The Modern Corporation Magnified: Managerial Accountability in Financial-Services Holding Companies

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I. Introduction

The financial crisis of 2008–2009 should—and doubtless does—stand out in our minds for a number of reasons. One of those reasons, to be sure, was the shockingly steep and seemingly unrelenting fall in stock prices world over. If that were not significant enough on its own, the financial crisis was glaring evidence of striking deficiencies in the operation of the economy as a whole. Not only had stock prices fallen, but the "system" had also revealed itself to be unstable. Risk-mitigation practices, combined with insufficient regulation of those practices, meant that no one had to bear any risk at all, which, of course, perversely meant that, in the end, everyone bore risk—a lot of it, at that.

And so, in the post-financial-crisis months and years, the systemic weaknesses that became evident have been explored, investigated, diagnosed, and, supposedly, remedied. We have learned much about the extent to which mortgage lending and securitization practices built a giant housing bubble. We have learned about how lending companies failed to conduct diligence on borrowers and, to the contrary, determined that that diligence was unnecessary and counterproductive. We have learned that the same creativity in financial products that fueled the housing bubble also served to heighten risk in all quadrants of the economy, as financial-services companies used "repo" financing to take on trillions of dollars of exposure from credit default swaps and other financial instruments, whether to hedge actual risk or simply to speculate. We have learned, moreover, that firms' positions in these instruments and the massive leverage that permitted them were often off regulators' radar screens, as part of the "shadow" banking system that was the topic of many a congres-

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sional hearing when lawmakers formulated the Dodd-Frank Act.[1] Indeed, so many untoward circumstances and conditions had been accumulating in the system that the financial crisis, in retrospect, seems all but expected, even though, at the time of its onset, it was anything but.

In other words, transferred risk, unregulated financial-services institutions and activities, complex and creative financial instruments, conflicts of interest, and illegal mortgage-lending practices—symbiotic factors in the financial crisis—are what, for many of us, stand out about the crisis and lessons to be learned from it. And although it may be easy to think of the financial crisis as the "black swan" event that many observers have claimed it to be, that proposition is dubious. There surely will be another financial crisis, and it may well be not far off, regardless of the additional laws and regulations that have come into being since 2008.[2]

Moreover, given the financial crisis's roots in systemic instability and its effects on the broader economy, some of the biggest losers in the crisis likely will be some of the biggest losers in any future financial crisis: shareholders—shareholders of financial-services holding companies, that is. That is awkward terminology, but one need only think of Lehman Brothers and Bear Stearns to grasp its meaning. Financial-services holding companies (FSHCs)[3] are publicly traded companies that engage in business activities unlike what we—or, at least, much of the public—generally think of as "business." What do FSHCs do? Nothing, really, if we conceive of a firm's "doing" something as producing tangible goods or providing services to others. Rather, the activity to which FSHCs appear mostly, if not exclusively, devoted is the investment of their own capital, a practice called (and notoriously so, in the wake of debates about the "Volcker Rule" under the Dodd-Frank Act[4]) "proprietary trad-

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010). We have also learned that those who gained the most from betting on credit events played an important and conflicted role in putting possibly unsuspecting parties on the other (losing) sides of the bets.

2. *See, e.g.*, Francine McKenna, *The Kids Aren't Alright*, AM. BANKER (Mar. 8, 2012), http://www.americanbanker.com/bankthink/the-kids-are-not-alright-1047351-1.html ("Most reasonably intelligent readers are finally willing to admit the financial crisis was neither an unpredictable, uncontrollable, once in a blue-moon 'black swan' event nor the result of a conspiracy by shadow bankers who've implemented a new world order while flying from Manhattan to Islip in black helicopters.").

3. This Article uses the term "financial services holding company" in a descriptive sense, rather than a legal one.

4. *See* Dodd-Frank Act § 619. The Volcker Rule is intended to limit "too-big-to-fail" and FDIC-backed financial institutions' ability to engage in trading activities for their own accounts. The rule is a product of Congress's goal of preventing future taxpayer rescues of financial firms that experience financial difficulty as a result of those activities. *See* DAVID H. CARPENTER & M. MAUREEN MURPHY, CONG. RESEARCH SERV., R41298, THE "VOLCKER RULE": PROPOSALS TO

ing."[5] These firms, regardless of whether they are "too big to fail" or engage in activities backed by government guarantees, present substantial risks to their shareholders.

Amid the recent flurry of policymaking and concerns about how the activities of financial institutions may dramatically affect the rest of the economy, and handwringing about how regulators are ill-equipped and inadequately motivated to hold key players accountable, neither scholars nor commentators have focused on the corporate governance implications of FSHCs' activities. This Article's goal is to revisit early and thoughtful commentary on the fundamental problem of the large corporate enterprise—managerial accountability to shareholders—to show that this fundamental problem is dramatically pronounced—magnified, if you will—in the types of enterprises that were at the center of the financial crisis, whether too big to fail or not. In particular, *The Modern Corporation* articulated that the evolution of economic organization has separated the beneficial ownership of property from those who control it and that this disjunction has created an irresolvable tension between shareholders and management.[6] Nowhere is that tension more pronounced than in the context of FSHCs, raising questions regarding whether the standard tools of corporate governance are equipped to address it.

This Article first recalls the primary contours of Adolf Berle and Gardiner Means's acclaimed observations regarding the separation of ownership and control in the "modern corporation," as well as their conclusions about the implications of those observations for the doctrine of shareholder primacy. Second, the Article describes how the activities of FSHCs generally differ from what we think corporations do and, certainly, from what Berle and Means conceived of as the purpose of corporations or, indeed, any business enterprise. In particular, rather than deploying physical property for the purpose of producing goods or providing services and, beyond that, creating economic value for the property's ultimate owners, FSHCs deploy their and their customers' and clients' financial assets for the purpose of generating profits through trading and investment activities.

LIMIT "SPECULATIVE" PROPRIETARY TRADING BY BANKS 10–20 (2010), *available at* http://www.fas.org/sgp/crs/misc/R41298.pdf.

5. *See* CARPENTER & MURPHY, *supra* note 4, at 2 (noting that a bank engages in "proprietary trading" when it "invest[s] as principal, rather than at the behest or for the benefit of customers, for the bank's own account"); *see also In re* The Goldman Sachs Grp., Inc. S'holder Litig., No. 5215–VCG, 2011 WL 4826104, at *2 n.3 (Del. Ch. Oct. 12, 2011) ("'Proprietary Trading' refers to a firm's trades for its own benefit with its own money.").

6. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

Third, this Article articulates how those business activities render more acute the problem of the separation of ownership and control that Berle and Means observed. In particular, FSHC shareholders face additional peril as a result of managerial incentives that cultivate excessive risk-taking, which is often difficult to temper, and heavy regulation, which raises the prospect of both regulatory enforcement actions and regulatory capture—all fueled by rules under the Bankruptcy Code that, in the event of insolvency, limit a firm's rights to recoup assets transferred in its final days.[7] Additional risk derives from FSHCs' relationships to their subsidiaries, which typically do carry on activities that fall within the more traditional role of corporate activity, such as performing broker–dealer or banking services. This discussion highlights that, because FSHCs are an evolved specimen of the modern corporation, there should be heightened concern regarding the possibility that FSHC managers may not be looking after shareholders' best interests.

Finally, this Article concludes that the special concerns that FSHCs produce both portend and necessitate rethinking the problem of managerial accountability in large, publicly traded corporations. The Article suggests, consistent with Berle and Means's conclusions, that the notion of shareholder primacy should be supplanted—but does so without necessarily embracing the notion that corporations should be managed in the interests of innumerable constituencies. Rather, the Article raises the possibility that many of the concerns associated with FSHCs' activities could be addressed through a greater governance focus on one constituency, in particular: those who seek out, and benefit from, FSHCs' traditional and foundational business operations—namely, clients and customers.

II. *THE MODERN CORPORATION*

The Modern Corporation is standard reading for any serious student of corporate governance. Accordingly, it is worth revisiting the book's arguments only as a reminder of Berle and Means's main premises and enduring insights and of the conclusions those insights ultimately allowed the authors to reach. Berle and Means articulated themes of evolution and transition to a new mode of enterprise, one that was itself potentially subject to further evolution as firms and their managers pursued activities that the authors could not have foreseen.[8] In particular, Berle and Means saw that, as the attributes of property had changed, so had the

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7. *See infra* Part IV.

8. *See* BERLE & MEANS, *supra* note 6, at 246.

relationship between those who owned property and those who controlled it.[9] (Indeed, arguably a jarring indicator of those changes was the new need to speak of ownership and control as separate groups.) Those changes, they discerned, had profound implications for both the function of the stock markets and the traditional "orientation" of the firm toward profit maximization and shareholder value.[10]

Berle and Means began their project with their study of the changes wrought to "property" as a result of the growth of the corporate form of enterprise. They wrote that "[t]he corporation has . . . become both a method of property tenure and a means of organizing economic life."[11] One of the most important effects of that transition has been a "division of the functions formerly accorded to ownership."[12] Whereas the shareholders beneficially own the corporation's property, only the corporation's managers have power over the property and the ability to act with respect to it.[13] In other words, accompanying the rise and increasing economic dominance of corporations has been the concentration of economic power in a small group of individuals whose relationship to property arises only through their having been appointed to particular positions rather than through their own economic resources. Conversely, property owners are now dispersed and, apart from their holding a few residual rights, virtually powerless to control that which they own.[14]

Moreover, if owners do not have "appreciable control," and control does not have "appreciable ownership," there arises the question of what is the relationship between the two groups and, more particularly, whether their respective interests are aligned.[15] Certainly, observed Berle and Means, we can discern owners' interests, which are that the corporation earn maximum profit and that owners receive as large a portion of profits as is practicable and retain the ability to sell their shares for a fair price.[16] The interests of control are another matter, but there is ample reason to believe that, lacking substantial ownership, managers may lack adequate incentives to further owners' interests and, instead, may be inclined to pursue their own.[17] In other words, the separation of ownership from

9. *See infra* notes 15–35 and accompanying text.

10. *See infra* notes 48–51 and accompanying text.

11. BERLE & MEANS, *supra* note 6, at 1.

12. *Id.* at 119.

13. *Id.* Meanwhile, "[t]he position of the owner has been reduced to that of having a set of legal and factual interests in the enterprise while the group which we have called control, are in the position of having legal and factual powers over it." *Id.* at 120.

14. *See id.*

15. *See id.* at 121.

16. *See id.*

17. *See id.* at 121–22.

control has allowed those in control to use their powers against the interests of ownership.[18] Because that separation is a creature of law, moreover, there arises at least the appearance that "the diversion of profit into the hands of the controlling group" is not only an expected consequence but also a perfectly legal one.[19]

Indeed, as the authors more succinctly posited, "the shareholder in the modern corporate situation has surrendered a set of definite rights for a set of indefinite expectations."[20] Shareholders can have no more than a "loose expectation" that managers will operate the firm in shareholders' interests.[21] In fact, we might now think of shareholders as similar to bondholders, in that both groups are part of a common hierarchy of capital suppliers who expect a return on their capital and whose expectations are based on rights set forth in a contract with the corporation.[22] In addition, in the case of both groups, the corporation's needs for additional capital—if it ultimately has such needs, something out of capital suppliers' control—limits the extent to which management may "abuse" either bondholders or shareholders.[23]

Of course, if there be risks associated with owners' placing control of "their" property in the hands of another, those risks may be worth taking, so long as there remains the prospect that a shareholder may obtain a repayment of capital by disposing of her ownership interest. Hence, noted Berle and Means, "mobility" in the securities markets—the ability of shareholders to rid themselves of further risk associated with their ownership interests—is important.[24] And, hence, the public securities markets are similarly important. Both intuitively and in fact, "mobility decreases as . . . the size of the unit of property sought to be made liquid increases,"[25] a circumstance that amply supports the divvying up of ownership interests into discrete shares of stock.[26] With the device known as a share of ownership, one need not be "married" to his property as is the case

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18. *See id.* at 123–25.

19. *Id.* at 335. That applicable rules were "sometimes inconsistent and often not clear in application" fostered this appearance. *Id.* Nonetheless, the authors noted that "not a single case on record denies the ultimate trusteeship of the controlling group, nor even faintly implies that such a group may use its power for its individual advantage." *Id.*

20. *Id.* at 277.

21. *See id.*

22. *See id.* at 279.

23. *See id.* at 280–81.

24. *See id.* at 280–83.

25. *Id.* at 283.

26. *See id.*

with the sole proprietor who cannot "absent himself very much."[27] Conversely, property whose productivity may be elicited only through its owner's work and attention is likely to be immobile.[28]

For property to be mobile, however, "the relation of the owner to it must necessarily play little part"; the property cannot depend on its owner for its value but, instead, must be "impersonal."[29] The authors described how shareholders' access to mobile property depends on control's maintenance of immobile property:

> The separation of ownership from management and control in the corporate system has performed this essential step in securing liquidity. It is the management and "control" which is now wedded to the physical property. . . . The management is more or less permanent, directing the physical property which remains intact while the participation privileges of ownership are split into innumerable parts—"shares of stock"—which glide from hand to hand, irresponsible and impersonal. . . . Two forms of property appear, one above the other, related but not the same. At the bottom is the physical property itself, still immobile, still there, still demanding the service of human beings, managers, and operators. Related to this is a set of tokens, passing from hand to hand, liquid to a degree, requiring little or no human attention, which attain an actual value in exchange or market price only in part dependent upon the underlying property.[30]

Tokens—the property that shareholders own—are quite different from the "physical property" on which the enterprise is based.[31] As an initial matter, the tokens' value is merely derivative of the value of the underlying property that the tokens represent.[32] Beyond that, however, their value is affected by a number of factors: the capabilities of those managing the underlying property, token buying and selling activity based on speculation or artificial manipulation, and shareholders' expectations as to the rights attached to the tokens, such as preemptive rights in connection with new issuances, dividend rights, and voting rights.[33]

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27. *Id.* at 284. Emphasizing the point, Berle and Means further observed that "non-liquid property immobilizes the owner by its own immobility." *Id.*

28. *Id.*

29. *Id.* at 284.

30. *Id.* at 285.

31. *See id.* at 285–86.

32. *See id.* at 285 ("Curious as it may seem, the fact appears to be that liquid property, at least under the corporate system, obtains a set of values in exchange, represented by market prices, which are not immediately dependent upon, or at least only obliquely connected with, the underlying values of the properties themselves.").

33. *Id.* at 286–87.

"Most striking of all," though, a token's value is based on the very fact of its liquidity.[34] Thus, it is the factors that have little or no relationship with the underlying physical property that are paramount to shareholders and, therefore, that constitute the foundation of the securities markets.[35]

Having established that shareholder value is only loosely based on the value and productivity of the corporation's physical property, the authors, at last, were able to ask: "Who should receive the profits of industry"?[36] In whose interests, in other words, should the country's large corporations be operated—those of shareholders or perhaps, instead, those of "some other or wider group"?[37] In light of "[t]he extensive separation of ownership and control, and the strengthening of the powers of control," it is not difficult to see how this is the question with which the reader is left.[38] Beyond the difficulties arising from the divergence of controllers' interests from those of shareholders is the undermining of the traditional logic of property, which, according to Berle and Means, no longer applies. Must it be the case, they ask, that one who has given up control of his own property should be protected to the same extent as a property owner who has retained and exercises control?[39] Allocating profits to shareholders beyond what is sufficient to ensure their continued supplying of capital seems not to perform any useful economic function.[40]

Turning to the other side of the equation—control—the separation of ownership and control, in its denying control a stake in the profits, subverts the traditional incentive of property owners to deploy that property for the most efficient and productive uses.[41] Berle and Means suggested the ultimate implications of these observations:

> [I]f profits have any influence as a motivating force, any surplus which can be made over a satisfactory return to the investor would be better employed when held out as an incentive to action by control than when handed over to the "owners" who have surrendered control. . . . The traditional logic of profits, when thus applied to the

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34. *Id.* at 286. The authors described in greater detail the relationship between value and liquidity: "The privilege of being able to borrow upon property at once, or the ability to turn it into cash on twenty-four hours' notice may in itself be worth paying for and thereby enhance the value of the token." Conversely, they observed that "the very sensitiveness of the value of liquid property to unreasoned surges of popular fear may detract from its value." *Id.*

35. *See id.* at 287.

36. *Id.* at 333.

37. *Id.*

38. *Id.*

39. *See id.* at 339.

40. *See id.* at 343.

41. *See id.* at 341.

> modern corporation, would indicate that *if profits must be distributed either to the owners or to the control*, only a fair return to capital should be distributed to the "owners"; while the remainder should go to the control as an inducement to the most efficient ultimate management. The corporation would thus be operated financially in the interests of control, the stockholders becoming merely the recipients of the wages of capital.[42]

This possible reorientation of property relationships, too, is suspect, as the authors readily admit:[43] "Modification of the principle of private property"[44] to allow control to divert profits to themselves is a far less desirable result than requiring control to act as "trustees" solely in the interests of "inactive and irresponsible security owners."[45] Fortunately, however, there are more than two options, in that "eliminating the sole interest of the passive owner . . . does not necessarily lay a basis for the alternative claim that [managerial power] should be used in the interest of the controlling groups."[46] The way out of the choice—or, more accurately, the conundrum—is to avoid it altogether, for there is another approach.[47]

Separation of ownership and control, by permitting control's expansion of its own powers and reducing ownership's claim to the full rewards of supplying capital, anchors the alternative notion that the modern corporation should serve "not alone the owners or the control but all society":[48]

> It is conceivable, —indeed it seems almost essential if the corporate system is to survive, —that the "control" of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity.[49]

This concept makes sense if the corporation, like the state, is a form of "social organization"—one that, indeed, may be seen as competing with the state for dominance.[50] Berle and Means suggested that the corporation is exactly that with their observation that corporations pervade all

42. *Id.* at 343–44.
43. *See id.*
44. *Id.* at 355.
45. *Id.* at 354.
46. *Id.*
47. *See id.*
48. *Id.* at 356.
49. *Id.*
50. *See id.* at 357.

aspects of individuals' lives.[51] If that is the case, then it is no great leap to think of corporate law as a variant of constitutional law and of the competing interests of society as the foundations on which corporate law should be based. The corporation, in other words, could (should) be conceived of as a mini-society, one that infiltrates and affects all of its members and that must balance the interests of each social constituency. The question that the authors could not have addressed is whether and how that conclusion might change when the brittle connection between ownership and control becomes still further compromised, as it does in the case of FSHCs.

III. PROPRIETARY TRADING

As discussed in Part II, *The Modern Corporation*'s analysis of corporations and its ultimate prescriptions for the role of corporations in society stemmed from the authors' observation that, in the corporate context, the nature of property ownership had fundamentally changed. Whereas the shareholder once held actual property over which she might exert control and deploy for a productive function, the shareholder now holds simply "a piece of paper" representing her rights and entitlements as to a firm and its property—property over which she now has no control.[52] For Berle and Means, that altered status meant that owners could no longer play a role in manipulating and engaging property in the name of producing goods or providing services for the benefit and consumption of clients and customers in the market place.[53]

Berle and Means's concerns about the separation of ownership from control over property reveal a notion of property as largely tangible and physical. It is perhaps a natural conception, given their juxtaposition of the productive property of the enterprise with the (flimsy and destructible) property that modern shareholders possess. Put another way, in the evolution of the modern enterprise, traditional property owners gave up something tangible for something intangible and are all the worse off for having done so. The authors' case may have been more challenging to make if what property owners had relinquished for their new slips of paper were, simply, other slips of paper. Perhaps partly for that reason, Berle and Means put banking and other financial firms off to

51. *See id.* at 24–26 (observing that "[t]he individual must come in contact with [corporations] almost constantly," in that he may be a shareholder, an employee, or a customer of them and, "above all, . . . is continually accepting their service").

52. *See supra* notes 15–35 and accompanying text.

53. *See id*.

the side throughout their study, focusing instead on "non-banking" or "non-financial" corporations.[54]

Having recognized the existence of financial firms, however, Berle and Means presumably could have addressed them, fitting them within their analysis alongside utilities and manufacturing firms. Of course, whether financial corporations gave rise to the same concerns the authors observed in other contexts would have depended on whether the financial firms resembled other large firms, in terms of their ownership structures and their business activities. Regardless of what may have been the case in the early 1930s, neither condition would seem to present particular difficulties today. Indeed, when many people think of the activities of firms such as J.P. Morgan, Morgan Stanley, and Bank of America, for example, they likely think of firms that are publicly held and that are engaged in a variety of financial-services activities. In particular, they may think of underwriting or brokerage activities, whereby the firms serve as intermediaries between buyers and sellers of securities, earning commissions as their compensation. Or, perhaps, in a similar vein, they think of deal-promotion activities—the business of bringing together two firms that are interested in pursuing a business combination. Less obviously, "market making" may come to mind. That is, rather than being a middleman, as a broker is, a firm may act as a dealer, in the sense that it may buy and sell certain securities as a principal in a manner that facilitates liquidity in the securities markets. Those who are familiar with the public offering process will likely also think of these firms' roles as underwriters, which take on the risk of finding buyers for the securities to be issued in an offering.

There is something about many financial corporations, however, that pushes the limits and enlarges the implications of *The Modern Corporation*'s analysis. In particular, financial corporations involve "holding company" structures. As the descriptive label "holding" implies, such a company is a parent company—one that carries out financial-services activities but that (usually) does so only indirectly, through its various subsidiaries.[55] The subsidiaries' activities include those we envision brokerage firms pursuing—such as broker–dealer, underwriting, and in-

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54. *See* BERLE & MEANS, *supra* note 6, at ch.3.

55. *See* James A. Fanto, *"Breaking up is Hard to Do": Should Financial Conglomerates Be Dismantled?*, 79 U. CIN. L. REV. 553, 553 (2010) ("Many securities firms, which are regulated as broker-dealers, operate within the [financial] conglomerate structure."); Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 509 (1994) ("[T]oday's financial giants—whether NationsBank or Merrill Lynch or Fidelity Investments—now operate in multiple sectors of the industry, typically through a network of subsidiaries specializing in deposit-taking, insurance underwriting, securities activities, and various other financial services.").

vestment-banking activities—but may also include providing financial planning or other investment advisory services. For example, Goldman Sachs has a number of subsidiaries that perform these varied roles: Goldman Sachs Execution & Clearing is an entity within the broker–dealer "arm," while Goldman Sachs Asset Management provides investment advisory services, including sponsoring hedge funds and providing discretionary investment advice to institutional investors.

The subsidiary structure allows the firm as a whole to pursue its various activities through separate entities. One reason for separating activities by putting them in different entities may be to alleviate conflicts of interest—both the appearance and the fact of them—that could arise if one regulated subsidiary and its personnel carried out multiple disparate functions, such as underwriting or investment-banking activity, on one hand, and brokerage activity, on the other. Another rationale, albeit more pedestrian, also seems evident: housing separate activities in separate entities may help insulate the assets associated with one activity from the liabilities associated with another activity. Finally, separate subsidiaries may be necessary to the extent that activities are conducted overseas. Non-U.S. activities typically counsel in favor of organizing an entity in the host country and submitting that entity to the foreign government's financial-services regulatory regime.[56] (The parent company, by contrast, is often not regulated and, therefore, cannot itself provide financial services to third parties.)

All of these circumstances raise the question of what, exactly, the parent company does, or whether it does anything at all. Prior to the onset of the financial crisis, at least, one might have thought that the parent company's "activities" and profits were simply reducible to the activities and profits of its financial-services subsidiaries. If so, however, one would have been mistaken. While the profits and losses of the parent—the holding company—include those of the subsidiaries, the parent company has its own project, one that, in the aftermath of the financial crisis, has become rather notorious: the pursuit of profit through proprietary trading, whether conducted directly or through designated branches, divisions, units, or subsidiaries, including ones based in non-U.S. jurisdic-

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56. *Cf.* Susan Schmidt Bies, *Remarks by Governor Susan Schmidt Bies*, 37 CONN. L. REV. 715, 715–16 (2005) (noting that "[a]s large U.S. banks have expanded their international operations, they have also become subject to supervision in their host countries," and that "as foreign banking organizations, in a continuing expansion of their presence in the United States, have established branches of their home country banking entities and acquired regional and large U.S. banks that are separate legal entities, they, too have become subject to additional supervision").

tions.[57] Proprietary trading, as its name suggests, is the activity of trading and investing on one's own behalf.[58] When a firm pursues proprietary trading strategies, it uses its own assets, which may include assets that it has acquired through borrowing from other financial firms or from the firm's clients and customers.[59] For present purposes, the important aspect of proprietary trading is not simply that FSHCs engage in it but that they may do so for purposes entirely unrelated to the business purposes mentioned above (that is, for purposes other than, say, to hedge risk). More importantly still, they often do so to an extent that the assets involved may rival, if not dwarf, the other, more traditional business activities carried out by the FSHCs' subsidiaries.[60] Those activities are the basis of the modern corporation, magnified.

The lure of proprietary trading may be discerned by considering the incentives behind it. First, let us consider the economics of financial-services activities. When a financial firm acts on behalf of a client, the profits that the firm may earn depend on what, exactly, the firm is doing for the client. If the firm is bringing together parties in a major deal, the firm will typically receive as compensation a percentage of the deal price. If the firm is acting as a broker in a securities transaction, the firm will likewise receive a commission for its efforts. Similarly, when the firm acts as a dealer, buying or selling a security for which it is a market maker, the firm will receive commission-like compensation, in that the price will reflect a "spread"—the difference between the price at which the firm will sell a security and the price at which it will buy the security[61]—that will go to the firm. Finally, when the firm manages a client's assets, it receives as compensation a percentage of assets managed or profits achieved for the client—but it must adhere to an investment strategy that is consistent with the client's investment objectives, however staid and conservative those objectives might be.

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57. *See, e.g.*, Ben Protess, *Citing JPMorgan Loss, Regulator Pushes New Oversight*, N.Y. TIMES DEALBOOK (May 21, 2012), http://dealbook.nytimes.com/2012/05/21/citing-jpmorgan-loss-regulator-pushes-new-oversight/ (noting that, although J.P. Morgan had executed problematic proprietary trades from its London-based branch, the U.S. holding company was "absorbing these losses").

58. *See* CARPENTER & MURPHY, *supra* note 4.

59. *See infra* notes 128–131 and accompanying text.

60. *See, e.g.*, *In re* The Goldman Sachs Grp., Inc. S'holder Litig., No. 5215–VCG, 2011 WL 4826104, at *3 (Del. Ch. Oct. 12, 2011) ("In 1999, [Goldman's] trading and principal investment segment generated 43% of Goldman's revenue; by 2007 the segment generated over 76% of Goldman's revenue.").

61. *See Bid-Ask Spread*, INVESTINGANSWERS, http://www.investinganswers.com/financial-dictionary/stock-market/bid-ask-spread-887 (last visited Sept. 3, 2012).

Now, let us remove the client—and her peculiar preferences and risk tolerances—from the scene. An FSHC's incentives to engage in trading on its own behalf may not be that different from the incentives of a day trader or other short-term speculator. Its activities are not limited to short-term trades, however. It may buy long-term bonds, for example, including those that are not "investment-grade" and that, therefore, come with considerable risk (recall Greek sovereign debt in 2011 and 2012[62]). To the extent that these trading and investment activities already carry a risk, which they do, the firm is often able to increase that risk, perhaps many times over, by using borrowed funds to pursue the activities. A common means of obtaining this "leverage" is to engage in so-called repo transactions, whereby an FSHC sells assets to a lender on a short-term basis (usually overnight) and promises to buy back those assets later, at a slightly higher price, with the difference between the sale and purchase prices constituting de facto interest.[63] From an economic perspective, repo transactions are secured loans, but the repo structure may have certain accounting or tax advantages for the parties.[64] FSHCs are able to augment their leverage still further through other means, such as reverse repos, combined with rehypothecation.[65] In those transactions, a firm typically lends ("on margin") to its brokerage clients, such as hedge funds and other institutional investors, and those loans are secured against the assets in the clients' brokerage accounts.[66] The firm then uses that collateral to engage in additional repos to further its own lending or trading activities—it, in other words, rehypothecates (repledges) those assets.[67]

The FSHC's rationale is not difficult to discern: placing its and its clients' assets on the line brings the hope of outsized rewards, without

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62. *See* Liz Alderman & Susanne Craig, *Europe's Banks Found Safety of Bonds a Costly Illusion*, N.Y. TIMES (Nov. 10, 2011), http://www.nytimes.com/2011/11/11/business/global/sovereign-debt-turns-sour-in-euro-zone.html; Stephen J. Lubben, *Greece's Sovereign Debt Lesson*, N.Y. TIMES DEALBOOK (Mar. 22, 2012), http://dealbook.nytimes.com/2012/03/22/greeces-sovereign-debt-lesson/.

63. Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 546 (2011).

64. *See Repurchase Agreement*, RISKGLOSSARY.COM, http://www.riskglossary.com/link/repo.htm (last visited Sept. 2, 2012).

65. For an explanatory discussion of rehypothecation, see Kenneth C. Kettering, *Repledge Deconstructed*, 61 U. PITT. L. REV. 45 (1999).

66. *See id.* at 50–51.

67. *See id.*; Manmohan Singh & James Aitken, *The (Sizeable) Role of Rehypothecation in the Shadow Banking System* 3 (Int'l Monetary Fund, Working Paper No. 10/172, 2010), *available at* http://www.imf.org/external/pubs/ft/wp/2010/wp10172.pdf ("Rehypothecation occurs when the collateral posted by a prime brokerage client (e.g., hedge fund) to its prime broker is used as collateral also by the prime broker for its own purposes.").

the firm's having to concern itself with whether the risk is too great for any particular client. After all, it is the firm's own money (or money that it has borrowed), and if the firm is comfortable with substantial risk, then that is all that matters. Why would the firm be comfortable? One response, coming from the field of behavioral psychology, says that the FSHC is willing to assume substantial risk for the same reasons that most of us, at one point or another, assume more risk than, logically—and, often, in retrospect—we otherwise would.[68] We are more inclined than not to believe the odds are in our favor.[69] That explanation is buttressed by another: the FSHC, at the end of the day, is not really using its own money, at least not if "ownership" is viewed as beneficial ownership. If ownership is so viewed, then the firm is, ultimately, using the shareholders' money.[70] In any event—and, arguably, more importantly—those who make the trades undeniably are not placing their own resources at risk.[71] That is not to say that the FSHC and its personnel lack ample reason to be cautious. In the event that a proprietary trading strategy has bad results, jobs may be on the line, and the prospect of one's losing one's employment certainly may have a disciplining effect on one's actions with regard to facilitating risky trades. The point remains, however, that the firm's incentives cannot be said to be what they would be if its personnel's own assets were at risk.

As Part IV discusses further, we need to look behind the FSHC's actions to consider the motivations of its employees (its traders, that is). As the aftermath of the financial crisis revealed, employees, in their pursuit of proprietary trading profits for the firm, did not necessarily set their sights on whether their trades or investments ultimately would be good, bad, or somewhere in between. Rather, their eyes were more plausibly trained on the next bonus season and the prospect of being rewarded based on the value of the trades and investments for which they were responsible, even those that were still open at the time of the bonus determination. Because of the use of "mark-to-market" valuations[72] in de-

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68. *See* Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1457–60 (2002).

69. *See id.* ("Studies indicate that the over-optimism bias affects humans in the sphere of investments . . . .").

70. *In re* The Goldman Sachs Grp., Inc. S'holder Litig., No. 5215–VCG, 2011 WL 4826104, at *4 (Del. Ch. Oct. 12, 2011) (reciting the plaintiff shareholders' argument regarding Goldman's proprietary trades and investments that "if the investment went south, it was the stockholders' equity at risk, not that of the traders").

71. *See id.*

72. *See Mark to Market (MTM)*, INVESTOPEDIA, http://www.investopedia.com/terms/m/marktomarket.asp#axzz26z29NhEx (last visited Sept. 2, 2012); *Valuation*, RISKGLOSSARY.COM, http://www.riskglossary.com/link/valuation.htm (last visited Sept. 2, 2012).

termining asset managers' compensation, whether in the FSHC context or otherwise, the value of an investment position is typically based on a hypothetical: if the firm were to close out the trade today, what amount would it fetch for the firm?[73] Never mind that if the bubble on which its value is based bursts before the trade is actually closed, it may become worthless to the firm.

The method of accounting, however, ultimately has not been the problem. The problem has been the short-term compensation structure that encourages traders to look no further than the end of the year, after which they may or may not remain with the firm.[74] In other words, that compensation structure does not force risk-takers to reap what they sow. Presumably—although there are occasional indications to the contrary—FSHCs' proprietary trading activities have slowed somewhat since the financial crisis. For example, to the extent that firms' institutional clients are limiting the firms' ability to rehypothecate, or repo "lenders" are becoming more circumspect about the creditworthiness of their counterparties, that trend seems reasonable and appropriate. Accordingly, proprietary trading may not be quite the heady and all-consuming pastime that it once was. However, as J.P. Morgan's revelation in May 2012 of its multibillion-dollar trading loss at the hands of the "London Whale" demonstrates,[75] proprietary trading remains a driving force of profits—and, importantly, of compensation—at FSHCs. From a corporate governance perspective, therefore, it remains a force to be reckoned with.

To be sure, the Dodd-Frank Act[76] and the rules to be formulated and adopted under that statute are to put a stop to, or at least limit, certain types of proprietary trading activities in the name of mitigating systemic risk. However, the rulemaking process is, as one might expect, laden with political maneuvering that may ultimately turn what could have been blanket rules into rules that provide for exceptions and admit of

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73. *See* Liz Rappaport, *Bank Quandary: Valuing the Assets*, WALL ST. J. (Nov. 10, 2011), http://online.wsj.com/article/SB10001424052970203537304577028422145660162.html (observing that, with mark-to-market accounting, "companies immediately take profits or losses as asset values fluctuate").

74. *See* Jake Zamansky, *Wall Street Compensation and J.P. Morgan: It's Déjà Vu All over Again*, FORBES (June 1, 2012), http://www.forbes.com/sites/jakezamansky/2012/06/01/wall-street-compensation-and-jp-morgan-its-deja-vu-all-over-again/ ("Wall Street traders who take huge bets with company money (and eventually taxpayer money) will keep doing it over and over again because the compensation system encourages them to do so.").

75. *See, e.g.*, Dan Fitzpatrick et al., *Bank Order Led to Losing Trades*, WALL ST. J. (May 13, 2012), http://online.wsj.com/article/SB10001424052702304070304577398490966089810.html (describing how Bruno Iksil, a J.P. Morgan trader, caused the bank to assume substantial "long" positions in credit default swaps (tied to a corporate bond index), which resulted in "losses of as much as $200 million a day in late April and early May").

76. *See* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

creative interpretations. In some respects, that result may not be troublesome. The zeal behind the Volcker Rule arguably was based as much on popular anger and frustration as on an understanding of what sorts of activities may actually have adverse systemic implications.[77] Still, by now the contours of the rule are coming into view, and, consistent with the Dodd-Frank Act's rulemaking mandate,[78] they still permit a fairly broad swath of proprietary trading activity. For example, although firms will be prohibited from myriad short-term trading activities, it appears that they will still be permitted to engage in longer term investment and trading activities.[79]

Moreover, and importantly, the Volcker Rule will not touch upon many firms that engage in substantial proprietary trading activities. Among other things, the rule will not address firms that are not "systemically important" (too big to fail), firms whose client and customer assets are not guaranteed by the federal government, and firms, such as futures commission merchants, whose businesses revolve around financial instruments other than securities.[80] Indeed, these categories of firms have received nary a mention, whether in the immediate aftermath of the financial crisis or during the fretting among lawmakers and commentators after J.P. Morgan's disclosure of its massive trading losses.[81] Put another

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77. *See* Peter J. Wallison, *Dodd-Frank and the Myth of "Interconnectedness*,*"* WALL ST. J., (Feb. 9, 2012), http://online.wsj.com/article/SB10001424052970204468004577164871060718662.html.

78. *See* Dodd-Frank Act § 619(b)(2)(A).

79. *See* JAMES DOTY ET AL., SECURITIES AND DERIVATIVES REFORM IN 2010: A GUIDE TO THE LEGISLATION 169–75 (2010).

80. Thanks to lawmakers' continuing demarcation between securities regulation and futures regulation, the Dodd-Frank Act does little to address any regulatory or systemic problems in the futures markets. Although Congress could have eliminated the division between the two realms, ultimately it did not do so. From one perspective, that is understandable: the activities that gave rise to the financial crisis, by all accounts, were not being conducted by firms focusing on futures. In our post-crisis world, however, the risks posed by proprietary trading by futures firms have become evident. One example was the calamitous bankruptcy of MF Global Holdings Ltd. and its brokerage subsidiaries in 2011. To be sure, the publicity it attracted was not because of the bankruptcy itself but because funds held in futures customers' cash accounts—for the customers' own use and no one else's—were taken by the firm to pay its obligations in the days just prior to the bankruptcy. *See* Report of the Trustee's Investigation & Recommendations, *In re* MF Global Inc., No. 11-2790 (MG) SIPA (Bankr. S.D.N.Y. June 4, 2012), *available at* http://dm.epiq11.com/MFG/Project (follow "Trustee's Investigation Report" hyperlink under "Latest Information and Court Filings"). Nonetheless, the firm's insolvency resulted from the firm's massive (40x leveraged) bet on European sovereign debt. *See id.* In other words, the firm's demise was due to nothing other than excessive risk pursued, using the firm's proprietary assets, in the name of potentially achieving outsized reward. Had MF Global survived, it would not have become subject to the Volcker Rule's strictures.

81. *See* Jessica Silver-Greenberg, *New Fraud Inquiry as JPMorgan's Loss Mounts*, N.Y. TIMES DEALBOOK (July 13, 2012), http://dealbook.nytimes.com/2012/07/13/jpmorgan-says-traders-obscured-losses-in-first-quarter/.

way, proprietary trading became a regulatory worry only because of its possible effects on the federal treasury and the broader U.S. and global economies and not because of its role in exacerbating the already tenuous relationship of shareholders to the property on which the value of their share holdings is based. Accordingly, if proprietary trading raises special concerns for the modern corporation, which it does, then, as this Article describes below, recent regulatory developments have not adequately addressed them.

IV. *THE MODERN CORPORATION*, MAGNIFIED

FSHCs are special in a number of ways that Berle and Means did not obviously consider.[82] As suggested in Part III, what is perhaps their primary business activity—proprietary trading—further attenuates the relationship between ownership and control within the corporation, and further alienates shareholders from the property that drives economic production. There are a number of factors contributing to that attenuation and alienation. This Part discusses four of them, recognizing that the factors overlap, whether in a temporal or causal sense or both. Specifically, it describes the shareholder-adverse distortions of managerial incentives that occur once proprietary trading becomes the firm's most important business activity; how those incentives come into play in connection with FSHCs' regulatory compliance and involvement with policymaking and rulemaking; how the provisions of the Bankruptcy Code that apply when an FSHC becomes insolvent worsen shareholders' plight; and the ways in which the multi-entity structures of FSHCs create risks and liabilities that are different from those present in other multi-entity structures and that likely are not evident to shareholders.

A. Incentives

In the corporation of the late 1920s and early 1930s, as Berle and Means observed, shareholders faced risk as a result of their inability to direct the property of the enterprise toward its most productive uses.[83] Moreover, those who did have that control, the corporation's directors and officers, generally did not have proper incentives to deploy property toward its highest and best use for the corporation, to distribute as much profit as possible to shareholders, or to maintain investor-favorable market conditions.[84] That was because, unless the managers were themselves

82. That should not be too surprising, particularly given that the U.S. financial services industry was in its infancy at the time they wrote.

83. *See supra* notes 11–23 and accompanying text.

84. *See* BERLE & MEANS, *supra* note 6, at 121–22.

significant shareholders, they would not have received the rewards of doing so.[85] Hence arose the authors' concerns over the conflicts of interests confronting managers and, specifically, managers' likely incentives to control property in a manner furthering interests other than those of the shareholders.[86]

To be fair, the authors were open-minded on this point. It was not necessarily the case that management's motivating force would always be the prospect of achieving profits for themselves.[87] There were other possibilities. Management might seek power, status, or professional achievement. Or, more beneficently, management might be incented to use its authority to further the interests of other groups—for example, it might serve employees' interests by improving labor conditions—to a degree beyond what would optimize shareholder returns. The most one could say with relative certainty was that control's interests were not aligned with shareholders' interests, a point that Berle and Means deftly made with their suggestion that we might learn more about the motives of control "by studying the motives of an Alexander the Great, seeking new worlds to conquer, than by considering the motives of a petty tradesman of the days of Adam Smith."[88] Of course, *The Modern Corporation* fully acknowledged that, if one were to specify the primary motivation behind control's efforts, realizing personal profit was the most intuitively plausible candidate.[89]

In the context of FSHCs, there is no longer any room for speculation or doubt. What is the lure of proprietary trading, after all, for those who research, select, and effect the proprietary trades? As one might expect, it is not simply that the trades will generate some profit, incrementally adding to the firm's revenues for the year. It is that the trades will generate considerable profits, adding significantly to the firm's revenues. The incentive is such because, at least historically, the employees' compensation has been designed to ensure that it is such. From the firm's perspective, if it is possible to trade and invest the firm's own capital and, as a result, realize gains of perhaps multiples of what was placed at risk, then that is the type of activity that is to be encouraged. The firm provides that encouragement through the means used by many nonfinancial firms seeking to shape employees' incentives beyond what is possible with only salary-based compensation. It gives them a "piece of the

85. *See supra* notes 41–47 and accompanying text.
86. *See id.*
87. *See* BERLE & MEANS, *supra* note 6, at 122.
88. *Id.* at 350.
89. *See id.* at 122–23.

action," in the form of annual bonuses tied to the profits generated by the employees or their division over the course of the year.[90]

The incentive provided by the possibility of receiving compensation based on any profit that can be achieved is not just different in degree from the incentives animating control in *The Modern Corporation*'s corporation. It is different in kind—a product of the fact that control's divergent interests, so the argument goes, are no longer something to be monitored, controlled, and reined in for the sake of shareholders. That is, it is no longer the case that shareholders automatically lose when traders further their own interests. Now those divergent interests are something to be encouraged and celebrated because, when someone's trades on behalf of the firm do well, everybody wins. We might think the concept is similar to a firm's granting stock options to its executives to encourage optimal management. There are critical differences, however.

The problem with proprietary trading lies in the unique risks associated with it. Making bets with the prospect of huge reward inevitably is the same as making bets with the prospect of huge loss. The trader need not recognize or internalize this risk, however. If things get bad enough, if the trades are losers and cost the firm dearly, the trader simply gathers her belongings and moves on to the next firm and the next opportunity.[91] This outcome differentiates incentive-based compensation associated with proprietary trading from stock options because an officer who has been granted (out-of-the-money) stock options wins only when the shareholders win. There is no situation in which officers benefit but shareholders lose, at least to the extent that the "currency" used to pay both is one and the same: the value of the firm's stock.

B. Regulation

The divergence of shareholders' interests from the interests of those in control, and the corresponding adverse incentives of the latter group, are apparent in the application of regulatory infrastructure to FSHCs' and their subsidiaries' activities, an arena that presents another challenge for FSHC governance. This challenge is more political than structural, but there are scant indications that it will be overcome anytime soon. In par-

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90. *See* Zamansky, *supra* note 74; *In re* The Goldman Sachs Grp., Inc. S'holder Litig., No. 5215–VCG, 2011 WL 4826104, at *3 (Del. Ch. Oct. 12, 2011) ("The Plaintiffs contend that this compensation structure [based on a "relatively constant percentage of total revenue"] led management to pursue a highly risky business strategy that emphasized short term profits in order to increase their yearly bonuses.").

91. *See In re The Goldman Sachs Grp.*, 2011 WL 4826104, at *1 ("If these ['highly risky' trading] practices turned a profit, Goldman's employees would receive a windfall; however, losses would fall on the stockholders.").

ticular, as noted above, FSHCs' subsidiaries are often heavily regulated, whether as brokers, advisers, or banks. Moreover, if a subsidiary is a bank, the FSHC will be regulated by the Federal Reserve as a bank holding company.[92] That regulation, one might suppose, is intended to accomplish a number of goals, all falling under the general rubrics of correcting one or more perceived market failures or promoting efficiency.[93] That is, regulation is predicated on the notion that, given power and information imbalances among participants in market transactions, investors would otherwise be systematically disadvantaged.

When articulated more granularly, the goals of regulation are generally considered to be maintaining market integrity, protecting investors, and promoting systemic stability.[94] These goals should strike a familiar chord in anyone who has been a customer or a client of a financial firm. Yet applicable regulation has not been working terribly well in recent years, assuming that it ever has. The financial crisis alone should demonstrate that point, but neither the devastation that the crisis caused nor the policymaking and analysis that occurred afterward appear to have done much to correct the problems. One might discern, and evaluate, regulatory deficiencies from at least a couple of perspectives.

First, difficulties with FSHC regulation arise, in part, from the ever-controversial relationship between the regulated and the regulators. The relationship arises, and gains reinforcement, both from the "revolving door" between government and regulated industries and from regulated industries' lobbying efforts. For example, as others have documented, it is not uncommon for SEC staff to secure employment in the private sector, either within firms that may previously have been subject to those staff members' or their departments' oversight or within law or accounting firms that represent such firms.[95] In this regard, the R. Allen Stanford fraud, involving an SEC lawyer who had allegedly quashed investiga-

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92. *See* PAULINE SMALE, CONG. RESEARCH SERV., RS 20826, STRUCTURE AND FUNCTIONS OF THE FEDERAL RESERVE SYSTEM 3 (2010), *available at* http://www.fas.org/sgp/crs/misc/RS20826.pdf.

93. *See* Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1790–91 (1997).

94. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-216, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 4 (2009), *available at* http://www.gao.gov/assets/290/284691.pdf.

95. *See, e.g.*, David S. Hilzenrath, *SEC's 'Revolving Door' Prompts Concerns About Agency's Independence*, WASH. POST (May 13, 2011), http://articles.washingtonpost.com/2011-05-13/business/35232119_1_sec-employees-sec-inspector-sec-enforcement-actions (noting that, according to a study by the Project on Government Oversight, "[o]ver the past five years, 219 former SEC employees filed disclosures with the SEC saying that they planned to represent clients or employers in dealings with the agency").

tions of Mr. Stanford and then obtained employment with Mr. Stanford's firm, comes to mind.[96] In addition—and, again, well-documented if not otherwise obvious—regulated industries expend substantial resources ensuring that their views, favoring fewer or less burdensome regulation (as one might suppose), are well represented in policymaking discussions.

Those expenditures are not without effect, in that there have been numerous instances in which financial firms have helped shape regulation. As an earlier (pre-financial crisis) example, the Commodity Futures Modernization Act of 1999 eschewed regulation of over-the-counter derivative instruments (credit default swaps, for example), in part at the behest of industry.[97] More recently, the mortgage industry was alleged to have influenced the Federal Reserve in connection with the latter's reliance, in relaxing credit standards, on a disputed study on racial discrimination.[98] Another example involves Countrywide, the mortgage company, which allegedly made "sweetheart" loans to policymakers who, in turn, acted favorably toward Fannie Mae, which packaged, for securitization purposes, mortgages that Countrywide had originated.[99] If we are seeking to discern some of the causes of the financial crisis, then, as one observer has noted, "it is very hard to imagine that heavily regulated banks could have engaged in such extreme risk-taking without the support of regulators."[100] Accordingly, regulation of FSHCs and their subsidiaries arguably is not as robust as it might otherwise be absent the effective participation of those firms in determining the scope of regulation and how it will be enforced.

Second, and apart from the presumed close ties between financial institutions and their regulators, where financial firms violate their obligations under applicable regulations, regulators arguably are not adequately holding the firms accountable. Recent examples of this phenomenon are settlements between the SEC and financial institutions of en-

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96. *See* Andrew Harris, *Ex-SEC Enforcer Settles Stanford Ethics Dispute with U.S.*, BLOOMBERG NEWS (Jan. 13, 2012), http://www.bloomberg.com/news/2012-01-13/former-sec-lawyer-barasch-settles-allen-stanford-ethics-dispute-with-u-s-.html.

97. *See* Lynn A. Stout, *Uncertainty, Dangerous Optimism, and Speculation: An Inquiry into Some Limits of Democratic Governance*, 97 CORNELL L. REV. 1177, 1207–08 (2012).

98. *See* John B. Taylor, *Cozy Connections that Led to a Crisis*, WASH. POST, May 9, 2011, at B1, http://media.hoover.org/sites/default/files/documents/MR-Review-WaPo-Outlook-p-B1-5-29-11.pdf (reviewing GRETCHEN MORGENSON & JOSHUA ROSNER, RECKLESS ENDANGERMENT: HOW OUTSIZED AMBITION, GREED, AND CORRUPTION LED TO ECONOMIC ARMAGEDDON (2011)).

99. *See id.* at B5.

100. *Id.*

forcement actions claiming fraudulent practices.[101] In these settlements, the firm typically "neither admits nor denies" the relevant charge and simply agrees to pay a fine. [102] When evaluating a proposed settlement, some judges[103]—including, most vocally, Judge Rakoff of the Southern District of New York—have challenged the SEC's settlement practices on the basis that they constitute no real sanction of the firms, either in a monetary or a reputational sense.[104] For these courts, therefore, the settlement practices are adverse to the public interest and, beyond that, the objectives that justify financial-services regulation in the first place. Having paid the applicable fine, firms are free to continue to engage in the fraudulent or otherwise illegal practices, viewing the sporadic enforcement actions and associated fines as simply the cost of doing business.[105] Regulators' contention that their resources are far too insufficient to pursue enforcement actions through to a trial and possibly guilty verdict, though perhaps a legitimate concern, does not undermine the broader point that regulation of financial firms simply is not what it should be to further its professed goals.

Of course, if we view settlements from the perspective of FSHC shareholders, it might seem that a monetary penalty of any amount is problematic, as any amount levied will be paid by the firm and, therefore, will ultimately be borne by shareholders. Because of that, perhaps alternative sanctions would be more desirable from a corporate governance perspective. Regardless of the form of sanction, however, if that sanction fails to fulfill punishment and deterrence roles, it renders regulation ineffective, which, in turn, feeds a bubble not unlike the practice of giving away mortgages. Put another way, when regulation is either insufficient or inadequately enforced, it implicitly encourages excessively risky behavior that should be, and otherwise would be, precluded.

Under the circumstances described above, one of two things may eventually happen, both of which were evident in the financial crisis and its aftermath. First, firms' behavior may not adequately account for the

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101. *See* Edward Wyatt, *Settlements Without Admissions Get Scrutiny*, N.Y. TIMES (Feb. 24, 2012), http://www.nytimes.com/2012/02/25/business/neither-admit-nor-deny-settlements-draw-judges-scrutiny.html.

102. *See id.*

103. *See id.* (noting that at least two federal courts have questioned the SEC's "entrenched practice of allowing companies and individuals to settle federal regulatory charges without admitting that they actually did anything wrong").

104. Edward Wyatt, *Judge Blocks Citigroup Settlement with S.E.C.*, N.Y. TIMES (Nov. 28, 2011), http://www.nytimes.com/2011/11/29/business/judge-rejects-sec-accord-with-citi.html (reporting that, according to Judge Rakoff, even seemingly large settlements are "often viewed by Wall Street firms 'as a cost of doing business'").

105. *See id.*

externalities that are created—diminished investor confidence, for example. Over time, the effects of the behavior on investor confidence may reach a tipping point, causing exactly the market crisis that the regulation exists to prevent. Second, should persistent excessive behavior finally become the subject of regulatory focus, which is particularly likely after an egregious instance of regulatory failure but not necessarily only then, regulation may increase suddenly and dramatically—and in a manner that precludes the firm's continuing its past practices, whether in part or altogether. In either case, the game will ultimately end, with shareholders (among others) losing substantially, regardless of the firm's too-big-to-fail status or the applicability of government guarantees.

C. Bankruptcy

By now, it is beyond dispute that FSHCs' proprietary trading and investment activities sometimes do not work out particularly well. In the worst of circumstances, both for an FSHC and its shareholders, the firm's trading activities, based on leverage as they are, lead to the firm's insolvency. Both Bear Stearns and AIG were on the brink of bankruptcy before being saved by the U.S. government.[106] Lehman Brothers and MF Global were less fortunate, ultimately declaring bankruptcy and undergoing reorganization or liquidation processes that, for both firms, have been fraught with competing claims and controversy.[107] If bankruptcy were not bad enough for shareholders, the bankruptcy rules that apply as to firms engaged in proprietary trading activities that involve derivative instruments or that are funded through repos may further disadvantage FSHC shareholders, at least in comparison to shareholders of the sorts of firms on which Berle and Means focused.

The Bankruptcy Code is structured such that, in the event of a firm's bankruptcy under Chapter 11 of the Code, repo and derivative counterparties are prioritized. [108] As Mark Roe details, "[t]he Bankruptcy Code allows derivatives and repo creditors, but not most others, to immediately seize and sell off their collateral and to demand and keep eve-

106. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, at xxi (2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

107. *See* Nick Brown & Katya Wachtel, *Battle Lines Forming Between MF Global Customers and Hedge Funds*, REUTERS (Feb. 27, 2012), http://www.reuters.com/article/2012/02/27/uk-mfglobal-legal-idUSLNE81Q02520120227; Maureen Farrell, *Lehman Bankruptcy Bill: $1.6 Billion*, CNNMONEY (Mar. 6, 2012), http://money.cnn.com/2012/03/06/markets/lehman_fees/index.htm.

108. Roe, *supra* note 63, *passim.*

of-bankruptcy collateral."[109] In practice, according to Roe, the rules create lender incentives along the following lines: when a repo or derivative counterparty (creditor) believes that an FSHC is in financial trouble, it might stop lending to that firm on the basis that it lacks sufficient information about the risks the firm poses.[110] (That the counterparty lacks that information should not be surprising: why should it investigate the FSHC's creditworthiness when the bankruptcy rules provide de facto superpriority protection in the event of insolvency?[111]) Alternatively, the counterparty may demand additional collateral from the FSHC—collateral that will not be subject to avoidance actions (clawback) in the event of bankruptcy, even if acquired during the ninety days immediately prior to bankruptcy.[112] If the counterparty ultimately declares the FSHC to be in default and liquidates the collateral, then, when the collateral loses value as a result, other counterparties are similarly induced to declare the FSHC in default and to seize and liquidate collateral.[113]

These bankruptcy rules were designed to maintain financial stability by ensuring liquidity at moments when the credit markets might otherwise seize up.[114] That is, Congress sought to address the prospect that one firm's insolvency could cause the insolvencies of its lenders (repo and derivatives counterparties), triggering a chain reaction of insolvencies.[115] Presumably, then, the rules targeted counterparties' incentives. If counterparties are assured that they will be paid what is due to them in the event of a firm's insolvency, then they will be inclined to keep lending—thereby promoting market liquidity—in the face of possible mar-

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109. *Id.* at 546; *see* 11 U.S.C. §§ 362(b)(17), 362(b)(27), 560, 561; Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 67 (2009) (observing that, in a bankruptcy, "termination of derivative contracts is expressly exempt from latter [sic] attack as either a constructive fraudulent transfer or preference . . . ; collateral provided as part of a derivative transaction may be foreclosed upon without concern that doing so violates the Bankruptcy Code;" and the Code "specifically preserves [for the solvent counterparty] the contractual right to terminate, liquidate, accelerate or offset under a 'master netting agreement' and across a broad range of derivatives contracts").

110. *See* Roe, *supra* note 63, at 545–46.

111. *See id.*

112. *See* 11 U.S.C. § 546(e). At least one court has determined, however, that this anti-avoidance "safe harbor" does not forestall alternative challenges to a transfer of collateral before bankruptcy, such as those based on unjust enrichment. *See* Lehman Bros. Holdings v. JPMorgan Chase Bank, N.A. (*In re* Lehman Bros. Holdings), 469 B.R. 415 (Bankr. S.D.N.Y. Apr. 19, 2012).

113. *See* Roe, *supra* note 63, at 545–46.

114. *See id.* at 547–48 (noting that regulators and market participants argued for the favorable treatment of derivative and repo counterparties in light of "the potential for one failure of a major derivatives dealer to cascade through the financial system"); *id.* at 566 n.65 (citing legislative history).

115. *See* Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 97 (2005).

ket-wide financial instability.[116] As various observers point out, however, by effectively providing a "bankruptcy subsidy" to firms that provide financing to FSHCs, the bankruptcy rules, in many respects, redound to the detriment of financial stability.[117] The incentive for lenders to stop lending because they are uncertain about the stability of their counterparties, or to declare default and liquidate collateral belonging to those counterparties, actually enhances the possibility of the proverbial run on the bank.[118] In other words, lenders are motivated to take rather extreme measures at the first sign of difficulties, including selling assets, which only spreads concerns and causes others to take similar defensive measures.[119]

To be sure, those consequences, given their systemic implications, are problematic, particularly with the financial crisis so fresh in our minds. There is more to the story, however, relating to the effects of these bankruptcy rules on other creditors. In a sense, this is simple. Prioritizing one type of creditor in an FSHC bankruptcy disadvantages other creditors. When a firm becomes insolvent, it has only so many resources with which to pay creditors' claims. If some creditors, such as repo lenders, will be fully paid (or close to it) because, for example, last-minute transfers to those creditors will not be subject to avoidance actions, then other creditors, such as vendors and tort claimants and landlords, will receive less than they otherwise would have.[120] That may not be much of a concern if those other types of creditors were incentivized to be more diligent and skeptical in their own involvement with FSHCs. If other creditors know that a bankruptcy proceeding will leave them with the short end of the stick, then, ideally, they will negotiate for control, monitoring rights, an easy out of the relationship, and other assurances.[121] If those other creditors "react well" to the rules, in other words, there might

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116. *See* Roe, *supra* note 63, at 547–48; *see also* Edwards & Morrison, *supra* note 115, at 99–107.

117. *See, e.g.*, Roe, *supra* note 63, at 546, 564 ("The Code's superpriorities made the financial system less stable by subsidizing riskier borrower and lender behavior.").

118. *See* Edwards & Morrison, *supra* note 115, at 105–06 ("[T]he most important risk to financial stability may come from the possibility that derivatives counterparties, exempt from the automatic stay provisions of the Bankruptcy Code, may 'run' on a financially distressed firm (or firms), causing a liquidity shortage that has the potential to spill over to other firms and markets and cause widespread instability in financial markets.").

119. *See* Roe, *supra* note 63, at 564–69.

120. *See* Edwards & Morrison, *supra* note 115, at 106 (observing that "a firm in distress is analogous to a scarce resource . . . to which users have unlimited, non-exclusive rights of access," and that "[t]he first user to exploit the resource will be satisfied, the last will not," leading all users to "rush[] to consume the resource first").

121. *See* Roe, *supra* note 63, at 546, 570.

be minimal social costs to the preferences granted to repo and derivative counterparties.[122]

Apart from the issue of how well other creditors react to the prioritizing rules,[123] however, is the fact that reacting—whether well, poorly, or otherwise—is simply not a possibility for shareholders. That circumstance further accentuates Berle and Means's concerns about the modern corporation. Although shareholders, as an FSHC's equity owners, are not creditors in the sense that they do not fit into the cascade of priority that has to be determined in any bankruptcy (other than that they "fit" into the back of the line),[124] they nonetheless have a claim on the too small pie that remains after a firm has declared bankruptcy. The greater a bankrupt FSHC's reliance on repo and derivative financing, the smaller becomes the pie to be divvied up by everyone else, which of course includes the shareholders. This problematic result, again, is not one with which shareholders of non-FSHCs must generally contend, at least not to the same extent. The bankruptcy rules become still more problematic for shareholders to the extent that other claimants to "superpriority" treatment exist at the time of the bankruptcy, such as the clients or customers of the subsidiaries' financial-services operations.

D. Subsidiaries

Another source of risk for FSHC shareholders derives from the fact that the holding company is just that: a parent company with a number of subsidiaries. Therefore, although we might be prone to think of Morgan Stanley, for example, as a single enterprise, it is most definitely not a single entity. Rather, the enterprise that is Morgan Stanley comprises the parent company and subsidiaries housing the firm's various operating units. Generally, each operating unit is defined by its particular function—whether the unit acts as a broker–dealer or as an investment adviser, for example—and possibly also (or instead) by the country in which the unit is based. So, for example, there is Morgan Stanley & Co., LLC, Morgan Stanley Capital Partners III, Inc., Morgan Stanley Distribution, Inc., Morgan Stanley Investment Management (Japan) Co., Ltd., Morgan Stanley Global Emerging Markets, Inc., Morgan Stanley Investment

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122. *Id.*

123. An unsurprising difficulty with this zero-sum-game analysis is that many other creditor types simply are too uninformed—or, if they are the U.S. government, too uninvolved and distant—to respond appropriately. *See id.*

124. *See, e.g.*, A. Mechele Dickerson, *Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 16 n.50 (2003) ("Directors of insolvent firms are deemed to have fiduciary duties to creditors because shareholders' residual interests in an insolvent firm are worthless and cannot be paid until creditors' claims are paid in full.").

Management, Inc., and Morgan Stanley Infrastructure, Inc., just to name a small portion of the entities in the Morgan Stanley "family" of companies.

The rationale for the parent–subsidiary structure is evident. As noted in Part III, apart from the circumstance that entity separation allows separate regulation and ostensibly helps diminish potential conflicts of interest, separation serves the obvious objective of liability protection. As any shareholder should know, the corporate form is desirable because it shields shareholders from liability beyond the amount that they paid for their shares. That important aspect of the corporate form can be deployed within an enterprise, in the ubiquitous parent–subsidiary relationship, to offset liabilities against a circumscribed bundle of assets. To be sure, the parent–subsidiary structure is effective in cabining liabilities only if other conditions hold. In particular, the parent company, as the subsidiary's sole shareholder, must respect the subsidiary's "corporate formalities," ensure that the subsidiary is adequately capitalized, and otherwise respect the subsidiary as a separate entity unto itself.[125] If the parent company does so, then, when a subsidiary creditor attempts to "pierce" the subsidiary's "corporate veil" by asserting that, in fact, the parent company should be obligated on the subsidiary's liabilities, courts should respect the planning purposes behind the subsidiary's existence.[126]

Although there may be many legitimate reasons for financial firms to use the parent–subsidiary structure, that structure may further militate against the interests of parent-company shareholders. The subsidiaries, again, are typically the entities actually providing securities-related and other financial services to others, whether those "others" be labeled clients, customers, or investors. The subsidiaries are, in other words, the locus of the creation of value in the Berle-and-Means sense—that is, operations-based value, as opposed to investment and trading-based value. Yet, in light of the enterprise's structure, the subsidiaries have the status of discrete assets that are owned and controlled by the parent company. The result of that circumstance is the further attenuation of managerial accountability to shareholders. After all, although a subsidiary's management must be accountable to that entity's shareholders, those shareholders generally consist only of the parent company and perhaps a few other affiliated entities. Of course, the parent company's management, in

125. *See* Douglas G. Smith, *Piercing the Corporate Veil in Regulated Industries*, 2008 BYU L. REV. 1165, 1169–82 (2008) (outlining standards that courts apply in corporate veil-piercing analysis).

126. *See id.*

its dealings with the subsidiary, must be accountable to its own (public) shareholders. However, where the parent company itself has no meaningful operations and, instead, pursues trading and investment for its own account, as is often the case with FSHCs, there may be few competing needs or countervailing forces to constrain management's pursuit of trading profits at the expense of operational value. Indeed, anecdotal evidence suggests that the parent company's management may be inclined to ignore most aspects of its subsidiaries' business operations.[127]

Furthermore, this dual separation of operations and corporate governance obligations in the parent–subsidiary structure raises the prospect of unrestrained conflicts between the parent company's (and its management's) interests, on one hand, and the subsidiaries' interests, on the other. In fact, as became evident during the financial crisis, FSHCs commonly rely on subsidiaries' operations to support their proprietary trading activities.[128] Specifically, with the blessing of applicable laws and regulations, financial firms may borrow funds that subsidiary clients and customers have deposited with the firm. The parent company of a futures commission merchant might, for example, engage in so-called "internal repo" transactions with a subsidiary, whereby the parent company sells assets to client or customer accounts in exchange for cash or other assets in those accounts, with the promise that the FSHC will buy the assets back from the accounts the next day.[129] Or the parent company of a broker–dealer might use assets that customers previously pledged to the broker (in exchange for "margin" loans) to engage in repos with third parties, as described in Part III.[130] Although the subsidiaries are legally separate from the parent company, there remains substantial latitude in the parent company's ability to use assets that neither it nor its subsidiaries own for the purposes of its own trading—and, to the extent there has

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127. *See* Scott Patterson & Aaron Lucchetti, *Corzine Defends Tenure, Puzzles over Missing Funds*, WALL ST. J. (Dec. 9, 2011), http://professional.wsj.com/article/SB10001424052970203413304577085953794621344.html; Scott Patterson & Aaron Lucchetti, *Other MF Officers Mystified by Missing Funds*, WALL ST. J. (Dec. 13, 2011), http://online.wsj.com/article/SB10001424052970203518404577094463791304578.html; Walter Pavlo, *Jon Corzine's "Nein, Nein, Nein" Strategy*, FORBES (Dec. 15, 2011), http://www.forbes.com/sites/walterpavlo/2011/12/15/jon-corzines-nien-nien-nien-strategy/; Ben Protess & Azam Ahmed, *Silence, Then Frustration at MF Global Hearing*, N.Y. TIMES DEALBOOK (Mar. 28, 2012), http://dealbook.nytimes.com/2012/03/28/silence-then-frustration-at-mf-global-hearing/.

128. *See* Singh & Aitken, *supra* note 67, at 4 (describing how, in both the United States and the United Kingdom, financial firms are permitted to use customer assets to fund their proprietary trading activities).

129. *See id.*

130. *See id.* at 7–9 (observing that "the pledged collateral is not owned by these [financial] firms, but due to rehypothecation rights, these firms are legally allowed to use the collateral in their own name").

been little risk of shareholder sanction, firms have likely done so routinely.[131]

At first blush, these lending activities may not seem too worrisome from the perspective of FSHC shareholders, in that the activities may not seem likely to adversely affect the firm. As suggested above, however, if the firm becomes insolvent, these arrangements may have a detrimental effect on the firm's limited remaining value. In particular, as a broad generalization, subsidiaries' activities have not been of the sort that might lead to the downfall of the enterprise. A subsidiary's bankruptcy, for example, is not likely to bankrupt the entire enterprise. More importantly, given what the subsidiaries typically do—perform brokerage, lending, market-making, or advisory services and hedge any risk arising from those activities—those entities arguably are not any more likely to face bankruptcy than are other types of companies. Rather, bankruptcy risk within the enterprise arguably emanates from the parent company, which, again, focuses its profit-earning efforts on its own trading strategies.[132] Think Bear Stearns. Think Lehman Brothers. Think MF Global. As to each of those firms, it was the firm's unhedged bets on certain asset classes or credits that caused a crisis of confidence among lenders and clients, which, in turn, led to a "run on the bank" and, ultimately, either government rescue or bankruptcy.[133]

Of course, the parent company's bankruptcy, on its own, is a devastating event for shareholders, who stand in line behind creditors and preferred shareholders for whatever might be left of the estate.[134] Based on recent examples, the prospect that there will be anything left—which, in many bankruptcy contexts, is at least a reasonable one—may be less like-

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131. *See id*. at 5, 10–11 (observing that, as of the end of 2007, the financial statements of "the ten large global banks" reflected receipt "(via securities lending, repo and prime brokerage)" of "total pledgeable collateral of $10 trillion").

132. Again, these trading strategies may be, and often are, conducted through or otherwise involve the firm's subsidiaries, including (perhaps especially) subsidiaries that conduct the firm's business operations—that is, that provide financial services to clients and customers. *See, e.g.*, Azam Ahmed & Ben Protess, *MF Global Dodged Capital Requirements, Report Says*, N.Y. TIMES DEALBOOK, (June 5, 2012), http://dealbook.nytimes.com/2012/06/05/mf-global-dodged-capital-requirements-study-says/ (noting that "under pressure from regulators . . . to increase its capital cushion, MF Global moved some of its risky European debt holdings" from one of the firm's regulated brokerage subsidiaries to an unregulated special purpose entity).

133. Jay Hancock, *Corzine Firm's Collapse Shows Need for Tough Wall Street Regulation*, BALT. SUN (Nov. 6, 2011), http://articles.baltimoresun.com/2011-11-06/business/bs-bz-hancock-mf-global-20111106_1_mf-global-jon-corzine-volcker ("MF Global employed the means and methods that caused Lehman Brothers and Bear Stearns to blow up, and we're still arguing about whether to ban or control those methods.").

134. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67 (1991).

ly in the FSHC context because of the interrelationships between the FSHC and its subsidiaries, suggested above. When a firm enters bankruptcy, the easy movement of assets between and among subsidiaries suddenly stops. If the subsidiaries, in addition to the parent company, are in bankruptcy (and absent a "substantive consolidation" of the ties[135]), transfers of assets and cash through fluid boundaries are replaced by a battle among the discrete and separate entities—and, more precisely, their creditors—making claims against one another for sums owed.[136] Moreover, value may be depleted from the parent company as a result of legitimate claims from the subsidiaries' financial-services clients and customers. Among other things, clients of brokerage subsidiaries have claimed that the parent company did not repay loans made by client accounts (the internal repos previously mentioned) and that it inappropriately commingled client assets with those of the parent company.[137] In any of those circumstances, the subsidiary may (on behalf of its clients, customers, or creditors) have a legitimate entitlement to the parent company's assets and, as with any creditor of the parent company, priority over parent-company shareholders.

V. Reorientation of Financial-Services Holding Companies

If managers have no meaningful stake in the enterprise or corresponding incentive to use property so as to further its highest value, and if their interests are in competition with shareholders', then perhaps it is time to overcome any pretense that the control–shareholder relationship at all approximates the rights and obligations that used to be consolidated within the sole proprietorship or small partnership. Similarly, if what shareholders buy when they buy shares of stock are tokens bearing only a remote relationship to property, as historically understood, and if shareholders simply trade those tokens with hardly a thought about what they represent, then maybe it is time to rethink the notion of shareholder primacy. Under these circumstances, maybe "control" should, instead, be

135. In a substantive consolidation, multiple entities are, for purposes of the bankruptcy process, treated as a single entity. *See* Timothy E. Graulich, *Substantive Consolidation—A Post-Modern Trend*, 14 AM. BANKR. INST. L. REV. 527, 527 (2006).

136. *See, e.g.*, Patrick Fitzgerald, *Consultant Enters Bankruptcy Fight Between Lehman, Swiss Unit*, WALL ST. J. (Mar. 7, 2012), http://blogs.wsj.com/bankruptcy/2012/03/07/consultant-enters-bankruptcy-fight-between-lehman-swiss-unit/ (discussing the "legal dispute Lehman Brothers Holdings Inc. is locked in with its former Swiss derivatives subsidiary over billions of dollars in guarantees and intercompany loans").

137. *See* Azam Ahmed & Ben Protess, *MF Global Is Said to Have Used Customer Cash Improperly*, N.Y. TIMES DEALBOOK (Nov. 17, 2011), http://dealbook.nytimes.com/2011/11/17/mf-global-is-said-to-use-customer-cash-improperly/.

charged with furthering the interests of a broad range of stakeholders, reflecting that the corporation now plays a dominating, constitutive role within the political community.

Regardless of whether Berle and Means would have characterized their argument in exactly that fashion, it can surely be said that, under their analysis, the modern corporation's upending the incentives that accompany the unity of ownership and control calls for refocusing the purpose and objectives of corporate action. If that is the case, then there arises the further question of what conclusion one might draw from the souped-up corporation that is the FSHC. Can we say anything additive to or different from the authors' conclusions when we speak of firms as to which shareholders are still further removed from value-producing property or where there, in fact, exists no value-producing property at all? Certainly it would seem that the authors' conclusions were not intended to encompass all large corporations for all time. They readily acknowledged that the suggestions they proffered may not capture all concerns that conceivably could arise from the separation of ownership and control and, indeed, that the specific concerns occupying their attention "may become academic within another generation."[138]

Accordingly, it is worth considering whether, and in what way, FSHCs fit within *The Modern Corporation*'s framework and what further possibilities may exist in the FSHC context for reuniting the elements of economic production with our social and political needs. Toward that end, it may be useful to recall that *The Modern Corporation*'s evocative proposition—that corporate law "may be considered as a potential constitutional law"[139]—is a reaction to a structural transformation of enterprise that had distorted common, core assumptions about private property and capitalism. If economic production has lost as its primary motivation the furtherance of owners' private, pecuniary interests, then, in order to properly orient the world again, a new approach for channeling incentives has to be determined. If, as it would seem, management cannot be made to prioritize shareholders' interests, then what should it be made to prioritize? Quite plausibly, there is only one answer. If corporations are, and will doubtlessly remain, so powerful, then they should be trustees of sorts for society as a whole, meaning all of its myriad constituencies. Also quite plausibly, the authors' proposal is not affected by

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138. *See* BERLE & MEANS, *supra* note 6, at 246. The authors predicted, moreover, that "the law [would] deal, blunderingly, with each situation as it comes up on its individual merits; and most likely of all, the transactions by the 'control,' lying outside the technical sphere of corporate action, will remain outside the normal cognizance of the law." *Id.*

139. BERLE & MEANS, *supra* note 6, at 357.

whether the subject of analysis is a corporation within their immediate lines of sight or whether it is a modern FSHC.

Without wading too deeply into the extensive literature on broadening corporations' horizons and encouraging more socially responsible propensities, one might reasonably suggest that *The Modern Corporation*'s proposed alternative comes with its own considerable challenges. One of them is evaluative. In particular, if, by virtue of its permeating all social interaction, the corporation is (or should be) a publicly oriented organization serving the interests of everyone, can we ever ascertain whether it is actually promoting the interests of anyone? This question is particularly acute given that, as compared with citizens' relationship to political authority, a corporation's various constituent groups have markedly dissimilar relationships to the corporation and its management. The query, moreover, only begins to scratch the surface of relevant analyses. *The Modern Corporation* raised innumerable avenues of exploration, which lead to no easy conclusions. In thinking about FSHCs, however, there may be approaches that allow us to avoid that thicket while still alleviating the FSHC-specific concerns articulated in Part IV.

In other words, stopping short of embracing the implications that Berle and Means drew from their observations or, indeed, reaching a conclusion about them at all, perhaps we can discern measures that would discipline management and provide greater incentives for them to act in the interests of firm value and, importantly for FSHCs, firm stability. If FSHCs are a magnified version of the corporations of an earlier era, as this Article has posited, then we might, at the very least, consider how FSHCs can be returned to actual size, as it were. Toward that end, and in light of the threat to long-term value that arises from FSHCs' traditional proprietary trading activities, the objectives of responsible corporate governance could be furthered by a governance paradigm that revolves around not only profit generation but also the interests of those who use the traditional business services that financial firms provide—namely, the firms' clients and customers.

Such a reorientation may initially seem to subvert the traditional and expected focus on returns to owners, but the sensibility of the suggestion should become apparent when one considers that some of the more substantial risks to shareholders of FSHCs arise in connection with the firms' work on behalf of clients and customers and the conflicts those operations create. That is, significant (additional) tensions between ownership and control arise as a result of activities that are enabled by the firms' relationships with clients and customers, whether directly or through controlled subsidiaries. Among other things, FSHCs generally do not face meaningful limitations regarding their ability to use client and customer assets for their own trading and investment purposes. If management of FSHCs owed stronger duties to those who place assets with the firms and their subsidiaries as clients and customers, presumably that would mute the firms' incentives to influence regulatory action and manipulate regulations; promote greater caution in management's use of third-party (client and customer) assets for firm purposes, such as in internal repo transactions; and lower the number or reduce the significance of competing claims to firm assets in the event of bankruptcy. In the too-big-to-fail context, there would also be less risk of crises requiring government intervention at taxpayers' expense.

In short, modifying the subject of management's obligations could have an ameliorative effect on management's incentives to engage in reckless and value-reducing proprietary trading activities. Those activities, after all, substantially arise from not-so-subtle conflicts between management's interests and those of clients and customers, and management's exploitation of information advantages vis-à-vis clients and customers.[140] More closely aligning management activities with client and customer interests will serve to better and more meaningfully align management's incentives with shareholder interests. That is to say, like clients and customers, shareholders are substantially harmed when the firm's dogged focus on generating trading profits leads to insolvency. Admittedly, this proposal, while realigning managerial motivations, would not affect FSHC shareholders' hyper-attenuated relationship with property. That, in turn, suggests that we cannot easily ignore or move past Berle and Means's more far-reaching proposal. However, this proposal may be a critical, yet workable, interim step, particularly in circumstances in which the risks to shareholders are especially pronounced.

VI. CONCLUSION

The Modern Corporation's astute articulation of the implications of the separation of ownership and control for traditional notions of private property remain important today, albeit in new and different contexts. As the authors speculated, their concerns have taken on a new character, as the roles of corporations have continued to evolve in response to new ways of doing business. Today, FSHCs starkly support the notion that

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140. Goldman Sachs' 2007 sales of certain collateralized debt obligations based in subprime mortgages come to mind. *See In re* The Goldman Sachs Grp., Inc. S'holder Litig., No. 5215–VCG, 2011 WL 4826104, at *5 (Del. Ch. Oct. 12, 2011). As one commentator describes it, "[t]he firm constructed the securities to be sold to its investors while failing to disclose that it was taking short positions against them." *See* Peter J. Henning, *The Litigation that Haunts Goldman Sachs*, N.Y. TIMES DEALBOOK (June 25, 2012), http://dealbook.nytimes.com/2012/06/25/the-litigation-that-haunts-goldman-sachs.

what shareholders own can hardly be thought of as property in the way it once was. Moreover, FSHCs subject those shareholders to unique risks, which arise from the firms' proprietary trading activities, combined with the roles the firms play in their own regulation, their employee compensation practices, applicable bankruptcy rules, and the proliferation of financial-services subsidiaries. Accordingly, in the spirit of *The Modern Corporation*, it may be time to begin thinking about a reorientation of the financial-services holding company. In particular, this Article has suggested that FSHC governance should, as an initial matter, more expressly attend to financial-services clients and customers, the FSHC-specific constituency that (unwittingly) enables and facilitates the risks these firms pose to their shareholders and, indeed, to all of their constituencies.