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The Collapse of Bear Stearns, or: Skinny Dipping on the Street

AARON BROUGHMAN*

I. INTRODUCTION

Warren Buffett once quipped to his Berkshire Hathaway shareholders, "you only find out who is swimming naked when the tide goes out."[1] For once-venerable investment house Bear Stearns, Buffet's witty aphorism proved to be more truth than the troubled bank could handle standing on a busy sidewalk in New York outside of 383 Madison Avenue[2] and taunting gleefully like a child, "I told you so! I told you so!" March 14, 2008 will dot the pages of history as the day the fifth-largest investment bank in the U.S.[3] bared itself to the world as the tide of capital receded, leaving it helplessly stranded on a deserted isle of insolvency, naked and surrounded by a sea of sharks. The collapse of Bear Stearns sent shockwaves throughout the financial community, ultimately resulting in federal government intervention in the capital markets.[4]

One of the most interesting things about the collapse was the speed with which it happened. Within a matter of hours, billions of dollars in liquidity dried up from a loss of confidence in the bank, leaving it without the capital necessary to carry out everyday transactions.[5] In its simplest terms, it was nothing more than an old-fashioned run on the bank.[6] Bear Stearns was stuck between a rapidly dwindling pool of capital on one side, and billions of dollars in short term obligations to be paid on the other.[7] In other words, the collapse was simply Bear Stearns succumbing to an agonizing financial bleeding.

The rapid speed with which Bear Stearns collapsed caused many to question what exactly happened. Rumors surfaced that the collapse was the

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* J.D., Ohio Northern Unviersity, May 2009 (with distinction).

1. Letter from Warren E. Buffet, Chairman of the Board, Berkshire Hathaway, to the Shareholders of Berkshire Hathaway, Inc. (Feb. 28, 2002), *available at* http://www.berkshirehathaway.com/letters/2001.html.

2. 383 Madison Ave. in New York City, once the headquarters of Bear Stearns, changed hands with the takeover of Bear Stearns by JP Morgan in 2008. Wikipedia, http://en.wikipedia.org/wiki/383_Madison_Avenue (last visited Oct. 4, 2009).

3. Daniel Gross, *How a Lack of Faith Pounded the Markets; Once-mighty Bear Stearns has become the latest victim of Wall Street's growing crisis of confidence*, NEWSWEEK, Mar. 31, 2008, at 48.

4. *Id.*

5. The events immediately preceding the collapse of Bear Stearns are discussed later in this article. *See infra* Part II.A.

6. Robin Sidel et al., *The Week That Shook Wall Street: Inside the Demise of Bear* Stearns, WALL ST. J., Mar. 18, 2008, at A1.

7. *Id.*

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result of hedge fund manipulation or that Goldman Sachs had engineered the death blow.[8] Some wondered why the SEC did not intervene whether the Agency had properly conducted oversight of the bank.[9] Only after the dust had settled did answers begin to arise as to the events that transpired that fateful week in March.

The collapse of Bear Stearns has broader implications as well. It was not an isolated incident that affected only the bank and its shareholders. There are greater concerns, involving the entire financial community, which must be considered: preventing the reoccurrence of such an event is most important. Understanding these concerns requires an examination of the collapse of Bear Stearns itself and an inquiry into why it happened. Only then can consideration be given to concerns involving the financial system as a whole.

II. ABOUT A BEAR

A. Fear on the Street

On June 20, 2007, Merrill Lynch seized over $800 million worth of assets from two Bear Stearns hedge funds – the High-Grade Structured Strategies Enhanced Leverage Fund and the High-Grade Structured Credit Strategies Fund – that were on the verge of collapse.[10] The two funds were heavily invested in subprime mortgage-backed securities known as collateralized debt obligations[11] ("CDOs").[12] After suffering losses of up to twenty percent on the year, the fund's creditors[13] sought protection by seizing some of the assets used as collateral on loans that provided capital to the funds.[14] Merrill Lynch

8. *See Peter Cohan, Did Hedge Funds Push and Profit from Bear Stearns's Collapse?,* BLOGGINSTOCKS (Mar. 31, 2008), http://www.bloggingstocks.com/2008/03/31/did-hedge-funds-push-and-profit-from-bear-stearnss-collapse/.

9. *See* Jesse Westbrook, *Cox Defends SEC's Role in Regulating Bear Stearns (Update 1)*, BLOOMBERG, April 3, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aNuVT6FoCDE&refer=home.

10. Vikas Bajaj & Julie Creswell, *Bear Stearns Staves Off Collapse of 2 Hedge Funds*, N.Y. TIMES, June 21, 2007, at C1.

11. CDOs "are packages of securities backed by bonds, mortgages and other loans." *See* David Evans, *Banks Sell 'Toxic Waste' CDOs to Calpers, Texas Teachers Fund*, BLOOMBERG, June 1, 2007, http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aW5vEJn3LpVw.

12. Bajaj & Creswell, *supra* note 10.

13. The funds borrowed at least $6 billion from major investment banks, including Merrill Lynch, JPMorgan Chase & Co., Goldman Sachs, Citigroup, and Bank of America, to purchase the CDOs. Mark Pittman, *Bear Stearns Fund Collapse Sends Shocks Through CDOs (Update 2)*, BLOOMBERG, June 21, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=a7LCp2Acv2aw&refer=home.

14. *Id.*

and Deutsche Bank then moved to auction off these assets.[15] However, other banks, including JP Morgan and Goldman Sachs, made new deals with Bear Stearns to forestall a complete collapse of the hedge funds, which would have required Bear to auction off up to $2 billion worth of mortgage securities.[16]

This was not the first time, however, that Wall Street faced the collapse of a major hedge fund. Long-Term Capital Management blew up in 1998, and Amaranth Advisors lost sixty-five percent of its $9.2 billion in assets in 2006.[17] Yet Wall Street managed to weather the storm: investment banks swooped in on the carcasses of the funds and stripped away assets on the cheap.[18] The collapse of the two Bear Stearns hedge funds, however, presented a new problem that sent shockwaves of fear rippling through the markets.[19]

The use of leverage and derivatives to maximize gains and manage risk has revolutionized the way financial markets operate.[20] Derivatives are used as a hedge against risk and to make speculative bets on future events.[21] For example, a hedge fund may purchase a large amount of mortgage-backed securities in the form of CDOs, and enter into a credit-default swap ("CDS"), a type of over-the-counter ("OTC") contract with an investment bank to hedge against the risk of default on the loans securitized through the CDO.[22] A credit-default swap is basically an exchange of cash flows: the bank assumes the risk of default in exchange for a stream of premiums paid by the hedge fund.[23] Leverage is used throughout these types of transactions.[24] Hedge funds borrow from banks to purchase the CDOs, and banks borrow to pay premiums on new CDSs to hedge against the risk of the original CDS.[25] The result is an intricate web of lenders and borrowers, with each party a

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15. Bajaj & Creswell, *supra* note 10.
16. *Id.*
17. Mara Der Hovanesian, *Amaranth's Loss, Wall Street's Gain*, BUS. WEEK, Oct. 9, 2006, at 78.
18. *Id.*
19. *See* Grace Wong, *Deadly ripples threaten subprime funds*, CNNMONEY, June 21, 2007, http://money.cnn.com/2007/06/21/markets/bear_fallout/index.htm.
20. *See* SATYAJIT DAS, TRADERS, GUNS, & MONEY: KNOWNS AND UNKNOWNS IN THE DAZZLING WORLD OF DERIVATIVES 26-27 (2006).
21. *See id.* at 24.
22. *See id.* at 25.
23. Neil Unmack & Sarah Mulholland, *Swaps Tied to Losses Became 'Frankenstein's Monster*' (*Update 1*), BLOOMBERG, Apr. 15, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aUsbb8HMdPJw&refer=home.
24. *See* DAS, *supra* note 20 at 31.
25. Paul Tustain, *Hedge Funds and CDO Investment Landfills: How professionals dump their toxic waste on you*, July 3, 2007, http://www.marketoracle.co.uk/Article1444.html; *see also* Das, *supra* note 21, at 31.

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counterparty to the others through thousands of similar transactions.[26] It is estimated that, as of year-end 2007, there were $43 trillion worth of outstanding CDSs in the market and the total derivatives market itself amounts to over $500 trillion.[27] It was within these numbers, as well as the complexity of modern-day capital markets, that the fear created by the collapse of the two Bear Stearns hedge funds arose.

Many of these new derivatives and securities are so complex or exotic and trade so infrequently that it is almost impossible to value them.[28] When investment banks have to report their holdings at the end of each quarter, they must supply some sort of value for these assets.[29] Enter Financial Accounting Standard ("FAS") Rule 157. According to FAS 157, banks and publicly traded companies must classify each asset as belonging to one of three levels and determine its value based on the rule for each level.[30] Level 1 assets use simple "mark-to-market" valuations using observable market prices.[31] Level 2 assets are slightly more complex: they do not have observable prices, but a value can be determined using other observable inputs such as component values or the values of similar assets.[32] Level 3 assets are the most complex: they have no observable inputs by which to determine their value.[33] Instead, managers must "mark-to-model," whereby; value is determined by using an in-house model.[34] Many subprime mortgage securities, such as the CDOs that were held by the Bear Stearns hedge funds, are Level 3 assets that are valued according to in-house models at investment banks.[35] Quite simply, therein lie the seeds of turmoil.

If Bear Stearns had been forced to auction off all of the assets in its two hedge funds at fire-sale prices, it would have provided inputs with which to value all similar types of securities held by other investors.[36] These investors

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26. Tustain, *supra* note 25; *see also* Das, *supra* note 20, at 31.

27. Investment Outlook from William H. Gross, Managing Director, PIMCO (January 2008), *available at* http://www.pimco.com (follow "Content Archive" hyperlink; then follow "2008 IO Archive" hyperlink; then follow "Pyramids Crumbling" hyperlink) [hereinafter "Investment Outlook"].

28. *See* Toan Tran, *The Perils of Mark to Model,* MORNINGSTAR GROWTHINVESTOR, Mar. 26, 2008, *available at* http://news.morningstar.com/articlenet/article.aspx?id=232738&t1=1209517730.

29. *Id.*

30. Mark Gongloff, *A FAS 157 Primer* WALL ST. J. MARKETBEAT, Nov. 15, 2007, http://blogs.wsj.com/marketbeat/2007/11/15/a-fas-157-primer/.

31. *Id.*

32. *Id.*

33. *Id.*

34. Tran, *supra* note 28.

35. *See id.*

36. *See* Bajaj & Creswell, *supra* note 10.

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would have had to mark down their assets, which were valued much higher based on in-house models.[37] With leverage involved, margin calls would likely have followed, causing a flood of these assets into a market with few buyers due to a fear of being stuck with a liability in danger of default that would lead to steep losses.[38] In other words, the collapse of the two hedge funds created turmoil in the markets out of fear that the subprime market would seize up, with heavy losses for the players involved, and fear of a ripple effect on the larger credit market itself, with less capital available for financing the many transactions that occur daily on Wall Street.[39] It was this fear that would later resurface as the death knell to Bear Stearns.

In August 2007, Standard & Poor's ("S&P") changed its outlook on Bear Stearns from stable to negative because of the hedge fund's problems and the potential for further problems, such as significant write-downs and litigation.[40] S&P did note, however, that the bank had strong liquidity and would be profitable again in the near future.[41] Despite that positive outlook, the damage that Bear Stearns' reputation suffered from the collapse of the two hedge funds and its exposure to mortgage-backed securities cast a negative pall over the bank.[42] Bear Stearns was quick to respond: "Contrary to rumors in the marketplace, our franchise is profitable and healthy and our balance sheet is strong and liquid."[43]

Bear Stearns CEO Alan Schwartz fell back on that rhetoric again in March 2008 when rumors began to circulate that the bank was having liquidity problems.[44] On Monday, March 10, Bear Stearns commented on those rumors: "'There is absolutely no truth to the rumors of liquidity problems that circulated today in the market.'"[45] Though Mr. Schwartz denied there were any problems, there was some truth to the rumors. The previous Friday, a major bank had declined to give Bear Stearns a short-term, $2 billion loan and the rumors persisted.[46] On Tuesday, Bear Stearns' CFO Sam Molinaro

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37. *Id.*
38. *See* Wong, *supra* note 19.
39. *Id.*
40. John Spence, *Mortgage worries, Bear Stearns ratings warning hits stocks*, MARKETWATCH, Aug. 3, 2007, *available at* http://www.marketwatch.com/news/story/mortgage-worries-bear-stearns-ratings/story.aspx?guid=%7BFA5E5DA5-93BB-474D-80F1-190321DF7C6C%7D.
41. *Id.*
42. *See id.*
43. *Id.*
44. Marcy Gordon, *Bear Stearns' words draw SEC's attention; Statements about its health before takeover could cause legal action*, HOUSTON CHRONICLE, Mar. 19, 2008, at Business 3.
45. Roddy Boyd, *The Last Days of Bear Stearns*, FORTUNE, April 14, 2008, at 86.
46. *Id.*

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appeared on CNBC, commenting on the rumors: "If I knew why it was happening, I would do something to address it . . . [t]here is no liquidity crisis. No margin calls. It's nonsense."[47] But the rumor mill continued to turn.

When questions of liquidity came up again on Wednesday, March 12, Mr. Schwartz again denied them.[48] He appeared on CNBC to defend the bank: "'Bear Stearns' balance sheet, liquidity, and capital remain strong[.]'" and "'[o]ur liquidity position has not changed at all, our balance sheet has not changed at all[.]"[49] And, in regards to the credit issues: "We're not being made aware of anybody who is not taking our credit as a counterparty[.] We don't see any pressure on our liquidity, let alone a liquidity crisis.'"[50] Mr. Schwartz's adamant defense of Bear Stearns' financial health seemed to add validity to stock-pimp Jim Cramer's advice to a viewer the day before on his CNBC program, "Mad Money."[51] The viewer wrote into the show asking: "'Should I be worried about Bear Stearns in terms of its liquidity and get my money out of there?'"[52] Cramer responded with one of his whiney, screaming replies: "'No, no, no . . . Bear Stearns is fine . . . Don't move your money from Bear . . . Don't be silly.'"[53] Three days earlier, Cramer's theStreet.com listed Bear Stearns as a "buy" at $62.[54] Despite all of this reassurance, the next few days would show that Bear Stearns was anything but safe and healthy.

The rumors that preceded Schwartz's statements on CNBC had reached a zenith the day before on Tuesday.[55] Fed by fear, clients who had entered into trades with Bear Stearns were calling other investments banks – including Goldman Sachs, Morgan Stanley, and Credit Suisse – worried that Bear Stearns would not be able to make good on its obligations.[56] The clients asked the other banks if they would be willing to step in and take their place in the trades with Bear Stearns.[57] But those banks had fears of their own, and they

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47. *Id.*
48. *Id.*
49. Henry Blodget, *Did Bear Stearns CEO Alan Schwartz Lie on CNBC?*, THE BUSINESS INSIDER, March 19, 2008, http://www.alleyinsider.com/2008/3/bear_stearns_bsc_did_ceo_alan_schwartz_lie_on_cnbc_.
50. Boyd, *supra* note 45.
51. *See* Al Lewis, *Not being aware is a Bear*, THE DENVER POST, Mar. 21, 2008, at B5.
52. *Id.*
53. *Id.*
54. Michael Lewis, *What Wall Street CEOs Don't Know Can Kill You: Michael Lewis*, BLOOMBERG, Mar. 26, 2008, http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_lewis&sid=aSE8yLAyALNQ.
55. *See* Sidel, *supra* note 6.
56. *Id.*
57. *Id.*

declined to do so.[58] The Goldman Sachs credit derivatives group sent an e-mail to its hedge fund clients saying that Goldman Sachs would no longer stand in on their trades with Bear Stearns if they were nervous about the bank's liquidity.[59] By the end of the day, banks were refusing to issue any more credit protection on Bear Stearns debt.[60] As that fear spread through the Street, clients began pulling their money out of Bear Stearns.[61] Though worried, Bear Stearns executives felt comfortable that they could weather the withdrawals, as they were sitting on a cash cushion of $17 billion.[62]

By Thursday, however, the situation had become dire. Clients had continued to withdraw funds, and Bear Stearns' cash position had deteriorated to a paltry $2 billion.[63] To make matters worse, the bank had obligations to meet the next day at 7:30 a.m.[64] At that time, Bear Stearns would have to begin paying back some of the billions of dollars it had borrowed in the "repo market."[65] The repo market is where banks and securities firms extend and receive short-term loans, usually made overnight and backed by securities.[66] With only a $2 billion cash cushion beneath them, Bear Stearns would not be able to repay its creditors on time.[67] If this were to happen, the creditors would have to begin selling off the securities used as collateral for the loans.[68] Furthermore, investors likely would have begun to question other loans made in the repo market, causing them to withhold funds from other banks.[69] Without these funds, the investment banks would not have been able to meet their obligations as counterparties to a variety of transactions or, like Bear Stearns, as borrowers of short-term loans.[70] The credit market could have possibly frozen up.[71] Without confidence in the system, the market itself could have collapsed.[72]

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58. *Id.*
59. Boyd, *supra* note 45.
60. *Id.*
61. *Id.*
62. Sidel, *supra* note 6.
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. *See* Sidel, *supra* note 6.
68. *Id.*
69. *Id.*
70. *Fed Backs Emergency Sale of Investment Bank Bear Stearns; Expands Lending, Cuts Key Interest Rate*, WORLD NEWS DIGEST, Mar. 20, 2008, at A2.
71. Economists worried that the credit markets would constrict if there was fear that the repo market had become a risky place to lend money. *Id.*
72. *See* Sidel, *supra* note 6.

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Seeing the potential wasteland before them, Bear Stearns executives initiated a conference call at 7:30 p.m. with officials from the SEC, the Treasury, and the Federal Reserve.[73] The executives informed the officials that, unless the Federal Reserve could loan enough cash through the discount window for Bear Stearns to stay afloat, little could be done other than filing for bankruptcy Friday morning.[74] There was also talk of a merger with or takeover by another bank.[75] Mr. Schwartz made a desperate phone call to JPMorgan CEO Jamie Dimon, seeking a lifeline.[76] Bear Stearns was now in panic mode. What followed was an all night, frantic rescue operation to discover a rescue package.[77] That Thursday night, the only thing lacking more than sleep was time. Friday morning loomed on the horizon.

B. When Black Friday Comes

At 5:00 a.m. on Friday, Federal Reserve Chairman Ben Bernanke, Treasury Secretary Henry Paulson, and Federal Reserve Bank of New York President Timothy Geithner joined in a conference call to determine whether Bear Stearns should be allowed to fail or the Federal Reserve should provide enough funding to get it through the weekend.[78] They decided on the latter, invoking powers that had not been used since the Great Depression.[79] Soon thereafter, the announcement was made that the Federal Reserve would open a lifeline to Bear Stearns through JPMorgan, for up to twenty-eight days, to get the bank through its cash crisis.[80] JPMorgan would be allowed to bring Bear Stearns collateral to the discount window in exchange for the loans, something Bear Stearns itself could not do as an investment bank because the discount window was open only to commercial, depositor banks.[81] In a conference call, Mr. Schwartz maintained his defense of Bear Stearns, saying that the new loan would wipe out the fear and restore calm.[82]

But the market's reaction was anything but calm. Instead, the reaction

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73. *Id.*

74. *Id.*; *see also* Louise Armitstead & James Quinn, *How Wall St. giant ran out of the Bear necessities*, SUNDAY TELEGRAPH (London), Mar. 16, 2008, at CITY 3.

75. *See* Armistead*, supra* note 74.

76. Boyd, *supra* note 45.

77. *Id.*

78. Sidel, *supra* note 6.

79. *Id.*

80. *Id*.

81. *The dramatic rescue of Bear Stearns*, THE ECONOMIST, Mar. 14, 2008, http://www.economist.com/finance/displaystory.cfm?story_id=10870166 [hereinafter "dramatic rescue"].

82. Boyd, *supra* note 45.

was exactly what one would expect with the imminent failure of a major investment bank: pandemonium.[83] Stocks sank; lenders turned cautious.[84] Bear Stearns' stock fell almost forty percent in the first half-hour of trading.[85] Federal Reserve officials began planning to open the discount window to all investment banks.[86] Fear ruled the markets: if Bear Stearns was on the brink of collapse, were other investment banks there as well?[87] Goldilocks had scarfed down the porridge and run; it was Bear Day on the Street, in more ways than one.

Friday afternoon brought more relief for Bear Stearns as JPMorgan, backed by the Federal Reserve, stepped up efforts to acquire the bank.[88] Federal Reserve officials made it clear to all involved that the twenty-eight day lifeline was a short-term loan and that they would have to complete a deal as soon as possible.[89] They would not, however, have the full twenty-eight days to complete the deal.[90] Instead, the deal would have to be completed over the weekend.[91] Bear Stearns, like other investment banks and hedge funds, was a counterparty to a number of trades.[92] The Federal Reserve and Treasury wanted the parties on the other side of those trades to be assured that, when they arrived to work on Monday, their contracts with Bear Stearns were still good.[93] The goal was simple: assuage the fear to prevent a generalized flight from the market.[94]

The stock market closed Friday with Bear Stearns having lost almost fifty percent of its value.[95] Inside 383 Madison Ave., teams of JPMorgan bankers were starting out on a due diligence marathon.[96] Federal Reserve staffers set up base camp in a conference room on the twelfth floor, overseeing operations.[97] Steve Black, co-head of JPMorgan's investment bank, flew back early from a Caribbean vacation to head the bank's efforts to buyout Bear

83. *See* Sidel, *supra* note 6; Armitstead, *supra* note 74.
84. Sidel, *supra* note 6.
85. Boyd, *supra* note 45.
86. Sidel, *supra* note 6.
87. Armitstead, *supra* note 74.
88. Sidel, *supra* note 6.
89. *Id.*
90. *See id.*
91. *Id.*
92. *See id.*
93. Sidel, *supra* note 6.
94. *See id.*
95. Armitstead, *supra* note 74.
96. Sidel, *supra* note 6.
97. *Id.*

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Stearns.[98] It was the beginning of a long and sleepless weekend, a weekend that would shock the financial community and end with one sweet deal for JPMorgan.

C. Everybody's Working for the Weekend

Saturday, March 15, brought new fears.[99] Bank executives were worried that the run on Bear Stearns could spread to other investment banks and financial institutions.[100] Mr. Paulson sensed a storm building strength: "'It was just clear that this franchise was going to unravel if the deal wasn't done by the end of the weekend.'"[101] The Federal Reserve and Treasury insisted that the deal be done before the Asian markets opened that following Sunday night, to assuage the fear that had so quickly begun to spread through the markets and threatened to cause a global run on the banks.[102]

Due diligence continued all day Saturday.[103] Once again, JPMorgan bankers flooded the offices of 383 Madison Avenue, while executives set up war rooms back at JPMorgan headquarters.[104] As the evening settled in, Mr. Black called Mr. Schwartz to inform him that JPMorgan would be willing to purchase Bear Stearns, subject, however, to the satisfactory completion of due diligence.[105] At 1:00 a.m., the bankers departed for home to nibble at a few hours of sleep.[106]

Early Sunday morning, JPMorgan and Bear Stearns executives met to discuss the deal.[107] There was concern that adequate due diligence could not be conducted in time to complete the deal before Sunday evening.[108] JPMorgan feared, as other banks had, that Bear Stearns' balance sheet may have contained deeply hidden problems that due diligence had yet to discover.[109] There was also fear that further turmoil in the markets could exacerbate Bear Stearns' problems, which would then become JPMorgan's problems.[110] In just a few hours, the entire deal had stalled out; JPMorgan

98. *Id.*
99. *See* Sidel, *supra* note 6.
100. *Id.*
101. Sidel, *supra* note 6.
102. *Id.*
103. *See id.*
104. *Id.*
105. *Id.*
106. Sidel, *supra* note 6.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*

refused to buy out Bear Stearns on its own.[111] They would need the safety net of another bank.[112]

Mr. Paulson had been keeping close contact with JPMorgan and Bear Stearns executives throughout the negotiations.[113] JPMorgan, leery of Bear Stearns' balance sheet, wanted to buy Bear Stearns' assets piecemeal, taking only the good ones and leaving the toxic ones behind.[114] Mr. Paulson informed them, however, that they would have to buy out Bear Stearns completely.[115] JPMorgan had no choice but to comply. Since the Federal Reserve had already guaranteed JPMorgan's earlier loans to Bear Stearns by accepting possibly toxic mortgage-backed securities as collateral, they were essentially a third party to the deal.[116] Since those guarantees were being made by the government on the taxpayer's dime, the Federal Reserve and Treasury had the final say.[117] As negotiations continued, it was decided that JPMorgan would complete its buyout of Bear Stearns with the backing of the Federal Reserve Bank of New York.[118]

The deal was considered highly unusual, even by those who had helped put it together.[119] JPMorgan was locked into the deal; even if Bear Stearns' business were to substantially deteriorate, there was no way that JPMorgan could back out.[120] The deal was heavily locked up, subject only to approval by shareholder vote.[121] The Federal Reserve would loan JPMorgan $30 billion to complete the acquisition, with Bear Stearns' troubled Level 3 assets being used as collateral to secure the loans.[122] JPMorgan was also granted an option to purchase Bear Stearns' headquarters at 383 Madison Avenue for $1.1 billion if the deal were not to go through.[123] The more interesting aspect of the real estate option, however, was its value in relation to the price that JPMorgan had negotiated to buyout Bear Stearns completely.[124]

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111. Sidel, *supra* note 6.
112. *Id.*
113. *Id.*
114. *See id.*
115. *Id.*
116. Sidel, *supra* note 6.
117. *See id.*
118. *See id.*
119. *Id.*
120. *Id.*
121. *See* Sidel, *supra* note 6.
122. *Id.*
123. Karen Donovan, *Behind Bear's Sale*, CONDE NAST Portfolio.com, Mar. 18, 2008, http://www.portfolio.com/news-markets/top-5/2008/03/18/JP-Morgan-Bear-Stearns-Deal-Lawyers; *see also* Sidel, *supra* note 6.
124. *See id.*

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Sunday evening, the announcement was made that JPMorgan would purchase Bear Stearns for the whopping sum of $2 per share, or $236 million.[125] The deal had included an option for JPMorgan to purchase twenty percent of Bear Stearns' shares at the $2 buyout price.[126] The price was a complete shock for the Street; more importantly, however, it was a complete shock to Bear Stearns' shareholders, many of whom were employees of the company.[127] Many jobs, along with millions of dollars in retirement savings, were lost.[128] According to one former employee: "My life has been flushed down the drain[.]"[129] Fear had rendered the once-venerable investment house almost worthless. On Monday morning, in a fitting end to the weekend, someone taped a $2 bill to the inside entrance doors at 383 Madison Avenue.[130] The complete collapse of Bear Stearns had been staved off. For some, it came with hefty consequences; for JPMorgan, the deal was the bargain of a lifetime.[131]

III. LOST IN THE SHADOWS

The collapse of Bear Stearns left many wondering just how such a catastrophe had come about. The general answer was that Bear Stearns had suffered from a run on the bank.[132] While that may have been the final blow that brought down the bank, another answer lies deeper within the financial markets as a whole.

As the dust settled on the collapse of Bear Stearns, the SEC found itself facing intense criticism over its oversight of the bank.[133] The SEC's mission is to maintain orderly markets and protect investor and customer accounts at brokerage firms, among other things.[134] To do so, the SEC requires banks to maintain certain capital and liquidity standards.[135] Pursuant to Rule 15(c)(3)-1

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125. *Id.*; Sidel, *supra* note 6.

126. Sidel, *supra* note 6.

127. Landon Thomas Jr., *For Bear Stearns employees, a punishing blow; Collapsed shares and an unclear future*, INTERNATIONAL HERALD TRIBUNE, Mar. 19, 2008, at Finance 11.

128. *See id.*

129. *Id.*

130. Gross, *supra* note 3.

131. *See* Thomas, *supra* note 127; *Bear Stearns Falls in the Hands of JPMorgan*, TURKISH DAILY NEWS, Mar. 18, 2008.

132. Gretchen Morgenson, *A Fed Bailout Crosses the Line*, CHICAGO DAILY LAW BULLETIN, Mar. 19, 2008, at 40005.

133. Kara Scannell, *Credit Crisis: SEC Comes Under Criticism in Light of Bear Woes*, WALL ST. J., Mar. 27, 2008, at A6.

134. *Id.*

135. *See id.*

of the Securities Exchange Act of 1934, brokers and dealers must maintain certain levels of net capital.[136] A broker or dealer is also not allowed to have its aggregate indebtedness[137] exceed a ratio of 15:1.[138] There are, however, exceptions to the aggregate indebtedness requirement, including indebtedness collateralized by certain securities or commodities, "[a]mounts payable against securities loaned," "[f]ixed liabilities adequately secured by assets acquired for use in the ordinary course of trade or business," and "liabilities on open contractual commitments."[139] While one could easily get lost in dissecting Bear Stearns' balance sheet to determine if the requirements of Rule 15(c)(3)-1 had been met, that is not necessary here. The SEC, which had been monitoring Bear Stearns' capital and liquidity on a daily basis prior to the collapse, maintained that the bank's capital and liquidity, all the way up to the collapse, had exceeded relevant regulatory standards.[140] It was the SEC's position, after the collapse, that they had adequately conducted oversight of the bank and had been caught off-guard by rapid erosion of the bank's liquidity due to the fear that caused a lack of confidence in the bank.[141] SEC Chairman Christopher Cox, in defending the Agency, stated that the problem was not with the bank's capital structure, but the unwillingness of other financial institutions to lend it capital: "'This was not a lack of capital. This was a lack of confidence.'"[142] Mr. Cox did, however, note that the traditional method of measuring liquidity, as enough money to handle everyday transactions, may now be inadequate: "These are unique problems that challenged the bank supervisory model that has relied on capital and liquidity standards."[143] Mr. Cox's statements may be quite relevant to current regulatory measures, but they may be even more relevant in pointing to more serious problems that lie deeper within the financial markets.

PIMCO's William Gross has repeatedly warned investors about the perils of the new "shadow banking system," a system that lies within modern

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136. Securities Exchange Act of 1934, Rule 15c3-1, *available at* http://www.law.uc.edu/CCL/34ActRls/rule15c3-1.html#c.2 (net capital is the adjusted net worth of the broker or dealer.).

137. *Id.* (aggregate indebtedness is the "total money liabilities of a broker or dealer arising in connection with any transaction whatsoever").

138. *Id.*

139. *Id.*

140. Katherine, Hunt, *SEC: Bear Stearns Had More Than $17B in Cash, Liquid Assets as of March 11,* Forbes.com, Mar. 14, 2008, http://www.forbes.com/markets/feeds/afx/2008/03/14/afx4776041.html.

141. *See* Kara Scannell, *Credit Crisis: SEC Comes Under Criticism in Light of Bear Woes*, WALL ST. J., Mar. 27, 2008, at A6; *see generally* dramatic rescue, *supra* note 81 (providing background to Bear Stearns collapse).

142. Scannell, *supra* note 141; *see generally* dramatic rescue, *supra* note 81.

143. Scannell, *supra* note 141.

financial markets but outside the scope of modern regulatory measures.[144] In the "shadow banking system," banks use financial derivatives and excessive leverage to create a pyramid scheme of securitized assets.[145] They avoid capital requirements and other regulatory measures by making use of "shadow banks": off-balance sheet conduits that hold numerous types of derivatives (CDOs, CDSs, etc.) and collateralized assets.[146] Hedge funds, engaging in the same types of transactions and activities, are also part of this "shadow banking system," as they are basically unregulated as well.[147] Like Bear Stearns, then, financial institutions on their face may appear to be highly liquid institutions, yet in reality they are thinly capitalized[148] and susceptible to collapse.[149]

Consider, for instance, Level 3 assets. Level 3 assets are considered in determining a bank's net capital and, thus, whether a bank meets regulatory capital requirements.[150] Net capital, in turn, determines how much a bank is allowed to lend.[151] Banks also use those assets as collateral in securing their own borrowings.[152] However, Level 3 assets are valued only according to a bank's own model.[153] When an actual value is given to those assets by the market – most often a lower one – banks are required to mark down the value of those assets.[154] Since the values are lower, the banks are required to raise new capital to meet regulatory requirements.[155] With less net capital, banks will not be able to lend as much money as they could before.[156] This inability to lend leads to the possibility of a credit crunch.[157]

The situation is more complicated than the inability to lend. This Level 3 asset problem does not involve just one bank.[158] Many banks hold Level 3 assets in amounts that have the ability to generate massive headaches for the

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144. *See* Investment Outlook, *supra* note 27.

145. *See id.*

146. *See id.*

147. *See id.*

148. Gross compares modern financial institutions with those of 20 years ago – the bank of Jimmy Stewart, as Gross calls them. Investment Outlook, *supra* note 27. A Jimmy Stewart bank held adequate capital reserves in relation to their assets and liabilities to ensure against a run on the bank. *Id.*

149. *See id.*

150. John Mauldin, *Credit Crisis to Credit Crunch*, THOUGHTS FROM THE FRONTLINE WEEKLY NEWSLETTER, Nov. 9, 2007, http://www.2000wave.com/pdf/mwo110907.pdf.

151. *Id.*

152. *See id.*

153. *Supra* Part II. A.

154. *See* Mauldin, *supra* note 150.

155. *Id.*

156. *Id.*

157. *Id.*

158. *See id.*

financial system.[159] Consider the amount of Level 3 assets held by six major banks in proportion to their equity:

Citigroup
Equity Base: $128 billion
Level 3 Assets: $134.8 billion
Level 3 to Equity Ratio: 105%

Goldman Sachs
Equity Base: $39 billion
Level 3 Assets: $72 billion
Level 3 to Equity Ratio: 185%

Morgan Stanley
Equity Base: $35 billion
Level 3 Assets: $88 billion
Level 3 to Equity Ratio: 251%

Bear Stearns[160]
Equity Base: $13 billion
Level 3 Assets: $20 billion
Level 3 to Equity Ratio: 154%

Lehman Brothers
Equity Base: $22 billion
Level 3 Assets: $35 billion
Level 3 to Equity Ratio: 159%

Merrill Lynch
Equity Base: $42 billion
Level 3 Assets: $35 billion
Level 3 to Equity Ratio: 38%[161]

These six banks have far more Level 3 assets than they do capital.[162] Not all of these assets, however, are valued improperly; some may actually have their stated value.[163] What is important here, though, is the illusory nature of mark-to-model valuation. A bank may state earnings or capital at far higher levels than actually exist.[164] So long as the bank is able to trade those assets at their stated value, all is well. But, when there is no longer a market for them, the banks are stuck. Write downs on these holdings will wreak havoc on a bank's balance sheet.[165] Investors may begin to fear for the bank's solvency and not wish to lend to it anymore, hindering the bank's ability to raise capital to meet regulatory requirements.[166] With less capital, the bank itself cannot

159. *See* Mauldin, *supra* note 150.
160. This is the amount of Level 3 assets held in 2007 prior to Bear's collapse.
161. Mauldin, *supra* note 150. Values are as of November 2007. *Id.* Since then, most banks have reduced their holdings of Level 3 assets following significant write downs. Posting of Peter Cohan to BloggingStocks, http://www.bloggingstocks.com/2008/04/20/bank-capital-to-shrink-due-to-write-downs-of-500-billion-in-lev/ (Apr. 20, 2008, 20:40 EST). Goldman Sachs, on the other hand, has increased their Level 3 assets by as much as $20 billion. MarketWatch.com, Level 3 assets for Goldman Sachs, Morgan Stanley climb, http://www.marketwatch.com/story/level-3-assets-for-goldman-sachs-morgan-stanley-climb (last visited Oct. 3, 2009).
162. Mauldin, *supra* note 150.
163. *See id.*
164. *See* Mauldin, *supra* note 150.
165. *Id.*
166. *See id.*

lend as much.[167] With so many banks facing the same type of crisis, credit becomes a scarce resource.[168] Lending slows down; capital levels diminish.

Beyond Level 3 assets, further problems arise in the financial derivatives held by the banks.[169] Considering only CDS contracts, if bond defaults were to approach 1.25% in 2008, losses to the parties who had sold the contracts would be over $250 billion.[170] With over $500 trillion in all derivatives outstanding, losses on only a small percentage could have harrowing consequences.[171] For a thinly capitalized bank, heavy losses on derivatives could lead to major withdrawals by investors and customers as well as a credit crisis due to lenders' fears for the bank's solvency.[172] With thin capitalization, the bank is setup to collapse.

In the context of the collapse of Bear Stearns, it seems that the criticism lobbed upon the SEC may have, in a sense, been unjustified. On its face, Bear Stearns had met all necessary capital requirements.[173] In the past, satisfying these requirements may have been adequate to prevent a run on the bank.[174] However, in the shadowy world of financial derivatives, unregulated hedge fund activities, and mark-to-model assets, it is no longer enough.[175] The "shadow banking system" operates so long as credit and capital are available.[176] Unless ever new sources are available, a terrible unwinding of pyramids of debt and derivatives is always right around the corner.[177]

The collapse of Bear Stearns illustrates the potential consequences of the interlinking of banks in the "shadow banking system."[178] The run on the bank was not the root cause of the collapse; rather, the fear that the borrow-short-and-lend-longer pyramid of credit used by the bank would crumble to the ground drove investors to withdraw capital and lenders to cease lending *en masse*, cutting off any source of funding for the bank's daily transactions. Indeed, Mr. Cox was correct: no amount of capital reserves could have

167. *Id.*

168. *See id.*

169. *See* Investment Outlook, *supra* note 27.

170. *Id.*

171. *See id.*

172. *See id.*

173. *See* Scannell, *supra* note 141.

174. *See* Investment Outlook, *supra* note 27.

175. *See id.*

176. *Id.*; *see also* Editorial Staff, *Subprime Might Just Be Tip of 'Shadow Banking' Collapse*, COLO. SPRINGS BUS. J., March 21, 2008.

177. *See* Investment Outlook, *supra note* 27.

178. *See* Andrew Leonard, *Bear Stearns: "Too Interlinked To Fail,"* HOW THE WORLD WORKS, Apr. 4, 2008, http://www.salon.com/tech/htww/2008/04/04/too_interlinked_to_fail/.

protected the bank; any amount could just as easily have been withdrawn.[179] Confidence is what matters most.

The word "credit" is derived from the Latin *creditum* (loan), which in turn stems from *credere* (to entrust) and *credo* (I believe).[180] Lending is based on faith: a lender must entertain the belief that the borrower will make good on the obligation or the lender will not lend to the borrower for fear of not being repaid.[181] A lack of faith can have dire consequences for a borrower.[182] Bear Stearns was known to be a heavy player in the "shadow banking system," taking on large amounts of risk by utilizing excessive amounts of leverage.[183] When fear entered the mix, the flow of credit was cut off, rendering Bear Stearns insolvent. No confidence, no credit. Bear Stearns was lost in the high stakes game of shadow banking long before the run in March occurred.[184] No amount of capital reserves could have prevented it from happening;[185] modern financial regulations are woefully inadequate in the face of the shadow banking system.[186]

IV. PREVENTING A BAD SEQUEL

A. Regulation Nation

If current regulations were inadequate in preventing the collapse of Bear Stearns, perhaps new regulations are needed to prevent such an incident from happening again. One area where regulation may be most needed is in the OTC derivatives market.[187] While the market has managed to stay self-regulated, the abuse of OTC derivatives – especially credit derivatives – as a form of speculation rather than as a hedge against risk has led to systemic risks that threaten a collapse of the entire financial system.[188] Speculation,

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179. *See* Scannell, *supra* note 133.

180. Tim Weithers, *Credit Derivatives, Macro Risks, and Systemic Risks*, 92 FED. RES. BANK OF ATLANTA ECON. REV. 43, 43-44 (2007).

181. *See* Daniel Gross, *supra* note 3.

182. *See id.*

183. *Id.*

184. *See* Daniel Gross, *supra* note 3.

185. *See* Scannell, *supra* note 133. Though Chairman Cox admitted as much after the collapse of Bear, the SEC nevertheless moved forward on requiring banks to hold more in capital reserves during times of market turmoil. Jesse Westbrook, *SEC May Require Banks Boost Cash Amid Market Stress (Update 1)*, Bloomberg.com, Apr. 23, 2008, http://bloomberg.com/apps/news?pid=20601087&refer=home&sid=aTuSaVkKoouI.

186. *See* Investment Outlook, *supra* note 27.

187. *Taming the Beast*, THE ECONOMIST, Apr. 19, 2008 at 18.

188. *Id.* ("These are the volatile instruments that, had Bear Stearns collapsed, could have brought down the financial system with it.").

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however, is not the only problem. The complexity of many derivatives may be just as pernicious.[189] Parties may not understand the intricate deals to which they are committing, later suffering heavy losses without knowing why.[190] Also, even when the parties understand their contracts the simple nature of the trades (many still done over telephone or fax machine) can lead to a legal quagmire when attempting to confirm and clear all of them.[191] Furthermore, because some derivatives, like subprime mortgages related to derivatives, are so complex and trade infrequently, they leave investors with only illusory, mark-to-model valuations to rely upon.[192] Warren Buffett went as far as to call derivatives financial "weapons of mass destruction";[193] one hedge fund manager, when asked about using derivatives as part of his investment strategy, responded: "'I don't go to that crack house.'"[194] Despite all of the negativity that surrounds derivatives, however, they do serve a purpose as a means of managing risk.[195] Regulation, then, may help separate the good from the bad and the risk managers from the speculators, and it may help avoid future blow-ups that could wreak havoc on the financial system.[196]

Consider, again, credit-default swaps. The CDS market continues to grow at a tremendous rate (with a current value of around $62 trillion[197]).[198] CDSs are properly used as a means of insuring against bond defaults.[199] But, they have also become a means for rampant speculation involving substantial amounts of risk.[200] A CDS must be tied to some underlying debt: bonds,

189. *See* Das, *supra* note 20, at 12; *see generally* FRANK PARTNOY, FIASCO: THE INSIDE STORY OF A WALL STREET TRADER (Starling Lawrence ed., Penguin Books 1999) (1997).

190. *See* Das, *supra* note 20, at 44. Famous examples include Orange County, Gibson Greetings, and Proctor & Gamble, all who suffered heavy losses from derivative deals that were not understood by the parties involved (except on the investment banking side who extracted large fees from the deals). *Id*.

191. *See Taming the Beast*, *supra* note 187.

192. *See* Letter from Warren Buffett, C.E.O. of Berkshire Hathaway, to Shareholders of Berkshire Hathaway (Feb. 21, 2003) (on file with author), *available at* http://www.berkshirehathaway.com/letters /2002pdf.pdf.

193. Das, *supra* note 20, at 12. When Berkshire Hathaway purchased General Re Securities, Buffet unwound all of the complex derivatives trades that the company had formerly engaged in, generating large losses, but, according to Buffet, saving the company from larger, more substantial losses in the future. *See* Buffett, *supra* note 192, at 13.

194. Weithers, *supra* note 180, at 43.

195. *See id.*; Das, *supra* note 20, at xiii.

196. *See Taming the Beast supra*, note 187.

197. *Id.*

198. Weithers, *supra* note 180, at 49 ("[w]ith . . . annual growth rates that have ranged between 40 percent and 160 percent").

199. *See* Unmack & Mulholland, *supra* note 23.

200. *See id.*

notes, or loans.[201] However, they are not limited by the amount of debt instruments outstanding in the market: multiple CDS contracts can be originated on the same underlying debt instrument.[202] The CDS market is estimated to be ten times larger than the total underlying pool of bonds.[203] In the event of a default, dire consequences could result and losses would be greatly magnified. One economist has gone so far as to say in regards to credit derivatives: "'[T]he amount of indebtedness outstanding is greater than could ever be repaid, so the system is hopelessly bankrupt.'"[204] Indeed, Wall Street has already taken $245 billion in losses that were tied to CDSs.[205] Even more important to consider is the counterparty risk to such transactions. The interlinking of banks through OTC derivative contracts – where risk management creates a chain of institutions tied by the same underlying instruments as each party offsets their risk by trading it with another party – means both that losses will not be confined to a single institution and that a major credit event could threaten a collapse of the whole system, as Bear Stearns almost did in March.[206]

Regulation could add stability to the credit derivative market by requiring that the derivatives be traded on an exchange, rather than over-the-counter as they are now.[207] Instead of each derivative being a specialized product, exchange-traded derivatives could be standardized.[208] This change would lead to greater transparency as to what each product is, lessening the risk of legal problems and making valuation a much easier process.[209] The risk of a trader collapsing would be far less as the exchange would act as a counterparty, ensuring the creditworthiness of buyers and sellers.[210] The exchange could also act as a market-maker, providing liquidity to the market, upholding value, and instilling confidence by ensuring parties that they can trade out of their contracts.[211]

The Federal Reserve's intervention in the Bear Stearns collapse also

201. *See* Weithers, *supra* note 180, at 50.

202. *Id.* at 51 ("[t]here are many bond issues outstanding in which the amount of credit default swaps is substantially greater than the amount of bonds outstanding.").

203. *Id.* at 50.

204. *Id.* at 51 (quoting Paul Gallagher, *The global financial system is burning at both ends*, Global Research, Mar. 18, 2007).

205. Unmack & Mulholland, *supra* note 23.

206. *See* Taming the Beast, *supra* note 187.

207. *See id.*

208. *Id.*

209. *Id.*

210. *Id.*

211. *See* Taming the Beast, *supra* note 187.

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supports this argument for regulation of OTC derivatives. The Federal Reserve had no choice but to intervene because Bear Stearns was too interlinked with the rest of the financial system through complex derivative transactions that its failure would bring down the rest with it.[212] If taxpayer dollars are to be put on the line to prop up banks for their bad judgment, then regulation is necessary to ensure that such incidents do not happen again.[213]

B. Alternative Medicine

Of course, regulation is not the only path to follow after the Bear Stearns debacle. In fact, in some instances it may not help at all. As SEC Chairmen Christopher Cox made clear, Bear Stearns was in compliance with all necessary regulatory requirements.[214] The current regulatory scheme could not have saved the bank.[215] Indeed, against the backdrop of the cacophony of commentators debating the need for more or less regulation, perhaps the financial industry could use some alternative medicine.

Aristotle's *Nichomachean Ethics* ("*Ethics*") stands as one of the greatest contributions to the field of ethics.[216] Though written over 2000 years ago, the principles espoused within the work are as relevant and applicable today as they were in ancient Greek society. The financial industry could perhaps benefit by taking heed of the basic principles that Aristotle developed in his *Ethics*.

Much of Wall Street's record earnings over the past few years have come through the use of leverage, securitized mortgages, OTC credit derivatives, and off-balance sheet transactions; because they were used (or abused) to excess, however, downside risks were magnified when the market turned, creating staggering losses for financial institutions and breaking Wall Street's business model.[217] Some have called it greed; others have called it abuse or speculation. But, the label attached does not matter; in the end, each is nothing more than rampant excess on the Street. For Aristotle, excess was a pernicious vice that derails one on his or her path to *eudaimonia* – a state of happiness and, according to Aristotle, the greatest end to be achieved, that which is good,

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212. Leonard, *supra* note 178.

213. *See id.*

214. Westbrook, *supra* note 9.

215. *See id.*

216. Aristotle, *Nichomachean Ethics*, *available at* http://classics.mit.edu/Aristotle/nicomachaen.1.i.html.

217. *See* Christine Harper and Yalman Onaran, *Danger Ahead: Fixing Wall Street Hazardous to Earnings Growth*, BLOOMBERG, Apr. 28, 2008, *available at* http://www.bloomberg.com/apps/news?pid=20601109&sid=a2ow 77PrJj14&refer=home.

and ". . . that at which all things aim."[218] *Eudaimonia* is attained through virtuous activity, and it is the product of a virtuous life: "With those who identify happiness with virtue or some one virtue our account is in harmony; for to virtue belongs virtuous activity."[219] Virtuous activity, then, is the path to happiness and goodness – the proper function of a human being.[220] Virtue "brings into good condition the thing of which it is the excellence and makes the work of that thing be done well[.]"[221] If Wall Street bankers had been acting virtuously within their profession, then their work would have been done well: "[T]he virtue of [a person] also will be the state of character which makes [a person] good and which makes [a person do their] own work well."[222] With the recent calamity on the Street, most notably with Bear Stearns, it would be hard to say that Wall Street bankers were doing their work well.[223]

If virtue is of being of a certain state, then there must be a state of being that is not virtuous.[224] As Aristotle said, for all things "continuous and divisible, it is possible to take more, less, or an equal amount . . . and the equal is an intermediate between excess and defect."[225] Virtue, then, is a state of being that lies within a mean – the "Golden Mean" that Aristotle is so famously known for – between two extremes: excess and deficiency (as they are characteristic of vice).[226] For example:

> With regard to giving and taking of money the mean is liberality, the excess and the defect prodigality and meanness. In these actions people exceed and fall short in contrary ways; the prodigal exceeds in spending and falls short in taking, while the mean man exceeds in taking and falls short in spending . . . With regard to honor and [dishonor] the mean is proper pride, the excess is known as a sort of 'empty vanity', and the deficiency is undue humility[.][227]

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218. Aristotle, *supra* note 216, at Book I.
219. *Id.*
220. *See id.*
221. *Id.* at Book II.
222. *Id.*
223. *See* Aristotle, *supra* note 216. Executives and traders reaping multi-million dollar paydays may disagree; on the other hand, that most likely cannot be said of investors and Bear Stearns employees and shareholders. But those who disagree would be see wealth as the proper end. This is in discord with Aristotle's ethics: "[W]ealth is evidently not the good we are seeking; for it is merely useful and for the sake of something else . . . it is evidence that not even these are ends." *Id.* at Book I.
224. *See id.* at Book II
225. *Id.*
226. *Id.*
227. *Id.*

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Much of the blame currently passed around Wall Street, for the heavy losses suffered in recent months, comes in the form of an admonition of investment banks' risk management practices.[228] If banks had properly assessed the long-term risks of their transactions, in light of the historical fact that markets never move in the same direction forever, then perhaps the staggering losses seen today could have been prevented. In other words, the losses may have been prevented if banks had acted virtuously in managing risk.

Perhaps it could be said that proper risk management is to act with caution or an appreciation of possible risks. Excess caution breeds absolute risk aversion. The operation of the markets requires some risk taking to obtain the premium or interest from capital lent. A deficiency of caution is carelessness or recklessness, a disregard for the known risks. The excess of Wall Street gorging upon leverage and securitized assets was a reckless disregard for the risks and consequences that they entailed. If banks had been cautious about the risks they were taking, they would not be in their current position.[229] This deficiency of caution is evident in the fact that many of the securitized assets that were created over the past few years will never come back again: they were too risky, and the disregard for that risk – unbridled confidence in the markets – is gone.[230]

If Wall Street banks could operate within a mean of caution, never being exposed to too much risk and never gorging themselves in excess upon the latest and greatest financial innovation, then perhaps catastrophes like the collapse of Bear Stearns would be avoided. *Only in Aristotle's dreams!* For now, caution is the name of the game.[231] Caution is a good thing, except for the bankers who now sit and watch as their precious earnings dry up.[232] Though the golden goose of securitization may be dead right now,[233] some new form of asset or deal-making will arise in the future. This new form will not have been contemplated by regulators, and it will stuff the pockets of Wall Street once again, until like junk bonds, derivatives, and subprime mortgage-

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228. *See* William Wright, *How Not to Run an Investment Bank*, Apr. 28, 2008, http://www.financialnews-us.com/?page=uscomment&contentid=2450491805.

229. *See* Westbrook, *supra* note 9. Hindsight bias, perhaps, but only slightly; many securitized assets were known to be "toxic," yet banks dealt in them anyway.

230. Harper & Onaran, *supra* note 217.

231. *See id.*

232. *See id.*

233. *Id.* (Harper quotes JPMorgan's Margaret Canella: "Most securitization, especially if it's leveraged, will never come back . . . securitization won't die out completely, but it will be a much smaller market.").

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backed assets the house of cards collapses, fear rules the Street, and the cycle repeats. It may be easy to blame the SEC or other regulators for being asleep at the wheel or to instill new regulations that apply after the fact; however, preventing a similar problem from arising in the first place may be simply, in the Aristotelian sense, an ethical issue.

V. CONCLUSION

Tides ebb and flow. Markets move up and down, never in one direction forever. As with other financial disasters, the collapse of Bear Stearns will serve as a lesson to future bankers and investors of the consequences of the use of excessive leverage and speculation in derivatives. While it may be ideal to think that an Aristotelian-type ethic could arise from the rubble of Bear Stearns and instill itself on the Street, it is probably a riskier bet than was Bear Stearns' subprime mortgage holdings. Instead, regulations may need to be developed in place of that ethic. The SEC was not necessarily asleep at the wheel with Bear Stearns. Rule 15(c)(3)-1 may no longer be adequate for regulating bank capital structures. Legal innovations must keep up with financial innovations. While regulations in the mortgage industry may be needed, they are too late. The SEC and other regulators should focus on the source of the problems: unregulated credit derivatives, the excessive use of leverage, and off-balance sheet entities. When the Federal Reserve begins using taxpayers to back the banks, it should be the right of the taxpayers to know just what the banks are doing and that the regulators – and regulations – are in place to prevent the abusive and fraudulent use of their money. The collapse of Bear Stearns, while a dark day for Wall Street, should be the starting point toward building a more structurally sound and efficient market. It is the opportunity to build something better so that when the tide goes out again, and someone has been swimming naked, the sight is not something that, like Bear Stearns, is going to sicken the entire Street.