

Derivatives and the Financial Crisis: Ethics, Stewardship and Cultural Politics

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“Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief,” [former Fed Chairman Alan Greenspan] told the House Committee on Oversight and Government Reform. . . . “You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others,” said Representative Henry A. Waxman of California, chairman of the committee. “Do you feel that your ideology pushed you to make decisions that you wish you had not made?” Mr. Greenspan conceded: “Yes, I’ve found a flaw. I don’t know how significant or permanent it is. But I’ve been very distressed by that fact.” (*The New York Times*, October 23, 2008)

In what follows we will explore ethical issues concerning the creation and use of Over the Counter (“OTC”) financial derivatives. This is an exploration that is, arguably, worthy in its own right, but we will also consider larger questions and issues that have to do with how we draw ethical conclusions and engage in ethical deliberation in the face of complex and exigent commercial (and social) variables. There are a number of different ways to consider, critique, or reflect upon the power and role of derivatives subsequent to the financial crisis that took place (roughly) from 2007 through 2010. We will (i) consider where the singular ethical lapses were, if any, regarding the uses of derivatives, a market of more than \$600 trillion (notional value, hereinafter, “NV”) – a gargantuan figure that, supposedly, posed and yet poses a huge threat to the stability of entire nations, and not just to the financial system comprised of commercial and investment banks and those firms that comprise the “buy side” of the markets – i.e., investors such as mutual funds, hedge funds, pension funds and the like. We will also (ii) consider the realm of policy formation, i.e. we will explore the role of regulators and lawmakers who, in their stewardship roles, allowed or paved the way for the use of certain derivative instruments, especially since 2000 when The Commodity Futures Modernization Act was passed by Congress – legislation that had very little to say about certain of what some have taken to be some of the most pernicious financial instruments ever devised (especially Credit Default Swaps, or “CDSs,” which investment guru Warren Buffet dubbed “financial weapons of mass destruction”). Beyond this, we will, in closing (iii) consider the debate about derivatives within the context of *cultural politics*, and the difficulties inherent in making ethical judgments about very complex practices and institutions, considering matters of risk management and corporate governance.

Before we proceed, a few words on cultural politics may be in order. Cultural politics has been aptly construed “not as something added to other more substantive domains but as an arena where social, economic, and political values and meanings are created and contested.”¹ The frame of cultural politics permits us to ask more sweeping (and often more interesting) questions, questions that have to do with the organization of society and its social institutions – of the civilization itself. This necessarily concerns values, and values are not always formed by the best uses of human intelligence but, often, by our

animal spirits and/or prejudices, and by our scripted ways of seeing and organizing the world. What are the cultural politics of the derivatives debate, the debate about the need for and the extent to which there should be certain sorts of instrument called derivatives? Embedded within this question are other questions: What does the existence of more than \$600 trillion (NV) say about the kinds of civilizations that have been constructed in (primarily) what is still called the West? What does the need for such instruments say about the hidden complexity that operates beneath the ordinary financial exchanges that are most ready to hand? Have we constructed civilizations that float upon seas of hubris, i.e. assumptions that we can properly manage mind-numbing levels of complexity without the expectation of series of “black swan” events? This may not sound like the normal fare for a business ethics text, but these are the sorts of question that business managers and political leaders (and philosophers) should be asking themselves if they wish to help avert painful and world-disruptive crises in the future. It is by considering such questions that better policies may be constructed. On the other hand (and here is the twist), the cultural politics that has come to drive much of the hue and cry concerning derivatives may be misplaced, and may be part of a larger *anti-finance/anti-business/anti-capitalist* sentiment that itself may serve to undermine the construction of useful policy solutions concerning the creation, employment and regulation of financial instruments and markets.

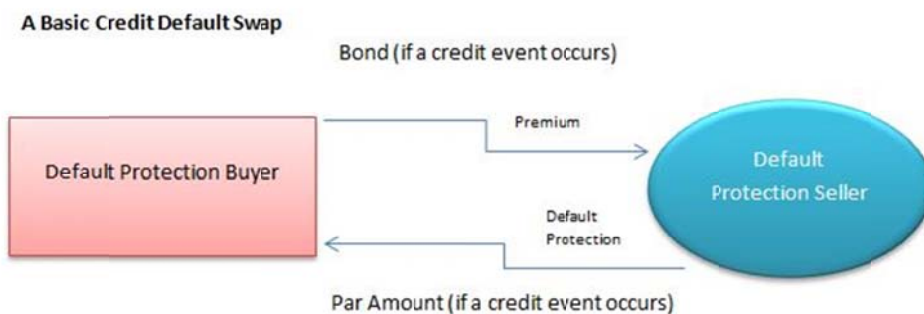
Derivatives, the Credit Crisis and the Right to Contract

A “derivative” is generally defined as a financial contract, the value of which is “derived from” some other instrument(s), such as equities, bonds, or commodities. Given this rather broad definition, it becomes obvious that there are many plain vanilla investments that are “derivatives” but that do not spring to mind readily, along with the sorts of more sexy instruments that we have come to associate with the word. Mutual funds (i.e., mutual fund shares), for example, are “derivatives,” since they fall under the definition just provided. A mutual fund share is itself a security, which invests in (usually) other securities, or other types of financial instrument. Clearly, a mutual fund share derives its value from the portfolio of other securities/financial instruments of which it represents a fractional ownership interest. The securities in the mutual fund portfolio derive their value from the success, or lack of success, of the businesses of which they represent a fractional interest of some kind, and so on.

But the sorts of derivatives that we will focus on here are those investment contracts that have been, somewhat arbitrarily, corralled to be the “proper” referent for the word “derivative.” These include CDSs, total return swaps, and futures. In particular, we will be most concerned here with bi-lateral contracts such as CDSs. This is because, as of the printing of this book, CDSs are the type of derivative that has given rise to the most concern in recent years. Part of what we will explore here is why they have caused such alarm, whether there is something about the nature of these instruments that is morally problematic, and whether or not their existence represents something about the nature of finance, risk, and the public culture writ large.

Let us begin with the fact that, as defined, derivatives of the type we are considering are *contracts*. A CDS, for example, is a contract between two persons (usually non-natural persons (institutions), such as

banks, hedge funds and insurance companies) for the exchange of money or financial instruments under certain circumstances, i.e. when there is a “credit event” or default on one or more credit instruments (bonds, for example), which are the referent instruments of the contract. This type of derivative has all of the indicia of an insurance contract. The party seeking “protection” (or the “buyer of protection”) is seeking to mitigate the risk that one or more credit instrument(s) in its portfolio will default. The “seller of protection” receives what have the indicia and function of insurance premiums for insuring the buyer of protection against loss.



For the moment, let us set aside the facts that CDSs were, prior to the credit crisis and subsequent economic downturn, regulated by neither state insurance commissions, nor by any federal agency. In the case of naked swaps (naked CDSs), i.e. swaps where the buyer of protection has no actual exposure to loss, there was no regulation by state gaming (i.e., gambling) commissions either, even though these swaps were no more than bets (a gamble) that a referent credit or several referent credits would or would not default. These things aside for now (we will come back to them later), what is wrong with two sophisticated financial institutions entering into such contracts?

There are many who say the answer to this question is: Nothing. There is a very sacrosanct freedom in the West, shared along a spectrum that contains anarcho-capitalists and extreme libertarians (on one end), and more nuanced forms of liberal and conservative libertarians (on the other end), that has to do with the right of free people to enter into contracts without interference from the state, even though the state is the mechanism for the enforcement of such contracts. We can consider a good many legal arguments and analyses, as well as a good many historical documents, to explore this fierce commitment to the right to freely contract, but the oft-cited Supreme Court case, *Lochner v. New York* (1905) (“*Lochner*”), is as good an exemplar as any. Joseph Lochner, the owner of a bakery, was convicted under a New York law that, for reasons of safety and the public interest, limited the number of hours bakery employees could work (no more than 10 hours per day and no more than 60 hours per week). Joseph Lochner argued that the law was “not a constitutional regulation of health and safety of a workplace under state police power.” His argument was tested against New York’s assumption that “The state has an interest in the health and safety of both the bakery workers as well as the quality of the bread that they make. Thus, these laws were passed under a valid exercise of the state’s police power.”

Lochner is, among other things, a showdown between the camp that valorizes rights-based approaches to public policy and the camp that valorizes social utility-based approaches. In this case, the camp that valorized rights-based approaches, i.e. the right of Joseph Lochner to enter into employment agreements with other freely consenting adults (and *vice versa*), won the day. The majority of the Justices, in a narrow 5-4 decision, concluded as follows:

[T]he power of the state to police the “liberty” of the individual to contract, which is protected by the 14th amendment, must be balanced against the state's interest. There is a limit on the police power of the states. . . . The state's justification for this law under health and safety is a pretext because the public interest is not sufficiently affected by this act. There is no demonstrable causal link between labor hours of a baker and the quality of his product or his own health.

Justice John Marshall Harlan wrote a dissenting opinion in *Lochner*, arguing that:

[T]he people of New York had decided that the health of an average man is endangered if he works more than 60 hours per week. Whether or not this is wise is not a question for the court to inquire. The only question for the court is whether the means devised by the state are germane to an end which may be lawfully accomplished and have a real or substantial relation to the protection of health of bakers. Common experience tells us that there is a logical relationship. There is abundant evidence that the workplace of a baker is hazardous to his health. Clearly, this is not a plain invasion of rights secured by “fundamental law.”

Lochner was decided during a time in which the industrial tide, with all its promises for greater prosperity, was rising. That is, the social moment both favored and, perhaps, emboldened the Supreme Court to lay aside the generally hallowed notion of judicial restraint and play a more robust part in setting public policy that, in this case, favored business interests, establishing a robust right to contract that could ward off the states’ attempts to create what they considered to be needed commercial reform.

In 1937 the court reconsidered its earlier position, in *West Coast Hotel Co. v. Parrish* (“Parrish”). In Parrish, the court let stand a Washington state law that required that women receive a minimum wage. The court indicated, quite clearly, that the right to contract was only relative to other exigent concerns. What we see in Parrish is another tradition in law, one that considers contracts from other than a rights-based point of view, i.e. other than from the point of view of the inalienable rights or the “liberty” of the individual persons contracting. This tradition considers contracts from a more or less utilitarian perspective, i.e. one that undertook policy and judicial deliberation while leaning in the direction of social welfare considerations. Legal theorists of this persuasion, versed in economic thought, consider the real-world social advantages and disadvantages of contracts, among other things, arguing that the right to enter into certain contracts must be constrained even if the parties that would enter into them do so without coercion and in the absence of factors that would otherwise operate to undermine the contract, such as fraudulent inducement (although Parrish emphasized the imbalance in the bargaining position between employers and employees). For example, these theorists argue that efficiency and negative externalities matter as much as, if not more than, the rights of the parties seeking to contract. Thus, on this view, a policy maker would take into consideration the general social welfare and employ tools of economic analysis such as the Kaldor-Hicks criterion of efficiency/compensation principle, which holds that an outcome is more optimal from the perspective of utility if, at least in theory, those who gain from some change in policy (for example) would be in a position to compensate those who are

made worse off by the policy. (This is a variant of the more well-known Pareto Optimization. A Pareto optimal outcome is an outcome in which no person would be made better off without making someone else worse off.) This, along with much that applies a utility calculus of some kind, pulls into play all sorts of competing *values*. What does it mean, after all, to be made “better off” or “worse off” outside of the consultation of values, some of which can be wildly subjective and even idiosyncratic? Still, it is widely accepted that to be in poverty means to be “worse off” than someone who has adequate amounts of food, medical care, worker safety, housing and the like, since in a condition of poverty these goods are missing or insufficient. It is as we approach the margins that the fuzziness concerning the meaning of “better off” and “worse off” becomes increasingly problematic.

What do *Lochner* and *Parrish* have to do with CDSs? These cases explicate the tensions, the competing goods, with which society must constantly contend, and concerning which easy answers are sometimes hard to come by. Most people wish to preserve the right to enter into commercial agreements as they see fit, without state interference. But this is a general preference. The same people, employing no more than normal, intelligent deliberation, would likely concede that laws that regulate the cleanliness of restaurants *they* patronize, or that address the general safety of the steel worker (such that the latter cannot contract away his/her right to safety in the workplace) are not extreme violations of the restaurateur’s or the steel mill owner’s right of free contract. A form of contract that can render society decidedly “worse off” by the less marginal standards would seem to be problematic indeed. A form of contract, say CDSs, that made the parties, in general, “better off” but that caused large numbers of persons to be made “worse off” is just the sort of thing utility-minded policy makers consider to be in need of constraints. The idea that CDSs meet the criteria for greater constraint because they were a major cause of the financial crisis, leading many to lose homes, jobs and financial security, would seem to be a clear case for policy intervention. Of course, an important question regarding derivatives such as CDSs is – Who is made worse off or better off by their use and proliferation?

This rights vs. utility duality supervenes a long tradition in the philosophical literature in which some, on the one hand, hold (for good reasons) that rights remain inviolable, are trumps in the face of other moral exigencies, even if the utility of those affected by their exercise is severely diminished and, on the other hand, others who hold that the consideration of rights – especially natural rights – at the expense of considerations of utility is nonsensical at best.ⁱⁱ It is no accident, then, that the arguments concerning the employment of derivatives such as CDSs have tracked these two traditional pathways of moral, legal and economic thought, and in law more or less track the thinking explicated in the majority opinions in *Lochner* and *Parrish* (and, for that, matter in the dissenting opinions). Businesses need the ability to freely contract, especially with other businesses, and the last thing they want is to have worries about whether shifting sands of policy will undermine the validity of contracts. But experience changes thinking and priorities, both in legal analysis and in policy making. In the case of CDSs, because of new suspicions (and newly and widely disseminated data) surrounding them, the focus shifted away from the assumption that large financial institutions had the right to enter into contracts with one another, and in the direction of the social impact of these contracts. Concerns with *systemic risk* and social harm took center stage. Suspicions regarding them were made worse by the opacity of the world in which they were constructed, as well as the problematic moral reputation of that world, loosely known as “Wall Street.” Of course, Wall Street’s reputation is more than well deserved.

Still, can the financial crisis be laid at the doorstep of OTC derivatives such as CDSs? As one scholar, René M. Stulz, has put it:

Credit default swaps are a subject of considerable ambivalence. On one side, they seem like straightforward financial derivatives that serve standard useful functions: making it easier for credit risks to be borne by those who are in the best position to bear them, enabling financial institutions to make loans they would not otherwise be able to make, and revealing useful information about risk in their prices. On the other side, in trying to understand the credit crisis, many observers have identified credit default swaps to be a prominent villain. One segment of the “60 Minutes” television show on October 26, 2008, called credit default swaps on subprime mortgages the “bet that blew up Wall Street.” Searching the Internet on Google, a search under “worst Wall Street invention” came up with credit default swaps as the first entry. George Soros, the prominent hedge fund manager, and many others want most or all trading in credit default swaps to be banned.

Stulz goes on to conclude:

In the aftermath of the financial crisis, credit default swaps and other financial derivatives have clearly lost any presumption of innocence that they once enjoyed among economists – and they probably never had such a presumption with the general public. But it would be premature and quite misguided to turn 180 degrees from the presumption of innocence to a presumption of guilt. There is a dearth of serious empirical studies on the social benefits and costs of credit default swaps and other derivatives – not just in the last two years, but in the last several decades.

My own sense is that the deep dramatic problems of the financial credit crisis were not caused by credit default swaps, nor by other financial derivatives. Neither Bear Stearns nor Lehman [Brothers] failed because of derivatives. AIG lost money by selling unhedged credit default swaps [that is, by acting as an insurer against other institutions’ losses in their investment portfolios], but it also lost money in all kinds of other ways, including by borrowing money to buy super-senior AAA-rated tranches of sub-prime-mortgage-backed securities. The common denominator of the large losses of AIG was that they occurred on subprime exposures and hence were brought about by a dramatic unexpected fall in house prices.ⁱⁱⁱ

Stulz wrote this for publication in late 2010. His observations jibe with the conclusions reached in the Financial Crisis Inquiry Report (the “Report”), published in January 2011, both in certain of the dissents written by Commissioners, as well as in the consensus conclusions of the report. For example, Commissioner Peter Wallison wrote, as part of his dissent:

Despite a diligent search, the FCIC [Financial Crisis Inquiry Commission] never uncovered evidence that unregulated derivatives, and particularly credit default swaps (CDS), was a significant contributor to the financial crisis through “interconnections” [the notion that the connections between CDSs among financial institutions led to a domino effect of sorts]. The only company known to have failed because of its CDS obligations was AIG, and that firm appears to have been an outlier. Blaming CDS for the financial crisis because one company did not manage its risks properly is like blaming lending generally when banks fail. Like everything else, derivatives can be misused, but there is no evidence that the “interconnections” among financial institutions alleged to have caused the crisis were significantly enhanced by CDS or derivatives generally. For example, Lehman Brothers was a major player in the derivatives market, but the

Commission found no indication that Lehman's failure to meet its CDS and other derivative obligations caused significant losses to any other firm, including those that had written CDS on Lehman itself.^{iv}

In another dissenting essay, Commissioners Keith Hennessey, Douglas Holtz-Eakin, and Bill Thomas wrote:

Rather than "derivatives and CDOs [Collateralized Debt Obligations] *caused* the financial crisis," it is more accurate to say:

- Securitizers lowered credit quality standards;
- Mortgage originators took advantage of this to create junk mortgages;
- Credit rating agencies assigned overly optimistic ratings;
- Securities investors and others failed to perform sufficient due diligence;
- International and domestic regulators encouraged arbitrage toward lower capital standards;
- Some investors used these securities to concentrate rather than diversity risk; and
- Others used synthetic CDOs to amplify their housing bets.^v

Derivatives and the Financial Crisis

I tend to agree with Hennessey, Holtz-Eakin and Thomas (but would also emphasize that there was a good deal of outright *fraud* in the system, which originated with largely unregulated mortgage brokers and the complicit bankers with whom they had cozy relationships). Even though I believe, and believe firmly, that many of the practices in the financial services industry need reform, and even that much of the culture of Wall Street needs to be turned on its head, when one is serious about public policy one has an obligation to do justice to the facts and contexts, to not operate from prejudice or ideological blindness. The fact seems to be that there is nothing wrong with either CDSs per se, or with other derivatives per se. There is nothing unethical about seeking to insure oneself, legally, against loss by means of a sophisticated and fully-informed party willing to provide that insurance, whether that other party is called "insurance company" or, simply, "swap counterparty." It is not even unethical, all else being equal, to lobby to create as many potential insurers as one can, or to lobby to be able to provide as much insurance as one can where the result will be increased revenue. As I discuss below, it is not the role of businesses to explore *all* of the possible public policy details of every product or service they wish to provide. Most of that responsibility lies elsewhere.

Much has been made, for shock value purposes, of the \$600 trillion (NV) derivatives market, of which CDSs are but a part – albeit a large part. But once one considers that the notional default risk – the risk that a chunk of that notional value of referent securities in CDS contracts will default – the real risk that this gargantuan number might imply begins to attenuate, absent a "black swan event" of the type we recently lived through. Throwing astronomically large numbers at the public, which may not be in the best position to place those large numbers into context, can serve to obfuscate and lead to bad public

policy, as is often the case with policy based upon populist consultation. By some estimates there is some \$25 trillion to \$30 trillion worth of real estate (commercial and residential) in the United States. But so what? By themselves the numbers mean little, other than as a general gauge or indicator of aggregate wealth. But the large numbers concerning the size of the derivatives market are, somehow, supposed to indicate the peril the world is in. There is a good counterargument that holds that it is because of the peril the world is in that we need robust derivatives markets – instruments (contracts) that permit the diffusion of risk, the transfer of risk from parties that are less able to absorb it to parties that are better able to do so. OTC derivatives, such as CDSs, may have exacerbated the financial crisis of recent years – in certain cases – but it seems hard to argue that these instruments *caused* it. This distinction is a critical one. Had there never been a burst housing bubble it is unlikely that OTC derivatives would be receiving the level of scrutiny they are now receiving. This is not to say that both the opacity and proliferation of these instruments were not, or would not one day become, problematic. Ironically, the housing market collapse shed light on these financial instruments, as it did on so many other areas of weakness or possible weakness in the financial system. It is arguable that, without such light, the unchecked proliferation of OTC derivatives might have set the stage for a far worse financial catastrophe down the road. Be that as it may, the *causes* of the most recent crisis lie elsewhere. One major factor, if not cause, among others, is that there was simply too much debt in the financial system, and too little savings to absorb the impact of the economic downturn that took place.

It is the job of regulators and legislators, drawing on the resources of informed experts (including those in the private sector) to consider and address systemic public policy issues. Businesses should not proceed as though public policy is completely irrelevant, but public policy and *systemic* risk are not the proper responsibilities of individual firms. Businesses seeking to build better mouse traps, even mousetraps of a kind that none had ever seen before, should not be required to study how the new mousetrap will impact, say, the butterfly population in another country, or whether the better mousetrap will impact populations of insects for which the mouse is a natural predator. They may, however, have some obligation to study how the better mousetrap will likely be used under strict liability considerations, how it will be discarded after use in view of environment impact considerations, and how the safety of the workers who manufacture it will be impacted in view of occupational health and safety concerns. Arguably, the same is true of the creation of better financial “mousetraps.” For the most part, CDSs and other OTC derivatives work as intended, for parties who understand the nature of the bargain into which they are entering. Absent contractual fraud and internal risk considerations, a firm’s analysis ends, so to speak, at the lobby door – at least for the most part. Most ethical and public policy issues that relate to or concern CDSs should be located at the level of policy makers on the outside of business organizations, beyond the lobby door.

There are certain internal actors, however, who do have special obligations to protect the firm from undue risk exposures, and when these actors are doing their part in this regard *systemic* risk is, we might say, naturally mitigated. These actors include boards of directors and risk officers (especially Chief Risk Officers). It is here that we find that there were indeed failures in judgment, oversight, corporate culture and responsibility, all of which led to the financial crisis in general – and all of which are salient from the point of view of business ethics. *For stewardship is squarely within the realm of ethics, and concerns the*

discharge of significant ethical duties to a firm's stakeholders, if not to society in general. Let us turn our attention to the failures of policy makers, and then take up the failures of boards of directors and risk officers.

Failures of Stewardship

We return now to the Commodity Futures Modernization Act of 2000 (hereinafter called the “2000 Act”), mentioned earlier. The 2000 Act exempted OTC derivatives, such as CDSs, from regulation by the Commodity Futures Trading Commission (the “CFTC”), even though these derivatives had many of the characteristics of the financial futures contracts that were already regulated by the CFTC. The very last page of the 2000 Act states:

This title shall *supersede and preempt* the application of any State or local law that prohibits or regulates *gaming* or the operation of *bucket shops* (other than antifraud provisions of general applicability) in the case of (1) a hybrid instrument that is predominantly a banking product; or (2) a covered swap agreement (emphasis added).

In summary (although it may seem hard to believe that this is a mere summary), a “covered swap agreement” includes:

. . . a swap agreement. . . including a credit or equity swap, based on a commodity other than an agricultural commodity enumerated in section 1a(4) of the Commodity Exchange Act if (1) the swap agreement (A) is entered into only between persons that are eligible contract participants. . . (B) is not entered into or executed on a trading facility . . . or (2) the swap agreement (A) is entered into or executed on an electronic trading facility (as defined in section 1a(10) of the Commodity Exchange Act); (B) is entered into on a principal-to-principal basis between parties trading for their own accounts or as described in section 1a(12)(B)(ii) of the Commodity Exchange Act; (C) is entered into only between persons that are eligible contract participants as described in subparagraph (A), (B)(ii), or (C) of section 1a(12) of the Commodity Exchange Act, as in effect on the date of the enactment of the Commodity Futures Modernization Act of 2000, at the time the persons enter into the swap agreement; and (D) is an agreement, contract or transaction in an excluded commodity (as defined in section 1a(13) of the Commodity Exchange Act). (See Section 402 of the 2000 Act.)

What all of this means is that most non-agricultural credit derivatives, such as CDSs, would not be regulated by the CFTC, *as a matter of law*. What is noteworthy, as well, is the implication that some OTC derivatives maintained the indicia of gambling (bets) of the sort referred to by the United States Supreme Court in *Gatewood v. North Carolina*.^{vi} In *Gatewood*, the court defined a “bucket shop” as “[a]n establishment, nominally for the transaction of a stock exchange business, or business of similar character, but really for the registration of bets, or wagers . . . on the rise or fall of the prices of stocks, grain, oil, etc., there being no transfer or delivery of the stock or commodities nominally dealt in.” While many OTC derivatives have useful purposes, others, such as naked CDSs, where the buyer of protection is doing no more than placing a bet with no risk exposure to the referent security, is nothing more than gambling. The wording of the 2000 Act suggests knowledge of this fact, and thus the provisions to protect OTC derivatives, including naked CDS contracts, from regulation. But why? How did this happen?

It happened because, *at best*, ideology trumped stewardship, as government insiders, including such powerful figures as Lawrence Summers, Robert Rubin, Alan Greenspan, Senator Phil Gramm and Arthur

Levitt (then Chairman of the Securities and Exchange Commission, engaged in a turf war with the CFTC) joined hands with powerful interests within the financial services industry to beat back any suggestion that OTC derivatives, as just described, should be regulated – by any agency, including the CFTC. The then head of the CFTC, Brooksley Born, attempted to draft regulations that would have captured CDSs and other OTC derivatives in the same regulatory net as other financial derivatives that were regulated by the CFTC, largely because of the systemic risks they might pose. She was concerned that the hidden size and pervasiveness of these instruments could possibly lead to financial disaster down the road. I have already stated my agreement with some who wrote a dissenting opinion in the FCIC Report, i.e. derivatives exacerbated but did not cause the recent financial crisis. But that is now a side issue in the face of whether policy makers, as high as the White House and Treasury Department, turned a blind eye to bad public policy decisions under the ideological cloak of a commitment to “free markets.” The answer seems clear – they almost certainly did. The lobbying pressure from banks and the large broker-dealers was enormous and effectively beat-back Born’s attempts to place some constraints on CDSs and other OTC derivative instruments, constraints similar to those found in the 2010 *Dodd-Frank Wall Street Consumer Protection Act* (typically referred to as “Dodd-Frank,” named for Senator Christopher Dodd and Representative Barney Frank, co-sponsors of the legislation), now the law of the land. The law firm Skadden, Arps, Slate, Meagher & Flom, in its analysis of Dodd-Frank, pointed out the impact of the legislation on OTC derivatives:

Title VII of . . . Dodd-Frank . . . imposes a regulatory regime on over-the-counter (“OTC”) derivatives and the market for such derivatives. The primary goals of the legislation and related rulemaking are to increase the transparency and efficiency of the OTC derivatives market and reduce the potential for counterparty and systemic risk. The main mechanisms for achieving this are: to require that as many product types as possible be centrally cleared and traded on exchanges or comparable trading facilities; to subject swap dealers and major market participants to capital and margin requirements; and to require the public reporting of transaction and pricing data on both cleared and uncleared swaps.^{vii}

This sounds sane indeed, and the reasons for such things as clearing houses – which lend transparency to the size and frequency of trades in OTC derivatives contracts – is precisely what Brooksley Born sought to accomplish many years earlier. In 2009, before the enactment of Dodd-Frank, Born received *The Profiles in Courage Award* from The John F. Kennedy Presidential Library Foundation. In her acceptance speech she said:

No federal or state regulator has market oversight responsibilities or regulatory powers governing the over-the-counter derivatives market or indeed has even sufficient information to understand the market’s operations. The market is totally opaque and is now popularly referred to as “the dark market.” It is enormous – the reported size of the market as of last June exceeded \$680 trillion dollars of notional value, more than ten times the amount of the gross national product of all the countries in the world. While over-the-counter derivatives have been justified as vehicles to manage financial risk, they have in practice spread and multiplied risk throughout the economy and caused great financial harm. They include the credit default swaps disastrously sold by AIG and many of the toxic assets held by our biggest banks. Warren Buffett has dubbed them “financial weapons of mass destruction.” We now have a unique opportunity – a narrow window of time – to fashion and implement a comprehensive regulatory scheme for these instruments. Existing U.S. laws governing the futures and options markets provide a model for regulating the closely related instruments traded in the over-the-counter derivatives market. The new regulatory scheme should provide that the instruments must be traded on regulated derivatives exchanges and cleared by regulated derivatives clearing houses to the extent feasible. This would allow government oversight and enforcement efforts, insure price discovery,

openness and transparency, reduce leverage and speculation, and limit counterparty risk. If any residual over-the-counter market is to be permitted, it must also be subject to robust federal regulation.

The story of the ethics of derivatives is not merely a story about these instruments themselves, but rather it is a story about the swirl of the questionable decisions that surround them, a story about how policy makers breached a trust of stewardship to the country, a trust that required that they protect it from the rapacity of certain business interests, from the pitfalls of ideological blindness, and from certain types of “establishment,” such as bucket shops, that spur rampant speculation rather than economic growth. It is noteworthy that under Dodd-Frank CDSs are still with us, and in a very big way, notwithstanding the hyperbole of some of the stellar critics of these instruments (Buffet, Soros, *et al.*). This speaks to the inherent utility of these contracts in mitigating risk, and even in generating revenue for firms. But we will now have, because of Dodd-Frank, much greater transparency into the contracts themselves as well as into those institutions that use them. Hedge funds and similar fund vehicles now have to report their exposures to CDSs and other derivatives, in some cases quarterly. It becomes clear in hindsight why the attempts by Born to institute similar, sound regulation was so fiercely beaten back. It was Senator Phil Gramm, then head of the Senate Banking Committee, who made sure that the CFTC was blocked by force of law from actually *doing its job* – from regulating instruments that it made all the sense in the world for it, or some other government agency, to regulate. (Phil Gramm’s spouse, Wendy Gramm, was once head of the CFTC herself, it might be of some interest to note.)

Was it all so that Wall Street could have a money party? Was it really all about greed? There are many who think so, and there is no doubt that many firms made lots of money in the OTC derivatives markets, and still do. But greed is the easy target in an ethical and public policy analysis of what happened, and to conclude that one has a full understanding of what happened by saying it was “all just greed” is to fail to do justice to the topic. People who peer into the ethics of business from the outside often do so with collections of prejudices about the nature of commerce in general. Commerce, for these persons, is nothing more than the haunt of greedy souls, of people who deliberately “turn away from the light” on their way to their hoped for fortunes. But the concerns that precluded the regulation of OTC derivatives, though attended by a desire for profit, also emanated from very serious *ideological views* about the nature of markets, contractual freedom (as previously discussed), and the role of capital. This takes us into a more interesting and useful analysis of what happened, of why OTC derivatives were not regulated before Dodd-Frank. Let us recall Alan Greenspan’s exchange with Henry Waxman, from the epigraph:

“Do you feel that your *ideology* pushed you to make decisions that you wish you had not made?”
Mr. Greenspan conceded: “Yes, I’ve found a flaw. I don’t know how significant or permanent it is. But I’ve been very distressed by that fact.”

Suppose we take Mr. Greenspan at his word, and note that there was a “flaw” in his view of things – not merely complicity in a rapacious system, but “merely” an error in judgment—an error in judgment every bit as damaging as stark rapacity? This is the error in judgment that always attends tethering oneself to a model of reality, an ideology, a dogmatic conceptual scheme, from which you cannot extricate yourself and which blinds you to the facts at hand. To quote the great writer and literary critic, John Erskine, there is, among policymakers as among ethicists, a “moral obligation to be intelligent.” Ideological commitments, such as Alan Greenspan’s libertarian Objectivism, or Phil Gramm’s conservative libertarianism, can block the use of intelligence in sounding-out issues and in attempting to derive the

best answer to the question “What is to be done?” Philosophers such as William James and John Dewey often warned of commitments to dogmas and stifling, untested prejudices of the sort that led Mr. Greenspan to the discovery of a “flaw” in his way of looking at the economy and at markets. The flaw was Mr. Greenspan’s assumption that executives would steer their firms away from untenable risk. He focused on data, on statistics, and did not notice other non-quantitative factors and trends taking place and that threatened to undermine good corporate governance, such as the shorter tenures of CEOs and other executives, who came to see short stints at large banks and broker-dealers as ways to get rich quick and get out, often at the expense of the organizations they would leave behind.

One must be a little Aristotelian when considering matters as complex and sweeping as financial markets. One must be, to various degrees, philosopher, psychologist, sociologist, and culture critic. That is, one must use one’s intelligence. Ideological commitments, whether they are of the left or the right, whether libertarian or statist, will only hamper the formation of good public policy. This does not mean theory is to be completely set aside, or can be. It only means that theories (whether capitalist or Marxist) tend to be riddled with questionable and untested assumptions, tend to impose an order on the world without sufficient empirical consideration and, often, need to be revised in the face of new evidence. Over the past 60 years or so, both capitalists and Marxists have learned that lesson the hard way.

Stewardship, Complexity, and the Interdependence of the Financial System

There is also the matter of the complexity and interdependence of today’s financial system, which the recent financial crisis bears out as never before, and OTC derivatives are at the center of that complexity and interdependence. This complexity and interdependence makes it difficult for ethicists and other analysts to draw pat or easy conclusions about what went wrong and who is blameworthy. Yet stewardship requires accountability. The trading of financial instruments ripples or reverberates well beyond local markets, with consequences in the ordinary lives of ordinary people. Extreme market libertarians worry about the unintended consequences of government regulation and so-called “interference” in the free market. Ironically, a much dearer cost has been paid in recent years due to the unfettered use of a variety of products and services that originated in the laboratories of Wall Street, away from the eyes of regulators and beyond the effective reach of internal governance. The libertarian hue and cry regarding unintended consequences should by now be seen to have lost some of its tenability, though it would be naïve to think it will ebb significantly since ideologues rarely admit the flaws in their conceptual schemes, the facts notwithstanding. In any event, since blameworthiness is increasingly difficult to determine in the midst of such complexity (which is why the search for actual criminality and criminals in the sub-prime meltdown has gone almost nowhere), policy makers have an obligation to make sure that the activities of market participants are regulated at each phase of product roll-out and at each level of a bank’s or dealer’s operation. As has been proposed by the SEC recently, more thought must be given to the nature, use, proliferation and even the non-indicated uses of OTC derivatives, just as the issue of the suitability of such instruments for even institutional market participants must be an ongoing concern for banks and dealers who market these instruments or serve as counterparties (e.g., as sellers of protection in the case of CDSs).^{viii} It is difficult for policy makers and regulators to be proleptic without stifling innovation, but that, alas, is the balance that must be struck.

It would be imprudent to conclude that positive law or static regulation will provide the final checks on excessive risk and speculation in financial markets. It is, in part, the complexity and interdependence of those markets that led the Obama administration to propose a dynamic approach, which came into

being under Dodd-Frank in the form of the Financial Stability Oversight Council (the “Council”). The Council “will provide . . . comprehensive monitoring to ensure the stability of our nation's financial system. The Council is charged with identifying threats to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States financial system.” The establishment of the Council extends the reach of Dodd-Frank beyond itself, so to speak, and provides a *dynamic* monitor that will think what others are not thinking, consider what others have failed to consider, and range over the financial system – internationally – asking the sorts of questions that did not get asked prior to the credit crisis because of self-serving concerns, ideological commitments, ignorance, or all of the preceding. Of all the things that arose from the recent crisis in the form of regulation, the establishment of a dynamic risk monitor with no water to carry for any particular constituency is one of the best, and should improve stewardship dramatically. The Council will be able to bring intelligence rather than ideology and politics to considerations of market risk in a way that has never been done before.

But this helps at the macro level. What about stewardship inside of banks, brokerages, hedge funds and other financial institutions? For many years, boards of directors have been coming up short when it comes to understanding both the operations and risks associated with the organizations over which they serve as stewards. As was reported in the *New York Times* recently, “Many directors clearly lacked the educational or work backgrounds needed to understand the derivatives and other complex products whose risks eventually overtook their institutions. Worse, they forgot or never learned the many lessons of past bubbles and manias. And industry knowledge on bank boards is no more extensive today than it was four years ago.”^{ix} Dodd-Frank does require the boards of certain large financial services firms to establish risk committees, which committees must “include at least 1 risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms.”

The problem of effective stewardship by boards of directors goes beyond the problem of insufficient expertise, however, and has to do, as well, with problems of corporate board culture generally. Robert A.G. Monks and Nell Minnow, experts in corporate governance, explain the problem this way:

Senator Carl Levin, as chairman of the Permanent Subcommittee on Investigations provided perhaps the most authentic view into the nature of US boards at a hearing with the five most senior directors of recently bankrupt [December, 2001] Enron. These individuals are the ultimate example of America's director culture: they each had served for 17 years; they chaired the most important committees (executive, finance, compensation, and audit); three had earned doctorates; all were paid a minimum of \$350,000 a year. They appeared voluntarily and at substantial personal inconvenience and legal hazard in order to articulate plainly and repeatedly that individually and collectively as members of a board they were not responsible *in any way* for the collapse of Enron or for the loss of investments, pensions, and jobs.^x

Directors of public companies take great pains to insulate themselves from legal liability. They tend to be “lawyered up,” so to speak (directors often have their own legal counsel, paid for by the corporation). They are able to invoke “the business judgment rule” and the protections afforded them by state law. They insist upon a proper understanding of their role – i.e., that they have a right to rely upon the expertise of the corporation's executive managers on all operational matters. Few people who are informed about governance blame corporate directors for wanting protection from the acts or failures to act of the executives, managers and employees who, whether directly or indirectly, report to them. Yet, recent corporate and financial crises and scandals have turned up the heat on directors who

think they can avert blameworthiness and liability completely. The Dodd-Frank requirement that risk experts be integrated into overall governance will undoubtedly lead boards to consider factors and issues that were once only considered at the executive and managerial levels. They will no longer be able to claim that they did not know the risks associated with certain activities or products – especially activities or products that have a significant impact on financial statements. At the same time, they will no longer be able to claim ignorance concerning risks, as they will have ample opportunities to pose questions directly to the risk committee or to the risk expert that is central to that committee.

Finally, senior risk and compliance officers should be given more autonomy and authority within banks and brokerages – autonomy and authority that will permit them to report their concerns directly to the board of directors (if there is one, but if there is not, to firm owners or senior executives), without interference from business units. Risk officers, in many cases, have a kind of presumed authority in firms, and can be paid handsomely, but they often get outmaneuvered by production personnel (traders, bankers, etc.) who live and die by short-term results. Chief Risk Officers should have the authority to shut-down or wind-down trading strategies or market exposures that they believe place the firm at risk in the long-term. This means that these professionals should be “off the desk” – not unduly influenced by the demands (and sometimes ravings) of traders and other producers in the firm. Also, there should be a rebalancing, a shift of emphasis from quantitative risk measures toward qualitative ones (such as conflicts of interest, dubious reporting lines, poorly established authority among business unit personnel, and subjective, professional assessments of conditions (such as corporate culture) that are not captured by quantitative risk models). This means moving toward an Enterprise Risk approach and away from a mere portfolio risk approach.

Derivatives and the Financial Crisis: Cultural Politics and Pedagogy

Some time ago, I was privy to a fellow academic’s confession that she could not teach business ethics because of her antipathy toward the business world. I believe that her antipathy is shared by not a few philosophers who teach business ethics. That is, of course, her (and their) right and, for my part, I am glad that she would not expose students to such an attitude. I have heard fellow philosophers make reference to the financial system, “with all of these fancy instruments and crazy and useless activities that add nothing to society” (to paraphrase), with great revulsion. This reflects, at least often, a more general feeling of revulsion for capitalism and “neo-liberal” economics.

There is certainly a good deal wrong with capitalism and neo-liberal economic thought. But nothing, so far, has any credible chance to replace capitalism, while there are efforts within the profession of economics to challenge certain basic assumptions that drive neo-liberal economic analysis. Amartya Sen, Joseph Stiglitz, and Jeffrey Sachs, to name a few thinkers, are on the front lines of these challenges. Capitalism, while tending to lead to wild and unsustainable disparities between the rich and the poor, remains, at least arguably, the best engine for the creation of wealth – *generally*.

Philosopher Slavoj Žižek, not usually known for measured analysis of capitalism or for melioristic approaches, had some interesting things to say about the recent financial crisis, demonstrating an insight into the complexity of the problems that led to it. In a radio interview with journalist Juan Gonzalez he warned against simplistic moral analyses, especially on the part of the left, of which he himself is a proud member:

Juan Gonzalez: Well, I'd like to ask you, you say you are also critical of the progressive or the left response here. You say in your article in *Harper's*, "There is a real possibility that the primary victim of the ongoing crisis will not be capitalism but the left itself, insofar as its inability to offer a viable global alternative was again made visible to everyone." Could you elaborate?

Slavo Žižek: I see—what worries me [are] two things about the left. First, it's more and more legalistic moralization. You know, it's kind of a pure form of protest against injustice. Then the only thing you can do is legal forums and so on. In this sense, many of the ex-leftists are getting depoliticized. They no longer ask the truly basic questions. Like even now, all the outcry was, "Oh, those bank profiteers," and so on. I totally agree with what we just heard. But don't you think that the truth is a little bit more complex. . . . It's that after the digital bubble at the beginning of our millennium, the idea was how to keep prosperity, how to keep economy alive. And it was, as far as I remember, even a little bit of a really bipartisan decision: let's make it easier in real estate, and so on, to keep it moving. . . . What I'm just saying is, let's not get rid of the problem by too easily making it into a psychological problem. You know, you can be an evil guy, but there must be very precise institutional, economic, and so on, coordinates, background, which allows you to do what you do.

The second thing, I also didn't like the cry shared by left and right-wing populists of "help . . . Main Street, not . . . Wall Street." Well, sorry, but those bank managers who emphasized, in capitalism there is no Main Street without Wall Street [, are correct]. In today's industry, because of the competition and immense investment into new inventions and so on, without large accessibility, availability of [credit], there is no prosperous Main Street. So this is a false choice. So, again, with all respect [to] the left and so on, I think we should avoid quick moralization, if we mean it seriously.^{xi}

Rather than stand aside and cast stones, there are many philosophers and other intellectuals who might do better to admit defeat as to tenable challenges to, at least, the more basic tenets of capitalism: private ownership of the means of production, more or less unfettered markets, a well ordered system of regulation, market-based price discovery, and so on. This does not suggest – except in the minds of the most rabid market libertarians – that governments should have no control over important social institutions and processes. But absent a tenable replacement for capitalism, it would appear to be a more useful employment one's critical skills to join the search for meaningful solutions to real problems that affect real people and real institutions. The working assumption must be that wholesale systemic change is a far off goal and would require a tremendous moral shift, a sweeping change in sensibilities. There is little evidence that any such moral shift or change in sensibilities is on the horizon. Perhaps the time will come when the very idea of ownership will become a relic of the past. For the moment, however, I must join those who label such thinking "pie in the sky." The cultural politics that seems to suffuse philosophy departments, which departments tend to be the seat of the teaching of business ethics, is, for the most part, unhelpful when it comes to challenging problematic business practices, and so a pedagogy that clings to theories that exclaim that "the system is rotten to the core" is one that does not prepare the student to engage with that system.

The American philosopher Richard Rorty once wrote, "When one of today's academic leftists says that some topic has been 'inadequately theorized,' you can be pretty certain that he or she is going to drag in either philosophy of language, or Lacanian psychoanalysis, or some neo-Marxist version of economic determinism. . . . These futile attempts to philosophize one's way into political relevance [or commercial relevance?] are a symptom of what happens when a Left . . . adopts a spectatorial approach to the problems of its country. Disengagement from practice produces theoretical hallucinations." ^{xii} Philosophers and others who teach business ethics do a disservice when they teach the subject as though they, and the students they teach, should take the roles of spectator and critic concerning what amounts to no more than a sea of rapacity and corruption. They do well to get a deeper understanding of the important role of such areas of culture as the financial system and commerce in general, and do their parts to both explain the logics of the markets and to help shape, through pedagogy, the people who will one day lead commercial enterprises, whether banks, hedge funds or tool-and-die factories – that those institutions will serve society as they should. The display of ignorance of many academics who have chimed in on the recent financial and credit crises has been, generally, disappointing, notwithstanding the insightful comments of Žižek and a few others. Some have mimicked the univocal populist commentators who have proffered that "Wall Street is completely unregulated" and that "what has happened is criminal." Both proffers are wrong, of course. Wall Street swims in a sea of regulation, and what is or is not criminal turns on facts that suggest the violation of certain criminal laws, not merely ethical lapses, blameworthiness, or failures of stewardship.

Cultural politics concerns the contestation of social, economic, and political values and meanings. Philosophers have a responsibility to enter this arena of contestation by restraining their biases and ideological commitments, as well as their assumption that abstract philosophizing is enough to affect behavior or policy. To the extent philosophy is still relevant in the public square (which is something that is itself contested) we philosophers might do better if we make sure that we have a firm grasp of all of the issues and facts before wading into public debates about policy. In an October 2010 *New York Times* article, philosopher Jay Bernstein wrote:

In pondering [Wall Street and the idea of free markets] I want to, again, draw on the resources of . . . Hegel. . . . Near the middle of the *Phenomenology of Spirit* (1807), he presents an argument that says, in effect: if Wall Street brokers and bankers understood themselves and their institutional world aright, they would not only accede to firm regulatory controls to govern their actions, but would enthusiastically welcome regulation.

He went on:

We know that nearly all the financial conditions that led to the economic crisis were the same in Canada as they were in the United States with a single, glaring exception: Canada did not deregulate its banks and financial sector, and, as a consequence, Canada avoided the worst of the economic crisis that continues to warp the infrastructure of American life. Nothing but fierce and smart government regulation can head off another American economic crisis in the future. This is not a matter of 'balancing' the interests of free-market inventiveness against the need for stability; nor is it a matter of a clash between the ideology of the free-market versus the ideology of government control. Nor is it, even, a matter of a choice between neo-liberal economic theory and neo-Keynesian theory. Rather, as Hegel would have insisted, regulation is the force of reason needed to undo the concoctions of fantasy. ^{xiii}

I applaud Bernstein for his willingness to engage in such an important public debate, and to do so as a philosopher. But the upshot of his article represents the sort of aerial view philosophers too often have when addressing issues of commerce. Aerial views have their place, but public policy analysis requires more granularity – a better acquaintance with the nature of the subject under review. The relevance of Hegel to the financial crisis is, at best, curious, if not eccentric. Bernstein’s invocation of *The Phenomenology of Spirit* (of all texts) as medicine for the financial crisis is probably unique. As to the allegations, the assertion that Wall Street is not already highly regulated is false, as I have already stated, and the deregulation of banks in the form of the repeal of Glass-Steagall had, in fact, little to do with the mess that the banks brought upon themselves (the exposures of the banks to bad loans and the securities backed by those loans is the principal cause of the crisis, and this had nothing at all to do with the separation of commercial and investment banking that Glass-Steagall instituted in 1933). Canadian banks were simply much less exposed to the sub-prime crisis than American banks were. Professor Bernstein had some interesting things to say about Wall Street, but none were of much use for the formulation of new policy. This does not mean that philosophers have no role to play, only that they must learn to take as much time to understand the commercial matters at hand as they do Wittgenstein’s *Tractatus* or Dewey’s *Experience and Nature*.

The cultural politics of academic departments of philosophy may often be in the way of sound policy advice, yet it is in these places that the more fundamental questions (what Žižek referred to as “the truly basic questions”) about our kind of civilization get asked and debated. That is why it is important for philosophers to continue to enter the fray, armed with the proper understanding of the issues they seek to address. Analyzing naïve or populist assumptions about basic and pervasive ideas concerning the nature and role of the state, the nature of freedom (and so of free markets), the nature of taxation, the idea of a political community, well, this is the bailiwick of the philosopher. The trick is to link her or his experience with respect to these sorts of questions to a solid grasp of the way the world actually works, and why it works that way. What is the nature of risk? Is it really contained by transferring it to other parties who, in turn, transfer it again? Are there really such things as “public” and “private” institutions? What is the purpose of compensation? What is an incentive? Should acute blameworthiness be criminalized? Good questions. How shall we go about answering them in a way that allows us to avoid real social pain in the future?

ⁱ www.culturalpolitics.net, as of May 31, 2011.

ⁱⁱ Jeremy Bentham argued vigorously against the notion of rights unmoored from considerations of social utility: “Natural rights is simple nonsense: natural and imprescriptible rights, rhetorical nonsense — nonsense upon stilts.”

ⁱⁱⁱ Stulz, R.M. (2010). Credit Default Swaps and the Credit Crisis. *Journal of Economic Perspectives*, Volume 24, Number 1, 73–92.

^{iv} 447-448.

^v 424-425

^{vi} *Gatewood v. North Carolina*, 27 S.Ct 167, 168 (1906)

^{vii} *The Dodd Frank Act: Commentary and Insights* (July 12, 2010)

^{viii} Securities and Exchange Commission, Release No. 34-64766; File No. S7-25-11, RIN 3235-AL10: “Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants.”

^{ix} “Unusual Directors in Boardrooms,” THE NEW YORK TIMES, April 8, 2011

^x Robert A.G. Monks and Nell Minnow, *Corporate Governance* (4th Edition). West Sussex, England: John Wiley & Sons, 2008, p. 257.

^{xi} Radio program, *Democracy Now!*, with hosts Amy Goodman and Juan Gonzalez, October 15, 2009.

^{xii} Richard Rorty, *Achieving Our Country – Leftist Thought in Twentieth Century America*. MA: Harvard University Press, 1998, pp. 93 and 94.

^{xiii} “Hegel on Wall Street,” THE NEW YORK TIMES, October 2010.