Hu & Black, *supra* note 28, at 820.

57. *Id.* at 820–21 (footnotes omitted).

*C. Reverse Exchange Securities*

“Reverse exchange securities” is another name for “reverse convertibles.” These securities combine into one financial asset two separate traditional bundles of benefits and risks. The terms of this third type of security seem complex, but after reflection, they are self-explanatory. These assets constitute part bond and part share. While the promise of returns is similar to a bond, the payment of the invested capital presents a share. Figuring out the risk and benefit of such a combination becomes complicated because the issuer of the bond part is different from the issuer of the share part. The results of the separation of ownership of these two financial assets from the two kinds of risk that they pose are rich in possibilities. The reverse convertible bond issuer may have far more information about the share issuer than the buyer of the bond may have.

Reverse convertibles combine the features of debt with the features of equity. The instruments are interest-paying—similar to debt. But the amount lent and repaid is linked to the value of particular shares or another event. The “reverse exchange securities,” or so-called “bonds,” issuer does not promise to pay back the amounts the bond buyer had paid. Instead, the bond buyer is promised on the payment date the price of a particular equity price or the financial value of a market event, such as future interest rates. The buyer will not gain if the stock price rises. The issuing company will not pay more than the price to the shareholders at the time the “bond” was issued. But if the stock price falls, the investors will lose and the issuing company will pay less—the lower price. For example, the instruments are sold for \$100 and bear 10% interest for six months—an unusually high return. These instruments are pegged to the price of certain equity securities at a specified date. The securities are issued not by the “bond” issuer but by an unrelated issuer (for example, a corporation or a bank). If the price of the equity security rises, the holder of the reverse convertible will not benefit from the rise. The holder will be paid the \$110; that is, the principal (\$100) plus interest (\$10). If, however, the price of the equity security is lower than the predetermined price, the holder of the reverse convertible will receive the equity securities rather than cash. Thus, if the issuer is a corporation, the corporation will not issue dividends to the shareholders (reflecting the profits) but will promise a fixed and anticipated interest. However, the amount lent is not fixed. That amount is linked to the future value of the specified equity securities in a certain way. The “bond” holder will not benefit from the higher price of the securities, but will have to accept the securities themselves if their price is below the bond principal amount (\$100). “The net result of this credit-enhancing relationship would be to reduce financial constraints and hence (perceived) default risk for the



sponsoring firm [the issuer] . . . .”<sup>58</sup> Bondholders gain a higher interest rate presumably to compensate for possible loss of the amount they paid for the bonds or shares.<sup>59</sup>

Corporations use the net proceeds of the issued bonds for general corporate purposes, including “additions to working capital, investment in or extension of credits to [the corporation’s] subsidiaries and the repayment of indebtedness” as well as hedging.<sup>60</sup> The instruments seem to be used by issuers as “other capital-raising securities.”<sup>61</sup> The first question is whether there is sufficient data and understanding to evaluate these instruments and anticipate the incentives of the issuer’s management. A second question is whether the information available to the issuer of the bonds concerning the securities, to which the payment of the bond is linked, is available to the buyers. Finally, it could be that the issuer of the “bond” can also affect the price of the other entity’s shares; for example, if the issuer is a significant lender of the company or sold its shares short and hopes for the price of the shares to fall.

#### *D. Securitization and Structured Finance*

Securitization is a process by which individual and unmarketable debts or loans are pooled and converted into marketable securities. The process starts with debt creation such as loans, future lawyer fees, lease payments, or credit card receivables. The next step is the creation of an institutional intermediary, such as a trust, a corporation, or a limited partnership, called a Special Purpose Vehicle (“SPV”) or a Special Purpose Entity (“SPE”). The third step is the transfer of the debt to the SPV. The fourth step is the issuance of securities by the SPV. The securities entitle the owners to a portion of the cash-flow from the aggregate debt held by the SPV.<sup>62</sup>

**The decoupling in securitization is similar to the reverse exchange securities: both are *decoupling by coupling*.** They combine debt and equity. But while the reverse exchange securities *combine* debt

58. Bruce A. Benet et al., *Gains from Structured Product Markets: The Case of Reverse-Exchangeable Securities (RES)*, 30 J. BANKING & FIN. 111, 125 (2006). See, e.g., *id.* app. A.

59. *Id.* at 114. Such instruments were issued by ABN-AMRO Bank, a leading financial institution based in the Netherlands. *Id.*

60. *Id.* at 125 (quoting the REX.S prospectus).

61. *Id.* at 125 (“RES are somewhat more attractive to issue than straight debt. When issuing straight debt, for example, the firm must reward investors for default risk (i.e., the risk it may not be able to make full face value repayment at maturity). In the case of RES, however, we conjecture that default risk may well be lower than for comparable ABN-AMRO bonds. . . . [There can be] a significant positive correlation between RES repayment obligations and sponsoring firm cash flows at liability expiration.”).

62. See generally 1 TAMAR FRANKEL, SECURITIZATION § 6.3 (Ann Taylor Schwing ed., 2d ed. 2005).

and equity into one security, securitization *transforms* debts into securities. In both cases, the difficulty of evaluating the level of risk of the debt is compounded by the difficulty of evaluating the risk of the securities which represent portions of the debts. In both, risk and ownership are decoupled.

Securitization provides many benefits. It allows enterprises that need capital to borrow not only from the banks but also from investors in the markets. It also allows borrowing enterprises to provide investors a lower-risk debt by separating the borrowers businesses, which can be risky, from the debts due to these borrowers from their customers (which may be far less risky). For example, while construction firms can be risky enterprises, if their income is based on rentals of apartment houses, the rentals may be far safer than the construction business. Securitization enables the business enterprise to raise funds by transferring the right to the rentals and mortgages on the real estate to investors and, thereby, borrow at a lower rate.<sup>63</sup>

Yet, securitization may pose, for investors, a somewhat greater risk because the underlying debt is difficult to evaluate. In reverse exchange securities, the issuer is one source of risk and the issuer of the securities or the market event is another. In securitization, because the debt is varied, it may be more difficult to evaluate the risk associated with the cash flow of the aggregate debt. In the past, rating agencies have assigned the level of risk to securities issued by the SPVs. The rating was sometimes required by law.<sup>64</sup> But the risk of the debts rose with the pressures to sell more asset backed securities.<sup>65</sup>

When banks and unregulated entities made mortgage loans and pooled them into SPVs that issued securities, their profits derived not from the interest of the debt they held, but by charging intermediation costs of lending, structuring the securitization, or both. Hence, the creators of debt securities for sale had incentive to produce as many securities as possible. Structures became very complex, and the rating agencies functioned under conflicts of interest: they were paid by the issuers of the securities that they rated. Consequently, a bubble was created in SPV issued securities based on low quality mortgage loans. At some point, the bubble in mortgage backed securities exploded (as all bubbles do). The year 2008 saw the decline in real estate prices, the drying up of

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63. *Id.* at 212–13.

64. *See, e.g.*, 17 C.F.R. § 270.3a-7 (2009) (exempting SPVs from the regulation of the Investment Company Act of 1940, and imposing a condition of rating on the SPVs' assets).

65. However, as the economic crisis has shown, the rating agencies' ratings did not reflect this increased risk, causing securities such as mortgage-backed securities to be overvalued.

the market in securitized mortgages, and the adverse effect on the financial system and economy.<sup>66</sup>

The trend in the financial markets has been toward the freedom to design and slice benefits, risks, and controls or powers (the contract part in the financial assets), and to create markets to trade in them (the market part in the financial assets). Legally, one would redefine the trend as the freedom to design various rights and liabilities for trading in open or restricted markets. These tendencies were encouraged based on the assumption that market prices of financial assets closely reflect the state of the economy and are more accurate than any other valuation. It was also assumed that markets are preferable to institutional intermediation, such as banks and insurance companies. Institutions may give the impression of low risk. Their structure, however, is usually risky. If they fail, they present significant risks to the financial system. In addition, it was assumed that market regulation, mostly by disclosure, is preferable to government substantive regulation. Even speculation is preferable to fixed values that do not reflect reality as much as the markets do.

These assumptions were flawed.<sup>67</sup> Market prices did not reflect the state of the economy but rather a bubble, rising high in part because of securities sales forces' drives and benefits. With the bubble rise, markets have not proven a preferable intermediary as compared to institutional intermediaries. When institutional intermediaries became active in the markets as market intermediaries, both the institutions' and markets' stability seemed to be harmed. Thus, some argue that the optimal structure of a financial system is separate markets and institutional intermediaries in clear competition among the two segments. The assumption that regulation is unnecessary, and if it is necessary, it should follow the "markets," has proven to be less than perfect.<sup>68</sup> Competition did not lead to greater efficiency or more balanced markets. On the contrary, it seems to have produced excesses that led to a crash. The regulators' "hands off" attitude seems to have allowed a tremendous bubble and its inevitable crash that has hit not only the financial system but the economy as well. Whether regulation could have prevented this disaster is, of course, de-

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66. See TAMAR FRANKEL & MARK FAGAN, *LAW AND THE FINANCIAL SYSTEM: SECURITIZATION AND ASSET BACKED SECURITIES: LAW, PROCESS, CASE STUDIES, AND SIMULATIONS* 88–99, 148–54 (2009).

67. See *The Financial Crisis and the Role of Federal Regulators: Hearing of the H. Comm. on Oversight and Government Reform*, 110th Cong. (2008) (statement of Alan Greenspan, former Chairman, Fed. Reserve). In response to a question by Chairman Waxman regarding whether Dr. Greenspan's free, competitive markets philosophy led him to make decisions he wishes he had not made, Dr. Greenspan responded, "[Y]es, I've found a flaw. . . . That's precisely the reason I was shocked, because I had been going for 40 years or more with very considerable evidence that [my ideology] was working exceptionally well." *Id.*

68. See, e.g., *id.*

batable because we cannot reproduce the alternative scenario of a regulatory regime.

In March 2010, Judge Richard Posner wrote a very thoughtful article which suggests that the main focus of the law should be making banks less affected by the collapse of other financial intermediaries. He argued that we should make “banks safe by confining them to their traditional activities, mainly the lending of federally insured deposits to small businesses and consumers and the purchase of federal and state government securities.”<sup>69</sup> The judge suggests a structural change to follow the functional purpose of banks and regulating other lenders. “Combining safe and risky financial activities in the same firm,” wrote Judge Posner, “endangers safety.” Therefore, he suggests not shrinking the banks but requiring them and their managements to be absolutely risk averse.<sup>70</sup>

Does this discussion veer us from the issue of ownership and control as well as decoupling of ownership from control? To some extent it does, if we focus only on the corporate universe. However, investors in asset-backed securities have been separated from the source of their income and capital as well. Only this source is not an individual or group of power holders. This source is the intermediaries who take no ownership and no control. This is the ultimate decoupling not only of those who own from those who owe but mainly from those who designed the system, benefited from the design, and left the losses to both the lenders (the investors) and the borrowers. Thus, in looking for solutions to strengthen the ownership from control we must consider the system as a whole. Judge Posner’s article focuses on the intermediaries and, in following Berle and Means’s ideas, we should not ignore this context as well.

### III. WHAT COULD BE DONE TO AVOID THE PROBLEMS THAT ARISE FROM DECOUPLING AND COUPLING WHILE MAINTAINING THEIR BENEFITS?

#### *A. Does Decoupling Undermine the Traditional Property-Type Protections?*

“Property-type protections” are the legal protections of property owners or shareholders. Some types of decoupling undermine the traditional property-type protections at a certain stage of the decoupling process. For example, when derivatives cover various risks of an enterprise, they might reduce an enterprise risk. Therefore, even if ownership

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69. Richard Posner, *In Volcker We Trust*, AM. LAW., Mar. 2010, at 53, 54.

70. *Id.* at 80.

and control of the enterprise are separate, the enterprise provides owners with benefits with lower risks (minus management costs). Hence, Professors Gilson and Whitehead suggest that because such derivatives produce ownership without risk, “property-type protections” for the owners are not justified; shareholders not bearing risk should not be entitled to voting rights and other controls over management.

However, if the risk coverage is itself risky, then the question of property-type protection rises again. Property-type protection by risk coverage can be a mirage. If the promises of risk coverage are not solidly backed, and if no regulation covers the promisors or enforces their obligations in any other way, the risk transfers and “protections” are empty promises. As noted, historically, coverage promises were based on faulty calculations and assumptions. The owners could not and cannot evaluate the risk coverage at a reasonable cost. In fact, the very nature of financial assets undermines traditional property-type protections. Promises cannot be touched, seen, checked upon receipt, or tested for reliability. The reliability of promises depends on the promisors’ ability and tendency to honor their obligations. In addition, the ability of promisors to honor their promises depends on future—mostly unpredictable—events affecting the promisors and their promises. The events in the years 2008 and 2009 suggest that market trading in risk-covering promises needs strengthening. This conclusion is reflected in the congressional and regulatory proposals that are currently being considered.<sup>71</sup> As the 2008 crash demonstrated, risk protection has not been what it seemed to be. Hence, owner protection should be strengthened rather than weakened.

The danger that controlling parties without ownership will adopt risks at the expense of the owners and the financial system is greater than imagined. Protections of owners and the system are weaker than imagined. Thus, the owner protections should be tighter, not lighter. In addition, the assumption that an ability to cover the issuing enterprises’ risks reduces the risks of the enterprise-shareholders is flawed. Shareholders are always the last to get paid. They are paid after the Internal Revenue Service, the employees, the managers, the creditors and other claimants. Therefore, the suggestion that shareholder voting and other protective rights against those who control their money and assets should be weakened is not convincing.

In addition, shareholders bear not only the enterprise’s risks, but also the risk that the controlling managers might abuse their power and

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71. See, e.g., Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795, 111th Cong., available at <http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf>.

misappropriate the shareholder assets. Therefore, even if derivatives protect the shareholders against enterprise risk, derivatives do not protect the shareholders from misappropriation of their property by management.

This issue is fundamental. America is a capitalistic country. The issue is not one of enterprise risk, but one of entitlement to ownership of the enterprise assets. Those who *own* have the right to ultimate control and to the residual profits. Those who *serve*, no matter how able, creative, productive and innovative they are, do not and should not have ultimate control and right to ownership. Similarly, even if lenders bear high risk of loss, they are not entitled to the control or the residual profits of the enterprise. If low risk is linked to lower control, the rationale is that there would be lower concern that controlling managers will abuse their power. Unfortunately that has not been the case. Besides, the United States could end up with managers—those who serve—as owners. This result is a different societal structure than capitalism. Regardless of how high or low a risk the financiers of enterprises pose, they, and not those who manage the enterprises, must have ultimate control. Otherwise, we will move to a system where service substitutes for capital.

**Other decouplings, such as “naked voting rights,” undermine property-type protections for owners.** These techniques hand control to those who do not bear ownership risk and have no fiduciary duties to owners or to the aggregate of owners. In these cases, traditional property-type protections disappear altogether. Empty voting rights can be held by those who reap benefits from control at the risk of others and gain from destroying current ownership of the enterprise. These are the situations which have been, and should be prohibited altogether—perhaps with the exception of a voting trust and full disclosure of the possible use of the votes.<sup>72</sup>

**Reverse exchange securities open the door to the weakening of ownership.** First, they may mislead debtors into believing that they have a bond instead of a share. Most critically, those who take the risk of a share have no iota of the control or protections that accompany ownership. In addition, these holds take the pure risk of the ownership of the shares and none of the benefits. These “bonds” operate as Berle and

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72. Interview with Nicholas Valerio III, associate professor of finance at Emory University's Goizueta Business School, *Risk, the Derivatives Market, & Proposed Regulatory Reforms: What's Ahead?*, (July 16, 2009), <http://knowledge.emory.edu/article.cfm?articleid=1247>. Currently, when listed derivatives are traded, there are mechanisms to reduce this risk, such as clearing corporations, margin requirements (i.e., a financial deposit), and price discovery (which can occur in the public market). *Id.* In OTC markets, each party has burden of identifying the financial stability of the other and “there is no pricing transparency, nor centralized reporting.” *Id.*

Means's ultimate model: ownership losses, but no benefits and no control.

**Securitization undermines property-type protections in another way.** Those who create the financial assets that end up in the hands of owners have little interest in reducing the risks from these assets, and a strong incentive to hide the risks and sell the assets as high quality assets. The ultimate owners incur high costs in determining the risk involved in the assets. In addition, securitization undermines the traditional property-type protection to the extent that the owners are unable to negotiate with the source of the payments—the borrowers—and no managers exist to account and answer for the shoddy assets or negotiate with the borrowers. The creators and sellers of risky financial assets have incentives to avoid and hide the risk. In all of these cases, unless there are different types of protections, owners remain with no or weakened protections. In securitization, the connection between the borrowers, the promisors, and the owners of the promises is severed. In fact, the process of securitization closely resembles mutual funds, except that this process is unregulated. In securitization, it seems that no one has full voting rights. There is no party that can negotiate changes in the terms of the borrowers' loans. The bankruptcy of millions of borrowers is an inefficient form of renegotiation.

**The only stable indicators of decoupling seem to be short-term benefits for intermediaries (the innovators) and, perhaps, for owners that continuously trade in the asset backed securities.** Long-term owners, even sophisticated owners, are less able to evaluate the risk of decoupled and re-coupled financial assets. For example, in the case of market instruments that combine bonds and equity, the owners cannot discover the use of these instruments and current regulation does not require the sellers or issuers to disclose their other financial positions and future seemingly unrelated activities. Had this information been available, owners would have understood their risk and thus eliminated the benefits gained by the issuers, the sellers, and the innovators.

#### *B. Does Decoupling Warrant More Regulation?*

**Not all de-couplings require more regulation but some require enforcement of the current law.** For example, abuse of control without risk, which is demonstrated by vote buying or renting (or a "second length ownership"), need not involve new regulation. Rather, vote buying is prohibited in corporate law and in the political arena. In the case of decouplings that result in the same separation, it was allowed perhaps because the vote buying involved market transactions (for example, borrowing). "Empty voting" should not be allowed and can be easily prohi-

bited by applying current legal principles. The prohibition on vote buying in the political arena should apply to any vote-ownership without ownership, no matter how it is acquired, so long as it is not accompanied by owner risk and rewards. No payment should be allowed for any vote of any corporation unless accompanied by ownership. And just as voting trusts require disclosure, so should similar arrangements in decoupling.

**Addressing past innovations may help, but only in part.** Some past innovations, especially those that caused significant losses, will not be repeated soon; other innovations will emerge. To be sure, regulation increases the cost for all intermediaries and reduces their profits. However, as recent events have shown, market competition does not work to prevent abuse. Intermediaries are unlikely to compete for lower fees or on strengthening property-protections.

**In addition, so long as innovations are used in one-to-one relationships, a regulatory reform is more costly and not as necessary.** So long as innovations are used in one-to-one relationships, there is lower payoff for regulatory reform, unless the owners sustain significant losses from the innovations and seek to escape the financial system for a shorter or longer period. This escape can bring down the system. Innovations used in the markets might cause significant failure as well. Unless promises are kept, a “run” on the promisees or on the promisors is likely.

The ultimate payoff for a regulatory reform is higher if the owner losses affect the entire financial system (or the economy). When owners may sustain sufficiently great losses, they might seek to escape the financial system for a shorter or longer period. This escape can dry up the markets and bring down the system. Effective regulation might reduce the risks of innovations, but not necessarily. Regulators may exercise judgment in evaluating the dangers from the innovations and allow some with or without conditions. In addition, regulation imposes costs, and these should be related to the cost-benefit analysis of regulation.

**Regulation of derivative over-the-counter markets (“OTC”) must be, and is likely to be, tightened.** This regulation will help assure the enforcement of promises, either by the government (threat) or by the group of derivative traders (having “skin” in the risk created by others). In her testimony before the House Committee on Agriculture, SEC Chairman Mary L. Schapiro noted: “The derivatives market has grown enormously since the late 1990s to approximately \$450 trillion of outstanding notional amount in June 2009.”<sup>73</sup> This market presents systemic

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73. *Testimony Concerning the Over-the-Counter Derivatives Markets Act of 2009 Before the H. Comm. on Agriculture*, 111th Cong. (2009) (statement of Mary L. Schapiro, Chairman, SEC), available at <http://www.sec.gov/news/testimony/2009/ts092209mls.htm>.



risk (e.g., risk concentration by significant leverage). The markets “behave unexpectedly in times of crisis.”<sup>74</sup> While “credit default swaps (CDS) . . . can reduce certain types of risk, [they can] caus[e] others, . . . heightened by the lack of regulatory oversight of dealers and other participants in this market.”<sup>75</sup> The result can be “inadequate capital and risk management standards. . . . OTC derivatives markets directly affect the regulated securities and futures markets by serving as a less regulated alternative for engaging in economically equivalent activity.”<sup>76</sup> This can lead to “a flow of funds out of the regulated markets and into the unregulated shadow markets. . . . These issues must be addressed, and I am committed to working closely with this Committee, the Congress, the Administration, and the CFTC to close this gap and restore a sound structure for U.S. financial regulation.”<sup>77</sup> The Administration’s bill “would mandate clearing and trading of all standard over-the-counter products, and setting capital and margin requirements for dealers.”<sup>78</sup> There is a proposal to create one central clearing house for trading standardized derivatives which will guarantee performance. This entity should be able to manage risk by daily cash margins.<sup>79</sup> Other proposals to improve disclosure and operational processes “have been tried before with limited success.”<sup>80</sup>

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74. *Id.*

75. *Id.* (“For example, CDS permit individual firms to obtain or reduce credit risk exposure to a single company or a sector, thereby reducing or increasing that risk. In addition to obtaining or reducing exposure to credit risk, a CDS contract participant will take on counterparty and liquidity risk from the other side of the CDS. Through CDS, financial institutions and other market participants can shift credit risk from one party to another, and thus the CDS market may be relevant to a particular firm’s willingness to participate in an issuer’s securities offering or to lend to a firm. However, CDS can also lead to greater systemic risk by, among other things, concentrating risk in a small number of large institutions and facilitating lax lending standards more generally.”).

76. *Id.*

77. *Id.*

78. Sarah N. Lynch, *CFTC’s Gensler Calls for Broad OTC Derivatives Regulations* (Sept 14, 2009), <http://www.fxstreet.com/news/forex-news/article.aspx?StoryId=c5966843-5823-4896-b131-80b35876387e> (“The bill would give the [Commodity Futures Trading Commission] and the [SEC] joint authority to patrol the markets and set capital requirements in some cases for non-bank derivative dealers. Regulators would also collect detailed information about the trading of customized products as well.”).

79. See, e.g., Posting of Yves Smith to Naked Capitalism, *Satyajit Das Weighs In on OTC Derivatives Proposals and Finds Them Wanting*, <http://www.nakedcapitalism.com/2009/07/satyajit-das-weighs-in-on-otc.html> (July 17, 2009, 1:36 a.m.) (quoting Das) (“Failure to meet a margin call requires the [central counterparty] to close out the position and offset any losses against existing collateral. The level of initial collateral posted must cover the fall in value from the last margin call. Traders want the maximum amount of leverage by reducing the amount [they post in cash].”)

80. *Id.* (quoting Das).

Focusing on the OTC,<sup>81</sup> the Treasury suggested derivative regulation by “[r]equiring central clearing and exchange trading of standardized OTC derivatives; . . . higher capital and margin requirements for non-standardized derivatives; . . . [b]roadening the definition of standardized OTC derivatives;”<sup>82</sup> and “ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.”<sup>83</sup> This proposal emphasizes the regulation and oversight of speculation.<sup>84</sup> In September 23, 2009, Senator Jack Reed introduced the Comprehensive Derivatives Regulation Act of 2009. The Act would:

[c]lear standardized credit default swaps (CDS) and other unregulated derivatives through a clearinghouse . . . and allow regulators to oversee new derivatives products that may arise in the future; [e]stablish robust capital and margin requirements for derivatives dealers and other major market participants, and establish higher standards for derivatives products not traded on clearinghouses; establish new conduct, recordkeeping and reporting requirements for firms, intended to protect investors from abusive practices and provide regulators and investors with extensive information regarding derivatives transactions and positions across the financial sector; [p]rovide regulators with new authority to set position limits and oversee the marketing of derivatives products to unsophisticated investors, and . . . combat fraud and manipulation . . . .<sup>85</sup>

There are several suggestions to strengthen the Treasury’s proposal.<sup>86</sup>

**Promoting market integrity.** Gary Gensler noted that there is a need to “promote greater market integrity and improve market transpa-

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81. Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795, 111th Cong., available at <http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf>.

82. Posting of Anjali Desai to Financial Markets Blog, *U.S. Treasury Delivers Proposed Legislation on OTC Derivatives to Congress*, <http://www.alston.com/financialmarketscrisisblog/blog.aspx?entry=2433> (Aug. 12, 2009, 10:19 p.m.).

83. *Id.*

84. *Id.* The Treasury proposed amendments in the Securities Exchange Act of 1934 and other relevant acts. See also Posting of Anjali Desai to Financial Markets Blog, *U.S. Treasury Announces Proposed Regulatory Framework for OTC Derivatives*, <http://www.alston.com/financialmarketscrisisblog/blog.aspx?entry=2077> (May 13, 2009, 7:07 p.m.).

85. Posting of Anjali Desai to Financial Markets Blog, *Senator Reed Introduces Comprehensive Derivatives Regulation Act of 2009*, <http://www.alston.com/financialmarketscrisisblog/?entry=2585> (Sept. 23, 2009, 5:51 p.m.). In response, market participants expressed concerns about increased regulatory costs. See, e.g., Posting of Christy Prendergast to Financial Markets Blog, *House Committee Holds Hearings on Regulation of Over-the-Counter Derivatives*, <http://www.alston.com/financialmarketscrisisblog/blog.aspx?entry=2584> (Sept. 23, 2009, 5:28 p.m.).

86. See, e.g., *Testimony Concerning the Over-the-Counter Derivatives Markets Act of 2009 Before the H. Comm. on Agriculture*, *supra* note 73.

rency.”<sup>87</sup> He pointed to two regimes—one regulating derivatives dealers, and the other regulating the derivatives markets.<sup>88</sup> This can be done by “extend[ing] the regulatory regimes of the Commodity Exchange Act (“CEA”) and the federal securities laws,” thus covering the entire marketplace.<sup>89</sup>

Professor Mark Roe focused on the intermediaries’ incentives. He noted that “[d]erivatives, repos and financial swaps . . . protect against foreign exchange and interest rate fluctuations . . . and in guarantees against loan defaults” obtain a favorable treatment in bankruptcy law.<sup>90</sup> “It has been a successful lobbying effort for this part of the American financial industry: priority treatment is important for the industry, but not well enough understood to engage much public attention beyond the financial press.”<sup>91</sup> Professor Roe argues against this favoritism. The favored treatment is so great, he wrote, that “financial players can set up deals so that they beat all other creditors if the other side of the deal goes bankrupt.”<sup>92</sup> Professor Roe predicts that if these instruments are not awarded this favored treatment, the “players . . . will act differently. If they know that their payments from a counterparty might be clawed back if the counterparty goes bankrupt, they will keep a sharper eye on the solvency of their counterparties, because a lower priority will not hurt them as long as their counterparties stay solvent.”<sup>93</sup>

The states’ regulation of derivatives is a hybrid of institutional and functional regulation causing “intense legal and jurisdictional uncertainty and high regulatory compliance costs.”<sup>94</sup> Yet, not all firms or derivatives must be regulated. One regulator is not necessarily better than multiple regulators, and functional regulation is not inherently preferable to institutional regulation.<sup>95</sup> Other academics suggested in a 1994 article that the public policy rationale for increasing the regulation of derivatives has “little or no economic basis. . . . Derivatives do not pose great-

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87. Gary Gensler, *Thoughts on Comprehensive Market Regulation*, (Sept. 23, 2009), <http://www.commodityonline.com/news/Thoughts-on-comprehensive-market-regulation-21352-3-1.html>.

88. *Id.*

89. *Id.*

90. Mark Roe, *End Bankruptcy Priority for Derivatives, Repos and Swaps*, FT.COM, Dec. 15, 2009, [http://www.ft.com/cms/s/0/16da702e-ea41-11de-aeb6-00144feab49a.html?nclick\\_check=1](http://www.ft.com/cms/s/0/16da702e-ea41-11de-aeb6-00144feab49a.html?nclick_check=1) (last updated Dec. 16, 2009).

91. *Id.*

92. *Id.*

93. *Id.*

94. Christopher Culp, *Derivatives Regulation: Problems and Prospects*, Competitive Enterprise Institute, Mar. 31, 1998, <http://cei.org/gencon/005,01275.cfm>.

95. *Id.*

er risk than other financial activities.”<sup>96</sup> There are no unique risks to users of derivatives. And in 1994, the regulatory framework was adequate. Institutional and functional regulation existed. This bifurcated framework renders derivatives regulation complex. This observation is probably true when one ignores human incentive and the division of risk and return.

**Fiduciary law imposes on money managers and corporate managers a duty of care.** The two cases discussed below suggest that “regulation cannot substitute for sound management practices. At the same time, government policymakers can act to minimize the potential for disruption to financial markets by promoting laws and policies that minimize legal risk.”<sup>97</sup> “In 1992, MGRM [a subsidiary of MG] began implementing an aggressive marketing program in which it offered long-term price guarantees on deliveries of gasoline, heating oil, and diesel fuels for up to five or ten years.”<sup>98</sup> The program included innovative contracts which MGRM hedged. This hedging program would have generated huge losses under certain conditions. When the conditions occurred, MG’s board moved quickly, removed the top manager and took other arguably hasty actions.<sup>99</sup> In the second case, Barings Bank perished because one of its unsupervised traders speculated and produced enormous losses.<sup>100</sup> Both cases involve exchange-traded derivatives contracts, and in both cases, senior management has been criticized for lack of strict supervision. Yet the two managements reacted differently. MG’s management has been faulted “for overreacting to the large margin calls faced by one of its subsidiaries . . . .”<sup>101</sup> “Barings’s management has been faulted for being overly complacent in the face of a large number of warning signs.”<sup>102</sup>

In both cases, management should have better understood their activities and their risks.<sup>103</sup> In MG’s case, “the sheer scale of its U.S. oil subsidiary’s marketing program exposed the firm to large risks. Although there is a great deal of disagreement over the efficacy of the hedging strategy employed by [MG],”<sup>104</sup> it seems that MG’s board failed

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96. Christopher L. Culp, *Regulating Derivatives: The Current System and Proposed Changes*, 4 REGULATION 38, 38 (1994), available at <http://www.cato.org/pubs/regulation/regv17n4/v17n4-4.pdf>.

97. Anatoli Kuprianov, *Derivatives Debacles: Case Studies of Large Losses in Derivatives Markets*, ECON. Q., Fall 1995, at 1.

98. *Id.* at 5.

99. *Id.* at 5–8.

100. *Id.* at 21–25.

101. *Id.* at 35.

102. *Id.*

103. *Id.*

104. *Id.*

to fully appreciate “the nature or magnitude of the risks”<sup>105</sup> and should “not have been so shocked.”<sup>106</sup> In Barings’s case, management allowed a single trader to control the trading and the back office (which was supposed to act as control of the trades). The management seemed to have believed that the trader could earn such huge profits without risks.<sup>107</sup> “[R]egulation cannot substitute for sound management practices. At the same time, government policymakers can act to minimize the potential for disruption to financial markets by promoting laws and policies that minimize legal risk.”<sup>108</sup>

**Therefore, the management’s duty of care should become stricter and carry far more enforcement in the future than it currently does.** Alternatively, or in addition, management should share in the risk it creates for shareholders. Regulation may impose on management part of the risk that it imposes on the owners who have entrusted their money to these managers. A similar rule should apply to brokers, dealers, analysts, rating agencies, and other financial market intermediaries. If they spread risk, they should take advantage of the gains, but they should also always share in the losses. The higher their gains, the higher their part of the losses should be.<sup>109</sup> The pain would be a good control mechanism for risk-taking. If intermediaries who control have close to no economic incentive to protect owners against risks of losses, then disclosure and the imposition of fiduciary duties may not be enough.<sup>110</sup>

To be sure, as fiduciaries, these intermediaries must be accountable. However, in an intermediaries’ culture that values self-gratification and intermediaries’ creativity, disclosure and feeble remedies on breach of fiduciary duties may not be enough. Therefore, self-interest should be used to impose a shared risk of loss. Brokers who sold auction notes as cash, without understanding how the notes work, should be paid in such notes, and own a portion of their assets in such notes. Managers of broker-dealer institutions that employed these brokers should own the notes they enable their brokers to sell. The percentage of the ownership should be reasonable and not merely symbolic.<sup>111</sup>

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105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.* at 36.

109. *See, e.g.*, 15 U.S.C. § 80b-5 (2006) (prohibiting performance fees under the Investment Advisers Act of 1940).

110. *See, e.g.*, Charles Davi, *How to Understand the Derivatives Market*, ATLANTIC, July 16, 2009 (discussing market makers, the buy and sell side of derivative trading, and inter-dealer trading), available at [http://business.theatlantic.com/2009/07/understanding\\_the\\_otc\\_derivatives\\_market.php](http://business.theatlantic.com/2009/07/understanding_the_otc_derivatives_market.php).

111. This idea is not new. At the beginning of the 1900s, corporate law took into consideration “directors’ qualifying shares.” Directors had to own the corporations’ shares which they managed.

**Regulations of specific innovations are likely to differ.** After all, not all couplings and decouplings pose the same type and magnitude of problems and risks to the financial system. Optimal regulation should encourage innovations but control excesses and abuse that might threaten the financial system and the economy. After all, everything good that sustains us, such as food and water, can be deadly as well. Therefore, the issue is not only the choice between “free markets” and “regulation.” The issue is mainly: where do the real problems reside and how should they be addressed?

**Regulation should govern situations in which self-protection by owners and market actors’ advice has proven to be faulty.** Innovations may increase the cost of information for owners. If the cost is too high, owners will rely on others to evaluate the benefits and risks of the innovations. If the others prove to be unreliable, such as the rating agencies in the case of sub-prime mortgages, a “run” by the owners is more likely, and regulation is necessary to restore the owners’ belief and trust. Further, regulation provides owners with a feeling of assurance that the intermediaries and managers, who hold owners’ money and assets, will not greatly abuse their entrustment and will balance risk and returns well. Therefore, the owners are less vigilant in protecting themselves from abuse by those who hold and manage their money and assets. When disclosure is either ineffective or extremely undesirable to the innovations, substantive regulation may be the solution. However, without enforcement, these regulations on which owners will rely might produce no supervision at all.

**Some innovations can be beneficial to intermediaries and toxic to the owners.** The United States has nurtured the financial system by feeding its intermediaries. This country has been the leader in financial system innovations and has increased the size of its financial system. It converted production into financial services and sales. The highest paid persons in the United States are financial intermediaries and managers of financial and corporate enterprises that have grown by acquisitions and borrowing.<sup>112</sup> Tax and other incentives have enticed Americans to trade

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The qualifying shares dwindled to one cent or one dollar, and the requirement was omitted altogether. See FRANKLIN A. GEVURTZ, CORPORATION LAW § 3.1.2a (2000).

112. See, e.g., *TARP Oversight: Is TARP Working for Main Street?: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of Dean Baker, Co-Director, Center for Economic and Policy Research) (“bank executives . . . are among the highest paid people in the country”); Floyd Norris, *Wall Street Paychecks May Wither*, N.Y. TIMES, Jan. 23, 2009, at 1B (“[I]nvestment banks, not to mention hedge funds and private equity funds, pay far better than companies in other industries.”); Posting of David to Business Pundit, *12 Highest Paid People of 2009*, <http://www.businesspundit.com/12-highest-paid-people-of-2009> (Dec. 28, 2009) (stating that highest-paid person is co-founder of a

in financial assets.<sup>113</sup> Savings have been channeled to the financial system.<sup>114</sup> Not surprisingly, the United States has been the leader of the 2008 bubble and crash. It is unclear whether nurturing the system, innovations of whatever kind, and high payment to its leaders is beneficial to the country and its owners. Thus, innovations may be toxic but innovators and their partners have no incentive to limit the innovations' potential harm. This is where regulation and enforcement must interfere.

**In addition, regulation affects not only current benefits and costs.** Regulation or absence of regulation affects the pattern of actors' behavior—their habits and values. Thus, regulation is successful when it allows innovations but monitors and evaluates them not only by market reactions but also by non-market actors who focus on the risk from innovations to the system as a whole. Rewards for low risk might preclude some innovations, but also protect against disastrous system failures. If the innovations share some of the pain of these disasters, they may be the best regulators and enforcers of the problem.

### *C. Where Is Decoupling Headed?*<sup>115</sup>

One might speculate rather than purport to predict. Focusing on the actors' incentives, one strong indication can be derived from the benefits of innovations to investors. Creating most such innovations involves less expense than creating innovations in real assets. I therefore expect decoupling to continue, subject to limitations by law. Owners and financial intermediaries (as well as those who are hired or financed by intermediaries) will gain short-term. Long-term owners, however, will bear future risks. These risks may be hidden or seem lower than they turn out to be and cannot be measured accurately in magnitude and time.

**From Banks to Markets.** I expect financial intermediaries to press very hard for moving from institutional intermediation—such as banks and insurance—to market intermediation—such as investment banks, underwriters, broker dealers, and various financial advisers. In fact,

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private-equity firm; second-highest is CEO of a technology firm; fourth-highest is CEO of petroleum firm).

113. *E.g.*, 26 U.S.C. § 163 (2006 & Supp. I 2007), *as amended by* American Recovery and Investment Act of 2009, Pub. L. No. 111-5, § 1232, 123 Stat. 115, 341 (providing deduction for interest paid or accrued on indebtedness); 26 U.S.C. §§ 860A-860G (2006) (granting special tax treatment for real estate mortgage investment conduits).

114. *E.g.*, *Too Big to Fail? The Role of Antitrust Law in Government-Funded Consolidation in the Banking Industry: Hearing Before the Courts and Competition Policy Subcomm. of the H. Judiciary Comm.*, 111th Cong. (2009) (statement of William Askew, Senior Policy Advisor, Financial Services Roundtable) (stating his belief that savings flowing into financial system was one of several factors causing the credit crisis).

115. Robert Ahdieh asked these questions at the conference held on November 7, 2009 at Seattle University School of Law.

banks will seek both government cheap money and the freedom to trade in the markets. Market intermediaries can innovate more freely, but the combined market and banking intermediaries might see new unexpected innovations, as securitization has demonstrated.

**If the financial sector continues to be profitable, it will grow both in assets and talent.** Even though not all talented young persons will be drawn to the financial sector, a sufficient number of talented persons who seek money will. It may well be that financial intermediation will spread to producers and sales organizations, and they might slice and dice promises through new and different means. “Risk protection” kinds of derivatives will also continue to spread, bringing immediate specific income for promises to cover risk that is less ascertained.

**Intermediaries will press to eliminate the current differences between various financial assets (promises).** The differences between equity and debt, ownership and fiduciary entrustment, private market and public market, risk and benefits, guarantees, insurance, and rating may all disappear. Instead of costly information, we might be offered mathematical formulas or letters, numerical evaluations, and measurements of benefits and risk. Regulation might be substantive, focusing on the ability of the issuers and intermediaries to meet their promises. Admittedly, in the short-term, this scenario is theoretical. Humans are the captives of habit. Institutions do not change fast, regardless of exciting innovations.

**More likely, financial innovations will be supervised with greater care, both within the institutions that create and buy them, and by the government.** We will continue to follow the same principles, and perhaps impose on the promisors a greater burden to protect the promises from significant risks. There are no signs of imposing specialization on financial intermediaries, such as the Glass-Steagall Act.<sup>116</sup> But, the future may be entirely different.

#### *D. What Regulation Can We Expect for Current Decouplings?*

**When are disclosure and the imposition of fiduciary duties sufficient to curb decoupling abuse, if ever?** Professors Hu and Black proposed enhanced disclosure of economic ownership (or lack of ownership), following generally the recent regulation in England and Hong

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<sup>116</sup> Even Allan Sloan, who berated bank managers in his column on January 19, 2010, and suggested that large institutions should split their safe and risky activities into separate operations, did not mention the Glass-Steagall Act. Presumably, market intermediaries grew at the expense of the banks, and the new financial institutions should be small, but also competitive. See Allan Sloan, *Let Wall Street Run Wild, Without My Money*, WASH. POST, Jan. 19, 2010, at A12, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/01/18/AR2010011803175.html>.



Kong.<sup>117</sup> “[L]arge shareholder disclosure under Schedule 13D or 13G focuses on voting ownership.”<sup>118</sup> Whether disclosure would enable market purchasers to understand what they are buying is questionable.<sup>119</sup> Indeed, complex instruments, described in Part Two, may perhaps be regulated by disclosure. After a conference on March 23, 2009, FINRA decided to issue an investor alert on reverse convertibles.<sup>120</sup> “The short-term structures pay a monthly coupon and return investor principal in the underlying stock if it has fallen by a certain amount. They have [always] been the dominant product in the US market, . . . but have been heavily punished by falling equity markets, with the majority returning principal in stock over recent months.”<sup>121</sup> “[FINRA] is treading carefully given the circumstances and what has happened in the industry. . . . This is why it is communicating with investors rather than developing a new enforcement.”<sup>122</sup> FINRA is “trying not to fan the flames, and to get investors through the difficult period that they are facing,” and is concerned “over disclosure in the offering material that accompanied notes and the suitability of the individuals who are investing in the structures.”<sup>123</sup>

**Should similar regulation apply to contracts and property?**

Decoupling should be divided into agreements among discrete parties that are aware of each other before they enter the agreements and trade in promises. In both this case and in market trading, the parties could employ brokers. In the markets, however, parties know the brokers rather than the identity of the other parties. Knowing one’s counterparty should be the dividing line and test between contract and market transactions. Attempts to hide, let alone hiding, the trades of agreements should be a criminal offense. While agreements may be left to contract law subject

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117. Hu & Black, *supra* note 28, at 879–80.

118. *Id.* at 882.

119. See Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 156 (2006) (“While the philosophy of disclosure may offer certain advantages for regulating the securities market, reliance on disclosure regulation alone raises broader questions about the law’s dependence on rational choice models of decision-making. The belief that disclosure is beneficial, and the emphasis on ensuring that accurate information is available to the public, rests on the assumption that investors are rational, competent actors who are capable of circumspectly processing the information. It would make no sense to insist that risks be disclosed if we did not assume that people could rationally weigh the costs and benefits of risky alternatives and select the optimal choice. However, . . . evidence suggests that this assumption may be somewhat misguided.”).

120. Sophia Morrell, *Finra to Issue Investor Alert on Reverse Convertibles*, RISK, Mar. 27, 2009, <http://www.risk.net/structured-products/feature/1527328/finra-issue-investor-alert-reverse-convertibles>.

121. *Id.*

122. *Id.* (quoting Richard Vagnoni).

123. *Id.* (quoting Richard Vagnoni).

to interference of the law when specific problems arise, trading in financial promises and risks must be backed by substantive regulation to ensure that the promisors are able to meet their promises. Otherwise, the financial system, and consequently the economy, may be threatened.<sup>124</sup>

**When, if at all, should institutional investors be regulated?** If complex, combined, decoupled instruments, such as bonds that carry shareholder risks, are truly wagers, I assume that investors may speculate with their own money. However, institutional investors should not be allowed to use entrusted money and assets to engage in wagering, even when they receive express permission from the true owners. If the owners wish to gamble, they must do so by exercising their control over their own money (not that of others).

#### *E. A Radical Regulatory View May Be Worth Examining*

Intermediaries that create financial risk for others should retain some of the risk that they create. Insured institutions and persons that create excessive risks for their insurers should retain some of the risks. Insurance companies know how to do that to protect themselves against the “moral hazards” of the insured. They do that through “deductibles, co-payments, exclusions, and experience rating.”<sup>125</sup> “A deductible is the exclusion of a certain amount of expense from coverage; coinsurance requires the individual to pay some fraction of each dollar of cost.”<sup>126</sup> Deductibles do not deter people from using insurance.<sup>127</sup> However, coinsurance varies inversely with the use of insurance. The higher the percentage of co-insurance and the more the insured must pay the less insurance the co-insurer will use.<sup>128</sup> “Exclusions serve to narrow the types of risks that are covered by a policy, e.g., most (if not all) policies exclude losses that result from intentional acts of the insured.”<sup>129</sup> The same prin-

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124. Interview with Nicholas Valerio III, *supra* note 72.

125. Eric D. Beal, *Posner and Moral Hazard*, 7 CONN. INS. L.J. 81, 86 (2000–2001).

126. Mark V. Pauly, *The Economics of Moral Hazard*, 58 AM. ECON. REV. 531, 535 n.4 (1968).

127. In a study regarding medical insurance, Mark V. Pauly finds that “the deductible either (a) has no effect on an individual’s usage or (b) induces him to consume that amount of care he would have purchased if he had no insurance. If there are income effects on individual demands, because the deductible makes the individual poorer his usage will be restrained somewhat even if he covers the deductible.” *Id.* at 536.

128. *Id.* Pauly also finds that the “optimal extent of coinsurance is the coverage of that percentage of the cost of each unit of medical care at which the utility gain to the individual from having an additional small fraction of the cost of each unit of care covered by insurance equals the utility loss to him upon having to pay for the ‘excess’ units of care whose consumption the additional coverage encourages.” *Id.*

129. Beal, *supra* note 125, at 86–87 (footnote omitted). “[A]n experience rating is the insureds’ ‘track record’; greater losses result in higher premiums.” *Id.* at 87.

ciples should apply to lenders who sell loans and to managers who manage other people's money, whether they are investment advisers or directors and officers of a corporation. The same principles should apply to investment bankers and brokers who offer auction notes. Intermediaries engaged in the financial system should carry some of the risk that they create for others, and that risk cannot be transferred. To be sure, both intermediaries and their clients may seek coverage for the risks they take that affect others. In such a case, however, the intermediaries will bear higher costs than others that are more cautious. Let the example of such coverage be the one that has been adopted by insurance companies for many years as deductibles.<sup>130</sup>

I conclude that the latest financial innovations have undermined ownership protection. These decouplings have not offered owners any risk protection. The reverse is true: the decouplings have benefitted intermediaries at the risk and expense of the owners. Never before has ownership been exposed to so much risk from those who control, and never before, not even during the 1920s, have innovations played such a deceptive role in giving free and unaccountable control over ownership. The time has come to focus on the separation of control from accountability to owners. This should be the focus of the future regulation.

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130. Pauly, *supra* note 126, at 535 n.4.