THE COMING DEMISE OF DEREGULATION II

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In 1993, I published an article with the rather grandiose title *The Coming Demise of Deregulation*.[1] This was an impressionistic discussion of some of the unattractive legacies of airline deregulation—specifically of the bankruptcies of some airlines and their bitter consequences. While accurate as to some of the seamier side of airline deregulation and failure, this was, I am afraid, far from a convincing demonstration why deregulation of the "regulated industries" would turn out to be a failure and would have eventually to be abandoned. As a matter of fact, this article appeared fifteen years after "deregulation" (also known in some contexts as restructuring) was applied to airlines, was in the process of being applied to telecommunications and natural gas, and was about to be applied to electric power. At that time, deregulation, or restructuring, was a mixed success, seemingly appropriate for the rapidly changing technology of telecommunications, apparently incompatible with solvency in the airlines (although seemingly not at risk of abandonment for that reason), not notably controversial in natural gas, and not as yet manifesting evident problems in electricity applications. So, at least the title of my article, although potentially prophetic, was strikingly premature on the basis of the existing evidence. A few years later, of course, developments in electricity—leading off with the California fiasco—furnished abundant ammunition for the critics of deregulation, although its supporters were also not slow to rise to its defense.

California, ever striving to be the leader, had adopted electric deregulation legislation in the middle 1990s, which contemplated full retail choice of generation—the most advanced stage of deregulation. Unfortunately, the results of the deregulation experiment in California were not only unfavorable but slightly short of catastrophic. Not only was there no easing in the price of electricity (which instead rose to record highs), but

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1. Richard D. Cudahy, *The Coming Demise of Deregulation*, 10 YALE J. ON REG. 1 (1993).

service was severely impacted, with numerous and extensive blackouts and other forms of power failures.[2] At this point, industrial and other very large users probably still had some support for electric deregulation in California, and particularly for its feature of choice of generator, but whatever support residential customers had for it was hopelessly lost. The demise of deregulation in California was followed by an upheaval in government—the recall of the Governor and the election of a Hollywood figure. Later, the collapse of deregulation was ascribed to manipulation by Enron and other electric suppliers, which allegedly had employed improper and fraudulent techniques to milk profits from the system.[3] This may have been part of the problem, but the California experience was generally also taken by many to demonstrate the inherent weaknesses of the deregulatory approach even when manipulators were not abusing the system.

More recently, events in the financial arena have eclipsed whatever was happening in the regulated industries. In finance, a crisis in the availability of credit has evolved into a severe recession in the economy. In light of this financial crisis, it may behoove us to remind ourselves of the principal lessons of our various experiments in deregulation. And, like the catastrophe in electricity in California, the recent financial and economic disaster has been blamed in significant part on deregulation. There seems to be no doubt that, as a result of the financial crash, regulation as a response to economic difficulties will enjoy a resurgence of popularity. It is a good guess that this attitude favoring regulation will carry over into the arena of regulated industries and elsewhere, and will powerfully affect attitudes toward regulation generally.

The financial industries in recent decades had treated regulation as a loathsome disease. Where proposed, regulation had often been rejected in the expectation that market forces and self-regulation could accomplish the same goals, furthering desirable public objectives. These developments in the financial industries have also been called deregulation and have shared much in common with the equivalent process in the regulated industries. Perhaps the most highly visible of these developments in the financial area was the repeal of the Glass–Steagall Act, the purpose of which originally had been to keep commercial banking separate from investment banking or,

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2. *See* Richard D. Cudahy, *Electric Deregulation After California: Down but Not Out*, 54 ADMIN. L. REV. 333, 343 (2002) (outlining the development of deregulation legislation and the subsequent problems involving power shortages and wholesale price increases).

3. *See, e.g.*, Jonathan Peterson & Dawn Wotapka, *Lockyer Sues Enron; FERC to Review Tapes*, L.A. TIMES, June 18, 2004, at C1 (discussing audio tapes of Enron energy traders chortling over the company's successful manipulation of the California energy market and reporting that two Enron traders had pleaded guilty to federal charges for market manipulation in California).

phrased differently, to keep the banks out of the securities business.[4] The repeal of this New Deal legislation permitted commercial banks to acquire investment firms and to put themselves in a dominant position in investment activity.[5] The repeal of Glass–Steagall was the culmination of a long campaign and removed a well-known restriction that had a broad impact. Responsibility for the financial crisis of 2008 was ascribed in part to consolidation in the financial arena permitted by the repeal of Glass–Steagall.[6] This consolidation was illustrated, for example, by Bank of America's acquisition of Merrill Lynch, a broker and investment house.[7] Bank of America had developed adequacy-of-capital problems in part from the developing demands of Merrill Lynch. It is interesting to see how the original concern of Glass–Steagall, that banks would dominate the investment business, has now been transformed into a situation where banks are struggling to survive when burdened with the capital demands of an investment firm.

The absence of regulation of certain important credit derivatives—primarily collateralized debt obligations (CDOs) and credit default swaps (CDSs), which were not traded on exchanges and not subjected to regulation—was also identified as a key source of instability in the credit crisis.[8] The primary purpose of the discussion here is to explore the extent to which lack of regulation as an element of the credit crisis may affect the formulation of future regulatory policy rather than to examine in detail exactly how regulation could have avoided the present crisis. This may be a subtle distinction of purpose, but it is important in establishing an appropriate perspective. An irresistible public demand for regulation is likely, even without an explanation of how exactly earlier regulation could have prevented the current crisis.

It is not difficult to outline the pros and cons of regulation as a theoretical matter in our economy. The essence of capitalism, as expounded by its very early exponent and apologist Adam Smith and by

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4. *See* Jonathan R. Macey, *The Business of Banking: Before and After Gramm–Leach–Bliley*, 25 J. CORP. L. 691, 716 (2000) (explaining the impact of the repeal of certain sections of the Glass–Steagall Act).

5. *See, e.g.*, Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 7–8 (2005) (discussing the impact of Gramm–Leach–Bliley on the financial services industry).

6. *See* Brishen Rogers, *The Complexities of Shareholder Primacy: A Response to Sanford Jacoby*, 30 COMP. LAB. L. & POL'Y J. 95, 95 (2008) (observing that the repeal of Glass–Steagall, together with the largely unregulated derivatives market, encouraged excessive risk taking throughout the markets).

7. *See* Louise Story, *Stunning Fall for Main Street's Brokerage Firm*, N.Y. TIMES, Sept. 15, 2008, at A1.

8. Dorit Samuel, *The Subprime Mortgage Crisis: Will New Regulations Help Avoid Future Financial Debacles?*, 2 ALB. GOV'T L. REV. 217, 220 (2009).

many others, was its alleged proclivity to transmute self-interest into the interest of society primarily through the mechanism of competition. According to free market theory, the system needed no intervention from the state or other external agent to work toward benign results, which instead were guaranteed by an "invisible hand."[9] And this remains the view of a very large body of economists. Over the years, their view has been bolstered by scholars who have, without necessarily concluding that regulation is generally detrimental, pointed out various ways in which it can go astray—notably under the "capture" theory, which sees the regulator as captive to the interests of the regulated.[10]

Starting from the thesis that capitalism contains benign tendencies that tend to move economies to socially desirable outcomes, most opponents of regulation see it as a retardant force, stifling initiative and innovation and inhibiting natural inclinations and, by the same token, good economic performance. On the other hand, advocates of regulation are much less persuaded of the market's tendency to regulate itself and to automatically provide social benefits. These regulatory enthusiasts see regulation as a crucial imposition of social needs on an otherwise anarchic economic process. Therefore, the debate between exponents of regulation and supporters of laissez-faire tends to remain mired in the fundamental conflict between a benign and a malign interpretation of the basic tendencies of markets.

The factors that move opinion back and forth between regulation and laissez-faire are (1) whether the regulation in question has been recently invoked in response to a crisis or an ongoing depression, or both, and (2) how it is thought to have performed in restraining the crisis or depression. Thus, as recent economic history demonstrates, many of the regulatory measures that have been recently considered for adoption (and, for the most part, rejected) were offspring of the New Deal period, which was a time of severe economic depression following a dramatic economic crisis, when capitalism itself was under scrutiny, and regulatory measures were thought to be the answer to every economic problem.

Later, after the period of depression passed and the economic crisis became more remote, the reputation of regulation as a cure-all declined and there came a movement to lighten the hand of regulation, which eventually

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9. *See* 1 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 456 (R.H. Campbell et al. eds., Liberty Fund 1981) (1776) (predicting that society will benefit more from actions taken in self-interest, which incidentally help society, than it will from actions taken expressly for society's benefit).

10. *See generally* H.D. Vinod, *Conflict of Interest Economics and Investment Analyst Biases*, 70 BROOK. L. REV. 53, 57 (2004) (explaining that powerful financial institutions were able to capture and co-opt the regulatory authority created by the Gramm–Leach–Bliley Act).

evolved into a movement for deregulation. As this evolution progressed, the antiregulatory arguments about the need to stimulate the natural juices of capitalism, which have been described above, once more became dominant academically, and the thrust of development in the law moved against regulation. Interestingly, this development equally affected policy in the financial arena and in the regulated industries, and in both, as I have noted, the movement away from regulation was called deregulation. But, sooner or later, the time came for events to cause the pendulum to begin to swing the other way.

The credit crisis that began in 2007 and gained unexpected momentum in 2008 was notable for one perhaps unusual feature: like a Florida hurricane, it gained strength as it advanced. Although some causes could be detected, the full process of collapse that led to an extreme unavailability of credit was surprising. It all seemed to begin with what was called the subprime mortgage crisis.[11] A subprime mortgage is one assumed by a borrower having a high debt-to-income ratio, an impaired or minimal credit history, or other characteristics correlated with a high probability of default in comparison with borrowers with good credit history. Typically, this means that the borrower in question had a less-than-reassuring credit history: that is, had a record of multiple bankruptcies, frequent periods of unemployment, or did not regularly command a salary capable of reliable repayment of the mortgage principal.[12] Widespread subprime lending was largely predicated on the expectation of rising home prices. The circumstances of a subprime mortgage, particularly when home price appreciation is flat or negative, could trigger defaults and indicate conditions of higher risk.

Subprime mortgages were, of course, frequently introduced in efforts to broaden the market for home ownership and to provide credit to potential homeowners whose economic circumstances had earlier precluded them from buying their own house. This sort of mortgage also not infrequently contained adjustable-rate features, where, after applying a low fixed rate for a few years (a "teaser rate"), rates could become variable and escalate sharply for a time.[13] In summary, subprime lending involves the extension

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11. *See generally* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 13 (2009).

12. Put otherwise, a subprime borrower is one with a credit score below 620 on a scale of 300 to 850, with a lower score indicating greater risk of default. In addition to having lower credit scores, subprime borrowers typically had loan-to-value ratios in excess of 80%, suggesting a lower down payment. Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: A Primer*, *in* THE SUBPRIME MORTGAGE MELTDOWN: WHO, WHAT, WHERE AND WHY . . . INVESTIGATIONS & LITIGATION 89, 92 (PLI Corporate Law & Practice, Course Handbook Series No. 15783, 2007).

13. *Id.* at 93.

of credit under conditions where the chances of default exceed those associated with normal business practices. This sort of lending practice may, as has been suggested, be associated with a desire to make mortgages more available to a broader spectrum of homeowners, or it may simply represent lenders who incur additional risks to increase the volume of lending without a realistic appreciation of the levels of risk. In the recent credit crisis, the risk inherent in subprime mortgages began to infect the financial system generally because the mortgages were resold in various forms.[14]

Whatever regulation was applied to retail mortgage lending has probably pressed lenders predominantly in the direction of liberality, by making mortgages more available to more homeowners, not reducing the chances of default. Legislators might well have concluded that the self-interest of lenders would have moved them to *tighten* mortgage practices, so it is not clear what increased regulation would or should have done to forestall default and foreclosure, except to increase truth and accuracy in promotional statements and activity. Nonetheless, since these initial defaults at the retail level first introduced the potential for increased risk into the credit system, regulation seeking to forestall defaults would be helpful in precluding a credit crisis. Such regulation would be in the interest of the consumer as well as the lender to the extent that it helps to reduce the risk of default and foreclosure—a benefit to neither the borrower nor the lender.

But, of course, credit crises do not arise out of isolated defaults in mortgage loans alone; they are basically the product of suspect credit at various points in the financing system and with respect to various institutions involved in the financing process. When banks or other savings institutions enter into mortgage loans, they typically do not retain them but transfer their risk to other financial institutions through the process of securitization. Securitization is the creation and issuance of debt securities whose payments of principal and interest derive from cash flows generated by pools of assets—in this case home mortgages. Securitization is not new, but its widespread application to home mortgages, and to subprime mortgages in particular, has been widely cast as the villain in the recent financial crash. In this process, home loans are "pooled," which is to say that thousands of mortgages are placed in trust, and securities backed by these mortgage pools are sold to investors.[15] Mortgage-backed securities (MBSs) are in some respects like derivatives (because their yield is based

14. Samuel, *supra* note 8, at 241–43.

15. *E.g.*, Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 69 (1996).

on the value of another asset), but they are not true derivatives.[16] MBSs, in turn, were "re-securitized." That is to say, they were purchased by new special purpose entities, which issue CDOs backed by specific classes of MBSs.[17] CDOs are true derivatives.

The issue of risk thus became central and came to dominate the behavior of the various parties in the financing process in hedging or offsetting their own risk, or in at least attempting to appreciate it with an adequate degree of confidence. In the case of cash-flow CDOs created from pools of bonds based on mortgage loans of varying degrees of risk, the debt might be split into pieces by issuing new securities linked to each piece. Some of the pieces are of higher quality and some of lower. Credit rating agencies give investment-grade ratings to most or all of these so-called tranches, with the exception of the most junior "equity" tranche.[18] Possibilities exist here for the mispricing of risk either by credit rating agencies or by hedge funds and other sophisticated investors, which are able to manipulate the pricing and structure of CDOs. "CDOs . . . are an opaque market . . . dominated by a handful of interests. And CDOs pose systemic risks, including the risk that a default on one or more bonds would generate a ripple effect of defaults in CDOs."[19]

The extensive credit crisis that we have undergone, based initially on subprime mortgages, was the cumulative product of the effort of banks and other financial institutions to provide home mortgage and other financing and to diffuse risk through the participation of other institutions and sources of credit. Apparently, in the workings of this process, the most dangerous and unacceptable condition was the undertaking of unknown or unmeasured risk. The possibility of encountering uncalculated risk induced financial institutions to refuse credit to new borrowers or decline to accept risk from a suspect quarter. The financial institutions were, as noted, in the process of hedging their own risks—of attempting to transfer all or part of those risks to other parties. But this sometimes led to their being exposed to new or unknown risks.

In addition to CDOs, another credit derivative that has played a major

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16. *See id.* at 69–70, 74 (explaining that mortgage-backed securities (MBSs) are not derivatives because they transfer rights to promised payments at the time of the sale of the MBSs, not at some future point).

17. *See* John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1386 (2008); *see also* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1022 (2007) (explaining how certain special purpose entities purchase portfolios of outstanding debt); STANDARD & POOR'S, GLOBAL CASH FLOW AND SYNTHETIC CDO CRITERIA 4 (2002), http://www2.standardandpoors.com/spf/pdf/fixedincome/cdo_criteria2002_FINALTOC.pdf.

18. Lynch, *supra* note 17, at 1386.

19. Partnoy & Skeel, *supra* note 17, at 1040.

role in the financing process is the CDS, "a private contract in which private parties bet on [the probability of a borrower's] bankruptcy, default, or restructuring."[20] In a sense, this is insurance against a bad-credit event of a borrower. Thus, a financial institution which makes a loan and wishes to hedge its risk enters into a CDS with a third party with respect to the credit of the party to whom it has made the loan. In the case of a credit-impairing event, payment by the CDS protects the financial institution against loss on the transaction.[21] CDSs may sometimes be acquired for nonhedging purposes, essentially as speculative vehicles in their own right—a practice perhaps especially ripe for regulatory control.[22]

Through the use of CDSs, it is not necessary to buy any actual bonds or mortgage-based securities in order to create what are called synthetic CDOs.[23] These are created by aggregating CDSs based on whatever securities are intended, so that if and when the banks, for example, run out of MBSs, they can sell synthetic CDOs to investors.[24] It has been the practice of some banks to retain MBSs on their own balance sheets and to buy protection against default by these MBSs through the purchase of CDSs, and then to sell synthetic CDOs to investors. These transactions, however, are essentially variations on basic hedging operations and have added little fundamentally to the process but may represent a high volume of transactions.[25]

A little something further might be said about CDSs, since they have become so pervasive in the modern credit system and, together with other credit derivatives, have been called "financial weapons of mass destruction."[26] The benefits of CDSs as hedging mechanisms have been widely proclaimed by Alan Greenspan and others, and they acted as "shock absorber[s]" in some of the recent corporate crashes.[27] Many of the lenders to Enron and others had heavily hedged their risks, so that, with the failure of the borrowers, the corporate scandals did not spread to the banking

20. *Id.* at 1021.

21. *Id*. at 1021–22.

22. Michael Santoli, *Where Pricing Anomalies Abound*, BARRON'S, Mar. 9, 2009, at 9; Paul M. Jonna, Comment, *In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation*, 45 SAN DIEGO L. REV. 989, 1005 & n.88 (2008).

23. Partnoy & Skeel, *supra* note 17, at 1022.

24. *Id*. (explaining that special purpose entities may issue financial instruments backed by credit default swaps).

25. Besides these basic credit derivatives, certain instruments provide a wide variety of variations on these basic conceptions, with new innovations being introduced all the time. *See* Lynch, *supra* note 17, at 1387–89 (discussing target annual review notes, constant proportion portfolio insurance, and constant proportion debt obligations).

26. Letter from Warren Buffett, Chairman of the Bd., Berkshire Hathaway, to Berkshire Hathaway Shareholders 13, 15 (Feb. 21, 2003), http://www.berkshirehathaway.com/letters/2002pdf.pdf.

27. Partnoy & Skeel, *supra* note 17, at 1023–24.

industry. Systemic benefits such as these persuaded Greenspan that the market in CDSs should not be regulated but should remain unfettered and encouraged to grow. Other observers felt that credit derivatives and other risk management techniques provided new opportunities for the banking industry, which could deal easily with ordinary risks such as interest-rate risk and, therefore, focus fully on more complex borrower-specific risk.[28]

Later, after the crash, Greenspan partially recanted, saying,

> The whole intellectual edifice, however, collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today, in my judgment.[29]

Thus, practices based on successful experience of high risk taking did not provide protection in more-sober circumstances.

By lowering the risks of bank lending, CDSs increase the liquidity of the banking industry. This effect is similar to the impact of securitization on home mortgage lending. The ability to sell a mortgage sharply reduces the risk of undertaking it in the first place, and risk reduction is the key to volume in mortgage placement.[30] But all these and other advantages in CDSs and other credit derivatives can also reveal potential sources of danger when viewed from other perspectives. Two of these problems arise from the disincentives which, for example, CDSs offer to financial institutions in the monitoring of borrowers and from the opacity of the CDS market.[31] Enron is cited as an example of loss of incentive to monitor and oversee a customer through massive hedging of loan debt. Enron borrowed billions of dollars from some of the country's leading banks, but these amounts were hedged by what is estimated to have been 800 swaps. Presumably, for this and other reasons the creditors provided little direction to the floundering energy upstart. Obviously, financial backers would prefer to have their wards survive and flourish, but with enough hedging of the debt, the creditor's anxiety is bound to be muted.[32] It is not easy to see how this particular effect of the use of CDSs could be reversed or improved by regulation, but the existence of a regulatory authority might play a role

28. *Id.* at 1024.

29. *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 3–4 (2008) (testimony of Alan Greenspan, former Chairman, Board of Governors of the Federal Reserve System), *available at* http://oversight.house.gov/documents/20081023100438.pdf.

30. Partnoy & Skeel, *supra* note 17, at 1024–25.

31. *Id*. at 1032, 1036.

32. *See id.* at 1032–33 (observing that several banks, including JPMorgan Chase and Citigroup, had a reduced interest in oversight of Enron because hundreds of swaps significantly reduced their exposure).

in keeping a financing agency awake and alert to the activities of its client.

Opacity is a different matter since disclosure is usually at the heart of securities regulatory philosophy. The hidden character of hedging is an obvious outcome of the use of CDSs. There is no way for the outside observer to know whether a given financier's risk is hedged or, in a complex arrangement, what entity bears the ultimate risk.[33] The International Swaps and Derivatives Association "has actively resisted disclosure of credit default swap documentation, insisting that this information is proprietary."[34] In addition, one party to a swap frequently sells its interest to someone else without notifying the other party to the arrangement. "Record-keeping, documentation and other practices have been so sloppy . . . that no firm could be sure how much risk it was taking or with whom it had a deal."[35] All this opacity leads to significant problems in interpreting the behavior of other actors in the market. For example, if a lender makes concessions, it may mean one thing if that party is fully hedged and quite another thing if the lender is unhedged. "The opacity of the market may also make it more likely that hedge funds or other parties will manipulate default" in various ways to the detriment of stability.[36]

Before leaving the financial crisis and its implications, it would be appropriate to mention the savings and loan crisis of a somewhat earlier period. In part, this crisis was based on the lifting of limitations placed by law and regulation on interest payable on deposits in savings and loan institutions. These limitations made it difficult for these institutions to compete for deposits with banks, which had been freed of such limitations. When the limitations on the savings and loans were removed, these institutions raised their interest payments. The institutions correspondingly raised their revenue requirements and began to search for more-profitable investments than the home mortgages in which they traditionally invested. Of course, in line with normal expectations, pursuit of more-profitable investments implied acquisition of riskier investments, and for the savings and loans this meant investments in commercial development projects, hotels, resorts, and the like. When times turned bad, these investments meant higher losses and a crisis in the industry attributable in part to a relaxation of regulation—not unlike the current credit crisis.

All this leads us to wonder whether a monstrous tide of regulation is coming back to the American financial system like the ocean tide to the

33. *Id*. at 1036–1037.
34. *Id*. at 1036.
35. *Id.* (quoting David Wessel, *Wall Street Is Cleaning Derivatives Mess*, WALL ST. J., Feb. 16, 2006, at A2).
36. *Id*.

Bay of Fundy. Examination of the technical details of credit derivatives and their usefulness or dangerousness does not provide an answer. We know that the economic setback following the credit crisis of 2008 has been and will continue to be stunning. We know, as described earlier, how the crisis grew out of the bourgeoning use of credit derivatives following a vigorous placement of subprime mortgages. What we do not know for sure is whether aggressive government regulation of either the mortgage business or credit derivatives could have avoided the problem, or at least weakened its impact. Following well-established precedent in the securities laws, effective regulation could at least have required transparency and eliminated the mystery that enshrouds the present use of credit derivatives. More-effective regulation could also have affected reserve requirements based on risk. But, at this point, there is no unanimity as to precisely what sort of regulation is required.

Most commentary on regulation of credit derivatives puts it within the context of securities regulation in general and emphasizes the need for centralization of responsibility and for increased efficiency, usually to make the industry in the United States more competitive with its counterparts elsewhere.[37] And most regulatory proposals rely on self-regulation and sometimes refer to guidelines laid out by the Major Dealers in meetings held to discuss improvements in the infrastructure of the industry.[38] But the dire circumstances under which regulation now may become an active issue seems to rule out any major reliance on self-regulation. After numerous failures on Wall Street requiring bailouts[39] and the Bernard Madoff scandal, there is little likelihood of any enthusiasm for committing regulation of Wall Street to the tender mercies of its denizens. It seems more likely that Congress would put arms-length regulators without strong ties to the Wall Street operators in charge.

Returning at last to the status of regulation in the regulated industries, we find that after California the push to deregulate in the electricity sphere lost force. In some states efforts went forward with vigor; in others there was a slowdown or freeze and little effort to press on with restructuring. In a few places, there was even some backsliding and withdrawal from arrangements already tentatively undertaken as steps toward deregulation. These tendencies were not entirely the result of the well-publicized failures in California, but that was certainly a turning point in a movement which,

37. *E.g.*, Lynch, *supra* note 17, at 1431–35.

38. *Id*. at 1396–1405. The Major Dealers are a group of fourteen Wall Street firms that meet regularly with the goal of creating self-regulation to improve the markets' structure. *Id.* at 1396–97.

39. *See* David Cho & Binyamin Appelbaum, *Historic Market Bailout Set in Motion: President Cites Urgent Need for Sweeping Intervention,* WASH. POST, Sept. 20, 2008, at A1.

up to then, had things going pretty much its way.[40] At that point, deregulation, or restructuring, seemed to be most successful in applications where few natural monopoly characteristics were in evidence and capital intensiveness was not overwhelming, such as in the airlines and motor carriers. In these applications, the economic characteristics of the activity seemed alien to efforts to prescribe prices and services administratively, which could be left to private arrangements between shipper or passenger and the carrier, with competition to enforce reasonableness. Currently, deregulation of the airlines seems successful in terms of route structure, fares, flight frequency, and other traditional concerns. The only major problem is that the airlines, taken as a whole, seem incapable of making money.[41] In 1938, the same deficiency was a prominent factor in the imposition of regulation. Presently, there is no clamor for re-regulation, but this might be imposed if all else fails. The price of fuel seems a dominant element in financial performance, but the ultimate impact of this is unpredictable.

On the other hand, in heavily capital-intensive industries where natural monopoly characteristics had traditionally been emphasized—like electricity—restructuring to emphasize choice and competition seems to have been least obviously and least consistently successful. In industries lying somewhere in the middle of this range of characteristics—like telecommunications, where innovative technology is prevalent—restructuring has been carried out with claimed success but not without some major difficulties.[42]

In light of this mixed performance, there seems to be no compelling reason why dire circumstances involving credit derivatives in the financial industry should reawaken interest in re-regulating the formerly regulated industries. The best answer is that in popular parlance and understanding both these areas of regulatory activity had been subjected to deregulation. This was literally true in the case of regulated industries. Here, control of price and service by regulatory agencies had indeed been lifted on a broad basis with degrees of success and failure that I have noted. However, credit derivatives were never regulated because they were not traded on an exchange as were, for example, futures and options (also derivatives).[43] So credit derivatives had not been literally deregulated, although the term was extensively applied to them after the credit crisis arrived.

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40. Cudahy, *supra* note 2, at 335.

41. Richard D. Cudahy, *The Airlines: Destined to Fail?*, 71 J. AIR L. & COM. 3, 7 (2006).

42. Natural gas is another industry where an approach favoring competition has been workable.

43. Lynch, *supra* note 17, at 1375–81.

That there will be strenuous efforts to regulate credit derivatives and anything else connected with the credit crisis seems virtually certain, and I would anticipate the regulatory tide's lifting all boats, including the one supporting the regulated industries. The era of deregulation is over and the sentiment that it is more important to let the juices of capitalism flow than to be sure they are flowing in precisely the right channel is no longer dominant. The pendulum has swung from the extreme of liberation to the extreme of restraint, and the ideology of the New Deal will be ascendant. This is almost sure to be the reaction to a widespread collapse of the economy based in part on negligence and in part on greed. The specifics of exactly what is to be regulated (although transparency is a likely candidate for high priority) will probably be less of a concern than simply a demand for a stern regulator to be in charge.[44] In the case of credit matters, the most popular proposal is to list CDOs and CDSs on an exchange and require the reporting of all trades.[45] This would supply complete transparency. In addition to requiring the reporting of transactions involving derivatives, the Treasury Department has proposed adopting registration requirements for hedge funds and stricter rules for large, interconnected financial firms, including increased reserve requirements.[46] Great interest also exists in altering the compensation arrangements of credit rating agencies to eliminate conflicts of interest. And, as indicated, I suspect that the newfound popularity of regulation will be felt almost equally in what were traditionally known as regulated industries. This is perhaps not as certain, but public psychology being what it is,

44. *See id.* at 1434–36 (recommending the creation "of a single regulator which oversees all financial markets, but delegates to those market participants the authority to formulate the rules and practices by which each market will operate"); *see also* Samuel, *supra* note 8, at 256–57 (advocating a flexible regulatory system that promotes full disclosure and results in severe penalties for noncompliance).

45. This proposal was the centerpiece both of the Senate's proposed Derivatives Trading Integrity Act of 2008, S. 3714, 110th Cong. (2008), *available at* http://216.40.253.202/~usscanf/index.php?option=com_content&task=view&id=1812&Itemid=2, and of the House of Representatives' proposed Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. (2009), *available at* http://agriculture.house.gov/inside/Legislation/111/PETEMN_001_xml.pdf.

46. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 10–12 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. Some liberal critics have argued that the Treasury Department's proposals do not go far enough, and that more in particular should be done to consolidate the functions of the different regulatory agencies. *See* DOUGLAS J. ELLIOTT, THE BROOKINGS INSTITUTION, REVIEWING THE ADMINISTRATION'S FINANCIAL REFORM PROPOSALS 10 (2009), *available at* http://www.brookings.edu/papers/2009/0617_financial_reform_elliott.aspx. Conservative critics, by contrast, argue that the proposal increases the power of regulators in ways that would stifle innovation. *See* Posting of James Gattuso to Foundry, http://blog.heritage.org/2009/06/17/obama-financial-regulation-plan-empowering-regulators-not-consumers/ (June 17, 2009, 16:49 EST).

disillusionment with deregulation should sweep across the board and reach far beyond financial matters, and even into unrelated areas like food processing, airplane safety, and commodity trading.[47] The impulse to apply social restraints will generally outweigh the demand to unshackle the dynamics of markets.

The deregulation movement in all its forms was energized for many years by academics and others deeply persuaded of the thesis that the unregulated operation of competitive markets worked to further stability and socially beneficial economic outcomes. This broad school of thought regarded intervention in markets as generally undesirable and disruptive of the natural equilibrium that markets tended to achieve when undisturbed. Carried to an extreme, this non-intervention school of thought would have eschewed tinkering, even to repair the damage of a major crash leading to an abrupt recession. Just as these laissez-faire advocates stepped back from vigorous measures to stimulate a lagging economy (à la Keynes), they would be suspicious of a regulatory regime designed to guide an economy around the shoals of crisis and slowdown. The same tendencies apply to the regulated industries where the deregulators want nothing to interfere with the natural and self-restorative rhythms of the market. But all of these sentiments are bound to fall before the harsh realities of a major credit crisis leading to a severe recession. Just as deregulation, based on a deep faith in markets, has dominated theory and practice in all areas for so long, now terrible damage to the economy has destroyed the underlying faith and replaced it with a penetrating mistrust.

This is certainly not to say that the swing toward regulation will last forever. Once the crisis is passed and remains passed for a long time, the beauties of laissez-faire will again be visible and influential. But that is a day beyond this one and far beyond it at the moment, and the old and somewhat shopworn arguments against regulation will fall on deaf ears. At last fulfilling the forecast in 1993, the demise of deregulation is now virtually guaranteed.

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47. *See Congress Says FDA Faulty in Audits*, NEWSDAY (N.Y.), May 19, 2009, at A26 (discussing salmonella outbreaks due to contaminated peanut butter); Andy Pasztor, *Airline Safety Gap Cited in Crash Probe*, WALL ST. J., May 15, 2009, at A3 (discussing commuter airline crashes); Edmund L. Andrews, *U.S. Weighs Curbs for Speculators in Energy Trades*, N.Y. TIMES, July 8, 2009, at A1 (discussing proposals to curb speculation in commodity futures).